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In the

# Supreme Court of the United States

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| WILLIAM E. BUTNER, PETITIONER, | ) | |
| V. | ) | No. 77-1410 |
| UNITED STATES, ET AL., RESPONDENTS. | ) | |

Washington, D. C.
November 27, 1978

Pages 1 thru 48



*Hoover Reporting Co., Inc.*
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*Washington, D. C.*
*546-6666*

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| WILLIAM E. BUTNER, Petitioner, | : | |
| v. | : | No. 77-1410 |
| UNITED STATES, ET AL., Respondents | : | |

Monday, November 27, 978
Washington, D.C.

The above-entitled matter came on for argument at 2:03 o'clock, p.m.

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
WILLIAM BRENNAN, Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice
HARRY A. BLACKMUN, Associate Justice
LEWIS F. POWELL, JR., Associate Justice
WILLIAM H. REHNQUIST, Associate Justice
JOHN PAUL STEVENS, Associate Justice

APPEARANCES:

J. STEVEN BRACKETT, ESQ., Rudisill & Brackett, Post Office Box 3506, Hickory, North Carolina, 28601; on behalf of the petitioner.

ALLAN A. RYAN, JR., ESQ., Office of the Solicitor General, Department of Justice, Washington, D.C. 20530; on behalf of respondent United States

JOE N. CAGLE, ESQ., Cagle and Houck, Fidelity Federal Building, Box 2050, Hickory, North Carolina 28601; on behalf of private respondents.

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# C O N T E N T S

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P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments next in 77-1410, Butner against United States.

Mr. Brackett, I think you may proceed whenever you are ready.

ORAL ARGUMENT OF J. STEVEN BRACKETT, ESQ.,

ON BEHALF OF THE PETITIONER

MR. BRACKETT: Mr. Chief Justice, and may it please the Court:

This case arose as a controversy between a mortgagee and the bankrupt estate as to whether or not the mortgagee of the bankrupt estate was entitled to rent realized from mortgaged property between the time of the mortgagor's bankruptcy and the sale of this property pursuant to an order of the bankruptcy court.

I think it's necessary preliminarily that we discuss some of the facts in this case as they relate to the North Carolina law, and if the Court will indulge me, I would like to discuss these facts in detail.

This case began as a Chapter XI proceeding; that is a plan of arrangement under the Bankruptcy Act wherein a bankrupt estate, in this case, owned tracts of real estate as well as personal property which was sold as merchandise in a retail business.

Only at real estate owned by the bankrupt estate

cw 4 there existed a first deed of trust, and also second deeds of trust.

During the period of arrangement, after the commencement of Chapter XI proceedings, work was done and performed at the instruction of the bankruptcy court by various attorneys, certified public accountants, and others.

There was about $800,000 worth of personal property which was inventoried in the bankrupt estate which was disposed of during this period of arrangement. No proceeds were deducted from the sale of this personal property in inventory to be applied to the cost of administering the bankruptcy estate or as payment for any of the attorneys, accountants and various other employees engaged by the bankrupt estate.

During the period of bankruptcy, some one year after the bankruptcy had been initiated, the second holder of deeds of trust in the property perceived that the bankrupt estate under its plan of arrangement was not able to keep current the first deeds of trust or the first security on the real estate.

Therefore, these first and second mortgage holders through the bankrupt debtor's attorney, sought the appointment of a receiver who was to receive and collect all inco me produced by the estate, that is, the rental income from the real estate, and apply that, pursuant to the order of the bankruptcy court, to federal and state income taxes, the monthly mortgage payments due the first mortgagors; to the

ikw 5 ad valorem taxes; payment of fire insurance; and to the interest and principal payments due the second mortgage holders.

It was also, within a period of a few months later, a standby trustee appointed. This standby trustee is the trustee defendant in this case.

Also, at the time this receiver was appointed for the collection of the rent, there -- bankruptcy court specifically ordered that the second secured parties in the real estate not attempt in any way to petition or foreclose their property in the state courts without the specific permission of the bankruptcy court.

This, of course, was in addition to the general stay order that had been executed against the creditors when the bankruptcy proceeding was initiated.

Because of default by several of the bankrupt -- the debtor-in-possession creditors, that is, several tenants on their real estate in their mortgage -- in their rental payments, the tenant and other financial reversals -- there was not sufficient cash flow being generated by the debtor in possession to comply with the bankruptcy judge's order regarding payment of the -- the various four payments that I've previously mentioned to the Court.

This petitioner, therefore, who is here before you today filed an application with the bankruptcy court on the

6 30th day of December, 1974, to have one of three acts performed by the bankruptcy court: that is, to convert the Chapter XI proceeding, that is the plan of arrangement, to a liquidating bankruptcy; two, to remove the stay outstanding against the second deeds of trust holders so that they could pursue their state remedies under the state laws of North Carolina; or three, to convert the proceeding from a Chapter XI to a Chapter X proceeding under the bankruptcy rules.

At this time, the second deeds of trust outstanding to the petitioner in this case were not in default; they were paid current.

On the 14th day of February, 1975, the bankrupt -- that is, the debtor in possession, was adjudged to be bankrupt -- was adjudged bankrupt.

A trustee was appointed, that is, the trustee who is the defendant inthis case, was appointed to proceed with the bankruptcy proceedings. He was ordered -- in his order, and the order appointing him as trustee, to collect and receive all rents, issue, income and profits and to hold and retain all monies and profit received to the end that the same may be applied under this or different or further orders of the court.

And on April 16th of 1975, some two months after the trustees appointment, there was a first meeting of creditors. It was suggested at this time by the trustee, as well as the petitioner in this case who was a second mortgage holder, that

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there was no equity in the property, and that the property should be conveyed -- not abandoned, but conveyed -- to the second mortgage holder in order that they could work out arrangements with the first security holders under the real estate.

At this time the bankruptcy court, in its hearing as documented in the appendix in this record, suggested that there were substantial amounts of administration costs of bankruptcy which had accrued during the period of the arrangement, and was curious as to what source would produce the money to satisfy the costs of administration, and indicated also that the economic conditions were bad at that time, that perhaps they would improve in the next several months, and indicated therefore to the second mortgage holder and the trustee that he was not inclined to convey the property to the second secured parties under the real estate.

Thereafter, the property was sold pursuant to an order of the bankruptcy judge, late in July of that year. At the time of the sale, which was a public sale after due notice, there was a substantial deficiency; that is, inthe sum of approximately $213,400; that is, that the second deeds of trust holders were without their security to that extent.

The petitioners in this case again approached the bankruptcy court, moved that the bankruptcy court not confirm

dkw 8 this sale, and that they abandon the property to the second secured holders.

The bankruptcy court declined. Then the petitioner in this case appealed it to the district court; the district court remanded to the bankruptcy court with the instruction that the bankruptcy court order the property sold again with the petitioners, that is, the second mortgage holders, being allowed to use the credit due them on their deeds of trust to the extent of $360,000.

Under these conditions your petitioner in this case purchased the property, having a deficiency under his debt of $186,000.

Thereafter, the trustee in this case drew a deed conveying all four tracts of property to the petitioner in this case. The petitioner -- the trustee also had that deed recorded and delivered it to the petitioner in this case.

Soon after the petitioner made claim for disbursement of funds on hand, some $160,000 plus accrued interest, which were collected by the trustee as rental on the property in which the petitioner held the security in.

The bankruptcy judge held a hearing regarding this, and found that the petitioner in this case was an unsecured creditor to the extent of $186,000.

From this ruling, petitioner appealed to the district court. The district court reversed the finding of the

kw 9 bankruptcy judge. This order was appealed to the 4th Circuit. The 4th Circuit reversed the district court's order, determining that the petitioner in this case had not complied with the state law of North Carolina in seeking to sequester and have these rentals set aside and held for his benefit, and therefore declaring him to be an unsecured creditor.

QUESTION: Mr. Brackett, let me interrupt then at this point.

MR. BRACKETT: Yes, sir.

QUESTION: Do you have any comment with respect to the passage of the new Bankruptcy Act and its bearing on this case?

MR. BRACKETT: Your Honor, we felt like that was probably one of the reasons we were here, and on this case.

I don't -- in my opinion, I don't see the bearing of the passage of the new Bankruptcy Act on this case, other than perhaps paragraph 57(h), which has been cited by the government in their brief here. That might have some bearing.

And also, I think we need to have a resolution of the diversion between the circuits here, in order that secured creditors can know what their standing is, and what is going to be required of them to protect their interests when their monies are in the hands of a trust fund.

QUESTION: Well, if it does have a bearing, it may

ikw 10 make this case a lot less important than it might otherwise be.

MR. BRACKETT: Yes, sir.

QUESTION: Let me read this one provision to you:

The commencement of a case creates an estate. Such estate is comprised of the following property: proceeds, product, offspring, rent. Which would cut against you?

MR. BRACKETT: Yes, sir.

To that extent, I again reiterate to his Honor, that to the extent of the new Bankruptcy Act, we're not that familiar with the proposed new Bankruptcy Act; to the extent that this affects, or the new draft of the Bankruptcy Act would affect the rights of secured debtors, then yes, this case is of extreme importance to the drafters of the new Bankruptcy Act and this Court in considering the case.

QUESTION: Do the courts of appeal in their split treat it as a question of federal law on which they disagree, or do they treat it as a question of state law arising within their various circuits?

MR. BRACKETT: Your Honor, I think that is the split of the cases. I think it's a perception of the various circuits as to what bankruptcy is.

Apparently the 3rd and 7th Circuits perceive bankruptcy to be an equitable remedy, and therefore the 3rd and 7th Circuits tend to apply equitable principles. The remain -- the

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2nd, 8th and 9th Circuits, I think, are the circuits that are involved here in these particular cases, follow the principle that so far as state law is not in conflict with federal bankruptcy law, they are going to apply the state law in recognition of a secured creditor's rights, only being consistent with the real estate that's located in your states.

QUESTION: Do any of the courts of appeal take the position that if the creditor had provided for, in the mortgage agreement, that the rent should secure the security, that that would not be followed by the bankruptcy court?

MR. BRACKETT: No, sir, I don't believe so. I don't think we have -- they have disregarded that principle, in any case, to apply a so-called federal rule. As a matter of fact, they have adhered to that principle. That has been a consideration in a number of --

QUESTION: So a mortgagee can protect himself within any of the circuits by putting a provision in the mortgage agreement.

MR. BRACKETT: Skillful drafting of the mortgage agreement would be the first step that a mortgagor would have to protect himself; yes.

As I have attempted to point out to the Court, there is a split among the circuits. And the circuits that follow the so-called equitable rule would be the 3rd and 7th Circuits. This was was a case -- the principal case set out there is the

ikw 12 Bindseil v. Liberty Trust Company.

This case says that, in essence, that bankruptcy interferes with state remedy to such an extent that a creditor is prohibited from exercising certain rights that he might have under state law, and in cases such as this, where equitable principles would allow it, the bankruptcy court will allow his lien, to the extent there is a deficiency, to follow the rentals that are turned over to the hands of a trustee.

The remaining -- the remaining circuits, that is the 2nd, 8th and 9th circuits, adhere to the rule that they will follow the state law, and that that law is to be applied carefully.

Under either comprehension of the law, we suggest that the petitioner has complied with -- under -- the diversion of both circuits. And in any event, in this case the petitioner should be granted a security interest in these rents.

And the primary basis for this is the case of Parker Company v. Commercial Bank of High Point. This is cited in 204 North Carolina 432.

We contend that this is the law in the state of North Carolina; and that the 4th Circuit failed to properly address itself to this case in determining that the petitioner in this case had not complied with the state laws.

In the Parker case, there was a judgment creditor, that is, a creditor who had pursued his remedy through a

cw 13 judgment; there was an outstanding mortgage held by a first deed trust against an automobile company, or motor company.

The mortgagor, under the deed of trust, began a -- initiated a foreclosure proceeding. The judgment debtor in that case filed an action to enjoin the foreclosure proceeding. Rents were accumulated while this action was pending in the courts of North Carolina.

Subsequently, the mortgage holder obtained a deficiency judgment and reduced it to judgment. The judgment debtor, who had initiated the action to enjoin the foreclosure had had a receiver appointed to collect these rents.

The court held that the mortgage creditor was entitled to satisfy his deficiency judgment from the funds collected by the receiver during the pendency of the action.

We contend that this case is directly analogous to the case before the Court here. The opposition would contend that we have failed to take steps as required under North Carolina state law to protect ourselves, citing the case of Gregg v. Williamson, which places North Carolina in alignment with the majority of states in this country that require that a mortgagee, in order to assert a security interest in the real estate -- in the rentals collected, take some action which substitutes for taking possession of the property.

That is, ordinarily, the mortgagee would have to take

ikw 14 possession of the property. And these courts have held that where taking of the property is not possible as in a bankruptcy case, the mortgagee must take some other action to protect his security interest; that is, he must seek to have the rental sequestered or seek to have a receiver appointed in the bankruptcy proceeding.

In this case --

QUESTION: Mr. Brackett, can I just interrupt you?

MR. BRACKETT: Yes, sir.

QUESTION: You're relying on the Parker case, is it?

MR. BRACKETT: Yes, sir.

QUESTION: Did you cite that in your brief?

MR. BRACKETT: No, sir, we did not, it was cited by the government. And we think that it was favorable to our position.

QUESTION: Oh, I see. All right.

MR. BRACKETT: Yes, sir.

QUESTION: It's in the government brief?

MR. BRACKETT: Yes, sir. We found in the Williamson line of cases cited by the government. And it's the best case we contend on the standing, on what the requirements of North Carolina law are; as to whether or not we have done the things necessary or required by North Carolina law, we contend that we have, and that's the factual issue that was addressed in the dissent in the 4th Circuit by Judge Bryant.

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The -- our opponents in this case would have the Court rule that actions taken by the petitioner during the plan of arrangement were not taken during bankruptcy.

We contend -- of course, have cited in our briefs that proper -- the applicable bankruptcy rules, which say of course that -- and there are anumber of cases so holding -- that actions taken during the plan of arrangement are, of course, equivalent to those actions which are taken after the adjudication of bankruptcy.

We say that the real crux of this case as it relates to the petitioner is that he had a receiver appointed by making requests of the attorneys for the debtor. Our opponents would argue to the Court that because the attorney for the debtor actually filed the motion that that the petitioner should not be allowed to benefit from that.

I ask the Court to address themselves in particular to that application which recites the fact that the secured creditors had approached the attorney for the debtor and requested this and the reasons therefore.

Subsequently, in the Chapter --

QUESTION: Mr. Brackett --

MR. BRACKETT: Yes, sir.

QUESTION: -- just so I can follow it. It's a rather complicated case.

MR. BRACKETT: Yes, it's a complicated set of facts.

I'm sorry.

QUESTION: Two questions on that. First, where in the record is the document you just described? And secondly, in that document, did they request an assignment of the rent?

MR. BRACKETT: No, sir.

The document is to be found in the record -- bear with me for just a moment. At 204A in the appendix. This was a petition by the attorney for the debtor, and it recites in the petition that the petition was made because of the request of the secured creditors.

QUESTION: I thought you said North Carolina required you to get the rents, to request them.

MR. BRACKETT: North Carolina requires that you take possession, that the mortgagee take possession or otherwise seek to protect himself by having a receiver appointed.

QUESTION: Well, but you didn't request the rent? You could have?

MR. BRACKETT: No, sir.

We contend -- what we did here was address the attorney for the debtor, ask him to have a receiver appointed, and that the receiver's instructions from the bankruptcy court were to collect the rents. And then they established a priority as to how those rents were to be disposed of.

QUESTION: What you called our attention to in the record is the order appointing the trustee or whatever he is

to act for the court. And that order recites that the motion was made by the attorney for the debtor.

MR. BRACKETT: Yes, sir.

QUESTION: And you're telling us that that motion was made by the attorney for the debtor because you requested him to do so.

Where is your request for him to do so in the record?

MR. BRACKETT: Your Honor, if you'll look two pages before that in the record, I believe you'll -- at 202.

QUESTION: There are several parties -- shall be savings -- are they all second mortgagees --

MR. BRACKETT: No, sir. As I point out to the Court, again, this is a complicated fact situation.

QUESTION: But this is the key to your case, as I understand it.

MR. BRACKETT: Yes, sir. There are four -- there were four tracts of land. Four different institutions held first deeds of trust on those properties. The petitioner held a so-called blanket deed of trust which was secured by all four tracts of property.

Yes, sir.

QUESTION: And the point is that the second mortgagee or second deed of trust holders requested this procedure and that the first lien holder be taken care of first and all the rest would be paid to your people?

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MR. BRACKETT: Yes, sir.

It might be important to note I think the record --

QUESTION: You really just asked that the mortgage payments be made, though.

MR. BRACKETT: Yes, sir.

QUESTION: And any balance to unsecured creditors?

MR. BRACKETT: No, sir.

QUESTION; Well, that's what your request was.

MR. BRACKETT: I think the request is to be taken in context with the order. And the request was --

QUESTION: For the benefit of secondary lien holders and the unsecured creditors.

MR. BRACKETT: Yes, sir.

To the extent that -- as the Court can see from the order, there were four priorities set up. And the unsecured creditors were not a part of the priority ordered by the bankruptcy court at all.

QUESTION: But the trustee didn't have to pay -- or didn't have to do anything more than pay the payments as they came due?

MR. BRACKETT: Yes, sir. He was required under the order to collect the rents, to sequester those, to keep proper leger cards, and then to apply them in accordance with the order of the bankruptcy judge.

We say that that was a sufficient action on our

dkw 19 part to comply with North Carolina's requirement that a receiver be appointed.

QUESTION: Well, suppose there was more current income than necessary to pay the mortgage payments.

MR. BRACKETT: Yes, sir.

QUESTION: What happens with the balance?

MR. BRACKETT: Then that -- it would be my contention that that would accumulate until the conclusion of the bankruptcy, and then it would be disbursed --

QUESTION: That wasn't what -- it doesn't sound like what you asked for.

You didn't -- was the -- did you accelerate the -- did you declare the entire balance due on these mortgages?

MR. BRACKETT: No, sir. As I stated to the Court in trying to recite the facts in this case, what brought about this request for a receiver was the fact that the bankrupt debtor in possession was not able from the cash flow to keep the mortgage payments current.

QUESTION: Well, I understand that. But this occurred after -- did this petition and order occur after bankruptcy, after a straight bankruptcy?

MR. BRACKETT: No, sir. No, sir. That's another significant fact. This occurred during the plan of arrangement. When the second creditors perceived that their security was in peril, they requested that a receiver be appointed.

This receiver --

QUESTION: After straight bankruptcy occurred, you could have asked that the property be abandoned to you. And I guess you did, didn't you?

MR. BRACKETT: Yes, sir, we did.

The Court will see --

QUESTION: Until you did that, you did nothing else in order to try to get the rents?

MR. BRACKETT: Yes, sir, we did.

If the Court will review the record, the Court will find in addition to the appointment of this receiver, that on December the 30th of 1974, and there is a petition application filed by the petitioner in this case, to have three things done by the bankruptcy court.

That is, to convert it to a straight bankruptcy; to allow the second secured creditors to be allowed to pursue their state remedies; or to convert it to a Chapter X proceeding under bankruptcy law.

So those things were done.

QUESTION: Well, I know. And the judge said -- what happened was, it was put into straight bankruptcy.

MR. BRACKETT: Yes, sir.

QUESTION: Now, what does the secured creditor, if he doesn't want to file a secured claim and proceed accordingly, what does he usually do?

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MR. BRACKETT: In this case --

QUESTION: In state bankruptcy.

MR. BRACKETT: In this case, if there's not equity in the property for the general creditors or beyond his own, he asked that the property be abandoned.

QUESTION: And did you?

MR. BRACKETT: Yes, sir, with a petition for abandonment filed. There was also an oral request made at a hearing which -- the transcript of the hearing is in the appendix.

And the bankruptcy court at that time indicated -- and I think this is an overwhelmingly significant fact -- that there were not sufficient funds on hand to pay the cost of administering the arrangement proceedings. There were not sufficient monies to do that, even though $800,000 worth of inventory had been sold.

QUESTION: But what are the priorities -- what are comparable priorities between costs of administration and rent in a situation like that?

MR. BRACKETT: We contend that where there is a secured creditor who has not realized the full extent of his debt, that the priorities for the rents generated by the real estate lies with the secured creditor on the deficiency of his debt.

QUESTION: So the bankruptcy judge is not entitled

to say, there's not enough to pay the costs of administration, so I won't abandon the property for that reason?

MR. BRACKETT: In my opinion, that was a gross abuse of discretion on the part of the bankruptcy judge.

What he did in doing -- in following this procedure is, he kept the security of a secured creditor away from him in an attempt to generate funds to cover the cost of administering a bankruptcy proceeding.

QUESTION: Well, it wouldn't be the first time a bankruptcy judge has done that.

MR. BRACKETT: No, sir, it would not. It would not.

In -- it's particularly significant though that the bankruptcy court had approved and confirmed the sale of a tremendous amount of retail sales inventory without taxing that property and the funds derived from that property with any cost of the administration.

I think that's very significant in this case.

QUESTION: Well, did the court of appeals -- I gather that the court of appeals though that you had not done whatever it is that North Carolina law --

MR. BRACKETT: Yes, sir.

QUESTION: -- says you should do.

MR. BRACKETT: Yes, sir.

QUESTION: And are you asking us to disagree with

the court of appeals as to what North Carolina law is?

MR. BRACKETT: Yes, sir. No -- I'm not asking you to disagree as to what North Carolina law is. I'm asking this court to examine carefully the Parker case, and find that to be the law in North Carolina, and find that to be a case on all fours of the situation we have here.

QUESTION: Well, then you are saying that the court of appeals made a mistake as to North Carolina law.

MR. BRACKETT: I think there was a misapprehension of law in North Carolina.

QUESTION: Well, you had three non-North Carolina judges on the court of appeals panel, and you have the opinion of the district courts of North Carolina to back you up.

MR. BRACKETT: Yes, sir. Judge Jones, our presiding district court judge, is an experienced attorney in North Carolina.

I contend his perception of the law in North Carolina was more clear than that of the 4th Circuit, with all due respect and discretion for that body.

I think Judge Bryan's opinion -- and I ask the Court to take particular note of the -- the dissenting opinion in this case in the 4th Circuit. It's very perceptive as to the -- whether or not this was done during bankruptcy or not during bankruptcy.

And that seems to be the fulcrum that the 4th

kw 24 Circuit swung on, is whether or not this was done during bankruptcy or not during bankruptcy. And I don't think there is any question that the actions taken during the plan of arrangement were during bankruptcy.

I only have a brief minute, and with the Court's permission, I'd like to reserve that for rebuttal.

MR. CHIEF JUSTICE BURGER: Very well.

Mr. Ryan.

ORAL ARGUMENT OF ALLAN A. RYAN, JR., ESQ.,

ON BEHALF OF THE RESPONDENT UNITED STATES

MR. RYAN: Mr. Chief Justice, and may it please the Court:

I think it's fair to say that all sides agree that this case -- the issue in this case is not answered by the Bankruptcy Act as such.

And if I may refer to a question Mr. Justice Blackmun posed earlier, I think that the new Bankruptcy Act will not be any more helpful than the old one was. I don't think that the new Bankruptcy Act will answer this question any clearly than it is answered now.

So although rents specifically are mentioned, the question is whether the mortgage interest overrides that right to rents.

I think it's also fair to say that all sides agree in this case that had Golden Enterprises not gone into

dkw 25 bankruptcy, the petitioner, as mortgagee, would have had no right under North Carolina law to the rents unless and until he instituted a foreclosure action and obtained the appointment of a receiver to collect the rents for him.

And where we part company in this case is that the petitioner says that bankruptcy makes all the difference after that fact, and we say it really makes no difference at all.

Specifically, we recognize that once the property here came under the aegis of the bankruptcy court, which in this case was when the Chapter XI petition was filed, the petitioner was no longer free to begin foreclosure and seek the appointment of a receiver without the permission of the bankruptcy court.

The petitioner argues that from that fact alone he was entitled to the rents as an equitable matter. And we believe, on the other hand, that just as the petitioner would have been required under state law to take some affirmative step to reach the rent in the absence of bankruptcy, so he should be required to take some affirmative step to reach them once bankruptcy occurred.

Although foreclosure in a state court and appointment of a receiver in a state court were barred to him, other steps were not, as I will discuss in a moment.

The petitioner argues, and he places a great deal

w 26 of emphasis on this, that even if we are correct in that reading of North Carolina law -- and I don't understand him to disagree with us on that -- he did pursue an alternate course sufficient to protect his interest.

We believe that the court of appeals was correct in holding that he did not do so.

And finally we believe that even if the minority view of the circuits, and the view of the petitioner is correct, that equity should prevail, the facts of this case demonstrate that the petitioner has suffered no loss, looking at the transaction as a whole; and therefore, that equity should not require that the rents be handed to him in this case.

But let me return to my first and most important point.

As this Court has recognized in a series of cases, the nature and extent of a creditor's security interest in the property of a bankrupt is a matter of state, and not federal, law.

Congress presumably could make it otherwise in its exercise of its powers under the bankruptcy clause, but it has not done so. In this respect, it has chosen to defer to state law.

Under North Carolina law, if petitioner wished to reach the rents of the property by virtue of his security interest, he would have had to go to court and request that a

27 receiver be requested for that purpose.

Such a remedy is provided in North Carolina law as a part of a foreclosure action.

As I say, we recognize that in this case that precise step was not open to him, but we do not believe that by that fact he could vindicate his claim by doing nothing.

That is essentially what he is arguing here. He is saying that since I could not go to state court, I ought to have the rent as a matter of equity.

We believe that if he wished to reach the rents, that he was obliged to take some action in the bankruptcy court.

As far as what the North Carolina law is, before I leave that, I don't think there is any dispute, and I don't think there is any need for this Court to resolve conflicting views of what the law is in North Carolina, because the petitioner has said that the Parker case, which we cite in our brief, is the best case on what the North Carolina law is.

And we agree with that, and we think that the Parker case states the law quite succinctly. And I would think that if the Court refers to that case, it will have all the North Carolina law it needs to decide this case.

That -- my opponent did not quote the whole holding of that case, and I will only point out to the Court that the Parker case says, and I quote, ordinarily a mortgagee or

creditor secured by a deed of trust has no right to collect the rents or other income from property even after default in the payment of a secured indebtedness. This right arises only after the mortgagee or trustee has taken possession of the property conveyed by consent, or pursuant to an order or decree of a court of competent jurisdiction.

But where, as in the instant case, says the court, a receiver appointed by the court in a foreclosure action has taken possession of the property and collected the rents, then the rents should be applied as payment on the secured indebtedness.

Now, we have no problem with that holding at all. What --

QUESTION: Mr. Ryan, why isn't that what happened here; in that order, he calls our attention to, that order at 204 of the record, that he requested that a representative of the court be appointed to collect the rents.

Isn't that -- doesn't that fall right within that language you just read?

MR. RYAN: In this case, no, Mr. Justice Stevens, it does not. And the reason it does not is because that request was made during the arrangement proceedings of the case.

In the first place, I would not agree that it was a receiver. It was not a receiver; it was an agent that was appointed.

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But even assuming that it was a receiver, rule 201 of the bankruptcy rules, provide that when a trustee is appointed in a liquidating bankruptcy, the receivership is terminated.

So even if there was a receiver appointed during the Chapter XI phase of that case, that phase was ended and that receivership was terminated by the appointment -- or actually by the qualification of the trustee.

Not only that, but the trustee -- this is why this is a matter of substance and not simply of form -- the trustee received a completely separate and distinct set of marching orders from that that had been applied to this agent or receiver or whatever he is called.

Because the agent or receiver was told to pay -- to apply the rents in a certain specific priority: taxes, fire insurance, and so on and so forth, with the second mortgagee on the bottom of the list.

The trustee, on the other hand, was told not to pay any expenses, but to simply accumulate the rents produced by the property until further order of the court.

So by reason first of all of rule 201 of the bankruptcy rules, and secondly, by the fact that the trustee was given a totally different set of instructions from that received by the receiver in this case, we say that that action is simply insufficient to govern the rents fromthe time

dkw 30 of bankruptcy until the time that the mortgagee took possession.

That's the time period that we're looking at in this case. It opens with the adjudication of bankruptcy. It closes when --

QUESTION: Well, suppose instead of there being a Chapter XI arrangement before the bankruptcy there had been a state court receivership, and pursuant to a petition by the second mortgagee a state court had entered an order verbatim the same as the one at 204A.

Would that not have entitled the second mortgagee to the rents?

MR. RYAN: I would answer that question by saying that it would depend on what the effect of an adjudication of bankruptcy is on a state receivership.

If, as I think, it would terminate that receivership, then the results would be exactly the same and my argument would be exactly the same.

In other words, if --

QUESTION: Even if it's a matter of state law up to the time of adjudication of bankruptcy, the ownership of the rents had been in the second mortgagee, it would retroactively extinguish that?

MR. RYAN: No, it would not retroactively extinguish it. As I say, we're talking about the period of time in this

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MR. RYAN: There are two things that I think the petitioner could have done in the bankruptcy court which we think that he should have done.

Rule 701 provides for adversary proceedings to, quote, determine the validity, priority, or extent of a lien or other interest in property. Petitioner could have filed an adversary proceeding claiming that his mortgage extended to an interest in the rent.

Under rule 765 of the bankruptcy rules, which adopts rule 65 of the federal rules,the court could have ordered the trustee not to commit the funds pending an adjudication, although this in fact is what that bankruptcy court had told the trustee anyway.

And then if petitioner had failed in this adversary proceeding, the bankruptcy court could have entered an order of sequestration or attachment telling the trustee to pay the rents over to the mortgagee.

Or, as a second course of action, the petitioner could have gone in under rule 601(c) of the bankruptcy rules and asked for relief from the stay of state court proceedings which rule 601 imposes.

In other words, 601 says you will not enforce any action against the property in a state court. But there is a provision, section 3(c) of that rule, that says that on application of any party or any creditor the state -- the

dkw 32 bankruptcy court may lift the stay and permit the creditor to go to state court.

So he could have done either one of those two things. We'renot asking for a feudal or ceremonial gesture. We're asking for very real andsubstantive compliance in this case.

QUESTION: Mr. Ryan, what about the conditions of the mortgage thatthe mortgagee will have the benefit of the rent?

MR. RYAN: There was no such provision.

QUESTION: I know, but what if there is?

MR. RYAN: If there is, that question of whether or not he is in fact entitled to them would be decided under state law. If --

QUESTION: Well, suppose it's valid under state law. Then automatically in bankruptcy, the secured creditor gets the benefit of the rents?

MR. RYAN: If it is a clause that is valid under state law, then I would think that absent some supervening reason, fraud or whatever, that it would be enforced in the bankruptcy court.

QUESTION: So that this whole argument is settled by careful draftsmanship?

MR. RYAN: Well, it maybe. And that certainly is --

QUESTION: Well, maybe. I'm wondering what the government's positon is on it.

MR. RYAN: Well, the government's position is, it

dkw 33 would have to be determined under state law.

Now if you assume that state law would give effect to that provision and give the rents to the mortgagee, then that's our position, that it would be done.

That's the Fidelity Banker's case, Judge Haynsworth's opinion.

QUESTION: It makes some difference whether that effort is made before or after bankruptcy proceedings are commenced?

MR. RYAN: I think it has to be made in the -- when the mortgage is drafted. It has to be included in the mortgage.

QUESTION: The exercising of that power. Let's assume it's in the mortgage, explicit. May it be exercised after the bankruptcy proceeding starts? In the same way it could be exercised before bankruptcy?

Or does bankruptcy have no impact on it at all?

MR. RYAN: I would think that if the claim is made after bankruptcy begins, that the bankruptcy court would have to give effect to that insofar as the state law would.

QUESTION: You wouldn't say that in a Chapter XI, would you?

MR. RYAN: Well --

QUESTION: Not until striaght bankruptcy, anyway.

MR. RYAN: I would not say it in a Chapter XI. I would say, again, here only under state law. I think there are

ikw 34 two reasons that we are asking that the Court require the petitioner to take some action.

In the first place, it is not the scheme of the Bankruptcy Act, it is not the intent of Congress, to give the creditor any enhancement of the remedies he otherwise would have merely by virtue of the fact that his debtor is in bankruptcy court.

He could not reach these rents in the absence of a specific action, namely, appointment of a receiver in state court; he should not be able to do so in federal court absent a comparable action.

The second reason, and one that I think is most important here, is that the petitioner's acts in this case, or lack of acts, have really disrupted the orderly administration of this bankruptcy. Because the first time that petitioner ever came in and said, I have a right to these rents, was after the property had been sold, after his proof of claim had been submitted.

In fact, in his proof of claim, he specifically disclaimed any interest in these rents. What he said was, I have no interest other than, quote, that in the note and deed of trust, end quote. Neither of those documents said anything about a security interest in rent.

So he presented this to the trustee and said, here's my proof of claim. The trustee looked at it and said fine,

dkw 35 and acted on that basis, and then some six months afterwards he comes back in and says, well, I have also a proof -- I also have a claim on the primary source of income in this estate.

That is simply confounding the trustee and will continue to confound the trustee in future cases if that is the result that is allowed here.

I will yield the remaining time of my argument to Mr. Cagle.

MR. CHIEF JUSTICE BURGER: Mr. Cagle.

ORAL ARGUMENT OF JOE N. CAGLE, ESQ.,

ON BEHALF OF THE PRIVATE RESPONDENTS

MR. CAGLE: Mr. Chief Justice, and may it please the Court:

Speaking as trustee, my colleague just stated it is important for the trustee and the bankruptcy court and the creditors' committee, and others interested in a bankruptcy case, to know as soon as possible what the liens or security interests are on assets in a particular bankruptcy case.

And this need to know, we suggest, is amply satisfied by reliance on local law.

The local law is the source that we contend should be applied in this case. Reliance on local law gives the debtor-creditor relationship emphasis -- or it gives them the knowledge that they need in the transactions in dealing with

real estate and the mortgages on them, that -- so that when there is a bankruptcy case, everybody knows what their liens and their status, their rights, are with respect to certain assets in the bankrupt estate.

Everybody in this particular case relied on that fact, that is, that the local law was governing, and the fact of the matter is that under local law, the petitioner had -- has no lien on the rent.

The petitioner had a second mortgage on the real estate, not a lien on the rents.

Bankruptcy intervening should not expand any of the rights of the second mortgagee and grant to him any lien that he did not have. That would be inconsistent.

We suggest that the bankruptcy law -- the bankruptcy court should follow the jurisdiction of the situs of the property. And I don't -- do not believe that we really have any dispute about the law of North Carolina. Gregg v. Williamson or the Parker case, as we have cited in our brief. In North Carolina, just to simply be redundant if I will -- if you permit me -- a mortgagee has to file an action in state court to foreclose his mortgage as a part of the foreclosure he can obtain, as an ancillary remedy, the appointment of a receiver.

The law is that he must obtain possession, that is, he must acquire a deed before he is entitled to the rent under

kw 37 the law of North Carolina.

The analogous part in bankruptcy, if you want to talk about due process, a mortgagee has remedies available, procedures available, to it, in existing Bankruptcy Act, that is, part 7 of the Bankruptcy Act, rule 701 and the subsections or sections thereafter, allows the a trustee or creditor to institute an adversary proceeding which is called a complaint, with service like our adversary proceeding before the court in North Carolina, to foreclose a mortgage.

This procedure and the adversary proceedings allow you to, quote, recover property or money; to determine the validity or priority or extent of a lien or other interest in property; to sell property free of a lien or other interest; to object to or revoke a discharge; to obtain an injunction; to obtain relief from a stay -- that is the injunction under rule 401 or 406 -- or to determine the dischargability of a debt.

That adversary proceeding section, rule 701, and part 7, is the whole mechanical or procedural setup in the Bankruptcy Act, in the bankruptcy court, whereby a mortgagee goes into court, seeks an order from the bankruptcy court to allow him to foreclose on his mortgage under state law.

We believe that adversary proceeding section of the Bankruptcy Act is the critical part of this case. That is the method or mechanics or procedure, whatever you want to call

dkw 38 it, whereby other secured creditors went into this bankruptcy court and filed an action to recover and did recover their --

QUESTION: But he cannot move directly in the North Carolina courts, can he?

MR. CAGLE: No, sir.

QUESTION: He must go to -- in addition to North Carolina law, then, he must get permission of the bankruptcy court?

MR. CAGLE: Yes, sir, because --

QUESTION: And it may be quite awhile until he can get it?

MR. CAGLE: Not necessarily.

QUESTION: Well, it's an adversary proceeding.

MR. CAGLE: It's an adversary proceeding which --

QUESTION: And meanwhile, what happens to the rents?

MR. CAGLE: Well, that should not take over 30 days.

QUESTION: Well, but what happens to the rents meanwhile?

MR. CAGLE: It's being held in abeyance.

QUESTION: Well, can it be spent? For administration expenses?

MR. CAGLE: Only if on order of the bankruptcy court. The administration expenses --

QUESTION: It isn't too hard to obtain, is it?

MR. CAGLE: No, sir.

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QUESTION: Well --

MR. CAGLE: File a petition and an order.

QUESTION: So if -- what if there is an adversary proceeding, and one side or the other wins, and the other loses, then there's an appeal.

And what happens to the rents meanwhile. The creditor says, the secured creditor says, I sure would like to go into the North Carolina courts and obey North Carolina laws.

But apparently, the Bankruptcy Act won't let me.

MR. CAGLE: If I understand your question --

QUESTION: And I need protection meanwhile.

MR. CAGLE: As a practical matter, I have not seen any case whereby the bankruptcy judge did not allow a mortgagee to recover the property from the bankruptcy jurisdiction.

QUESTION: But here there was a petition for abandonment that was denied, wasn't there?

MR. CAGLE: I disagree that there was a petition for abandonment, your Honor.

Even if the court abandoned the property, that's not the -- that's not analogous to the state court's foreclosing proceedings. And even if there was abandonment --

QUESTION: No, my only question to you, in response to your statement that you had never seen a bankruptcy court turn down a petition for abandonment.

kw 41 indebtedness, as I remember it.

MR. CAGLE: We were --

QUESTION: At the time ofthe sale.

MR. CAGLE: At the time of the sale.

QUESTION: There was then nothing in the record to indicate that there was a substantial equity in the property over and above --

MR. CAGLE: No, that was substance. Substance.

QUESTION: Well, don't we have to look at it at the time of the sale?

MR. CAGLE: Well, I don't think so, because you're looking at it in hindsight there. The time that the petitioner asked --

QUESTION: Excuse me. You're looking at it with the benefit of hindsight when you say that later on it turned out that the property increased in value, and the petitioner made a profit on it.

MR. CAGLE: I was saying that the equity was there by reason of the appraisal in December, 1974, just a few weeks before it was adjudicated in '75, January or February of '75.

QUESTION: But he had a lien, a second mortgage lien, for about $300-some thousand dollars, and he bought the property for $170- or something like that, didn't he?

MR. CAGLE: At the second sale, it was obvious the

district court had an order allowing the second mortgagees to use the amount of their second mortgage to bid at the sale?

QUESTION: And they didn't have to use it all.

MR. CAGLE: That's correct. That sort of put a damper on the sale, may it please the Court.

But the time that the petitioner orally requested the court, at the first meeting of creditors in April of '75 to abandon the property to him, that is not sufficient and it's the wrong procedure.

That was a request or suggestion to the court. That was not an adversary proceeding to recover the property out of the jurisdiction of the bankrupt. If the court had abandoned the property, he would still have had to file an adversary proceeding to get relief from the stay and bankruptcy, from the automatic stay and bankruptcy.

QUESTION: Tell me one other thing about the abandonment, because I just really didn't understand.

Had there been abandonment at that particular time, would that have extinguished entirely the second mortgage indebtedness, or would there have still had to have been some kind of --

MR. CAGLE: They would have still had to go ahead and just -- first mortgage --

QUESTION: I don't understand what would have happened if there had been abandonment.

MR. CAGLE: The first mortgagee or the second mortgagees, one or the other of the several, would have had to file an adversary proceeding to get permission from the bankruptcy court an order removing the jurisdiction of the bankruptcy court from the property; that is, to get relief from the stay and bankruptcy, so that they could foreclose under state law.

QUESTION: But what I'm trying to find out is, had there been abandonment at that time, what would the effect of the abandonment been on the second mortgage indebtedness?

MR. CAGLE: I don't see that there would have been any effect.

QUESTION: You mean he would have taken over the property, would become the owner of the property, and still retained his entire $360,000 claim?

MR. CAGLE: The court, if they had abandoned the property, the first mortgagees would have foreclosed, under state law, ultimately.

QUESTION: Was there any provision in the mortgage at all with respect to rent?

MR. CAGLE: No, sir.

QUESTION: Had there beenan assignment?

MR. CAGLE: No, sir.

QUESTION: Had there been an assignment, what would their situation have been?

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MR. CAGLE: No, sir.

QUESTION: I said, if there had been.

QUESTION: Assuming the mortgage contained an assignment of rents.

MR. CAGLE: He would still have had to foreclose to perfect that lien.

QUESTION: Even though --

MR. CAGLE: He has not -- yes, sir. He is not entitled to the property until he forecloses. He is not entitled either to the property or to the rents, had there been an assignment of rents, until he institutes foreclosure proceedings, and obtains possession which nowadays, as a practical matter, means a deed to him.

QUESTION: And that he cannot do because of the bankruptcy.

MR. CAGLE: But our position, if Your Honor please, is he can under the adversary proceeding which he did not utilize.

QUESTION: In a Chapter XI, though, the notion is to pay the debts as you go along and -- but at the same time, a Chapter XI isn't supposed to be able to hold off secured creditors unlessyou pay them, is it?

Now what happens in a Chapter XI if a secured creditor may not move in because it's an arrangement to pay off the

creditors, isn't it?

MR. CAGLE: Yes.

QUESTION: Isn't there -- and there was an order not to foreclose.

MR. CAGLE: Simply an order not to foreclose, that was superfluous, because the Bankruptcy Act says that he can't foreclose.

All he had to do, even with the arrangement --

QUESTION: I know, there's an automatic stay in a Chapter XI case.

MR. CAGLE: All right.

Even during the arrangement people go in, creditors go in, and file an action under --

QUESTION: Yes, but the plan is scuttled completely if the --

MR. CAGLE: That's correct, that's why many of them are.

QUESTION: -- property is abandoned. That's the end of the plan.

MR. CAGLE: Well, there is no abandonment during the arrangement period. The abandonment would have occurred during the straight bankruptcy or liquidation part of the bankruptcy proceeding.

But even during the arrangement, what I wanted to emphasize is, the adversary proceeding is available to all

w 45 creditors. And in fact that does stop a lot of arrangements because one of the creditors better secured, that is secured, does not go along, and he files an adversary proceeding.

We suggest that the petitioners took no comparable or analogous action in the bankruptcy court under rule 701 that is comparable to the state law of North Carolina.

We think that the local law is the law that should be followed in the bankruptcy courts, where the site of the property is. That's where everybody knows, or should know, what the law is.

And that is what we believe should be applied in this case.

And even if the property had been abandoned, that does not automatically give him title or give him a lien on the rents. Thatsimply is not the North Carolina law.

And we suggest that abandonment really is immaterial. And back up just a minute to -- I might say that during the arrangement that was an agent, a disbursing agent. And the preamble to that petition to appoint Simon Joseph Golan as an agent said that there was only one employee left and that there needed to be somebody there to disburse the funds, to collect and disburse the funds.

It was not a receiver in any bankruptcy sense.

Thank you, Your Honor.

MR. CHIEF JUSTICE BURGER: You have anything further?

46 MR. BRACKETT: Your Honor, if I could have just a few more moments. I want to address myself to one --

MR. CHIEF JUSTICE BURGER: Two minutes remaining.

MR. BRACKETT: Two moments, yes, sir.

REBUTTAL ARGUMENT OF J. STEVEN BRACKETT, ESQ.,

ON BEHALF OF THE PETITIONER

MR. BRACKETT: First of all, I'd like to address myself to Mr. Justice Stevens' questions. That is, I appreciate the fact that he brought to the Court's attention that this affidavit would take up a substantial part, perhaps two-thirds of the government's brief in this case, and their argument regarding equity in the property was filed on November the 11th, or was prepared and signed by the trustee on November the 11th.

And the decision of the district court judge was on November the 12th. I frankly do not think that that was even considered by the district court judge, and it is a hindsight look at what happened after the petitioner got the property.

And we argue and contend it should not be considered in any decision of this Court.

Secondly, it's clear from the record in this case that there was no equity in this property. If that is a consideration of the Court, it's clear that there was no equity.

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At the first sale, even according to the government's figures, the deficiency on the petitioner's debt was substantially more than at the second sale.

Now the trustee would argue that the fact that there was a bankruptcy order involved in that allowing the petitioner to bid in his second deed of trust chilled the competitive bidding.

In fact, the sale brought more money at the second sale than it did at the first sale.

There was clearly no equity in this case. I ask that the Court look at the first meeting of creditors in the appendix. And -- where the trustee who has argued before this Court today stated that in his opinion there was no equity in the property; that it was clear there was no equity in the property as in December.

The particular argument that I want to address myself -- my attention to the Court is that --

MR. CHIEF JUSTICE BURGER: Do that very briefly. Your time has expired.

MR. BRACKETT: Yes, sir. Pardon me, Your Honor.

I would like to reiterate Justice Bryan's dissent in the 4th Circuit regarding continuation of whether this was during or after bankruptcy.

QUESTION: Can I take five seconds and ask you one question?

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MR. BRACKETT: Yes, sir.

QUESTION: If there had been an abandonment, what would that have done to the second mortgage indebtedness when you requested it?

MR. BRACKETT: I think that it would have extinguished the second mortgage indebtedness.

QUESTION: Entirely?

MR. BRACKETT: Thank you.

MR. CHIEF JUSTICE BURGER: Thank you, gentlemen.

The case is submitted.

[Whereupon, at 3:02 o'clock p.m., the case was submitted.]