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CREDITORS' RIGHTS AND SECURITY TRANSACTIONS — 1955 TENNESSEE SURVEY

PAUL J. HARTMAN*

Application to Bankruptcy Proceedings of Federal Rules Concerning Compulsory Counter Claims: In *Meacham v. Haley*¹ the Tennessee Court of Appeals was faced with the problem of to what extent Rule 13 of the Federal Rules of Civil Procedure concerning compulsory counterclaims applies to a bankruptcy proceeding. In the instant case a trustee in bankruptcy of the Dr. Pepper Bottling Company sued the defendants, Haley and Johnston, for alleged fraud practiced on the bankrupt debtor prior to the bankruptcy. However, some time before the present case, Haley and Johnston had filed claims in the bankruptcy matter of Dr. Pepper Bottling Company. In the bankruptcy proceeding the claim apparently was allowed but was deferred to the claims of all other creditors. The claim of fraud which trustee asserted in the case at hand was predicated upon alleged fraud in the transaction which gave rise to the claim of the creditors (Haley and Johnston) in the bankruptcy proceeding.

In the instant case the trial court found against the trustee on the question of fraud by Haley and Johnston, and both sides appealed. The Tennessee Court of Appeals did not pass on the question of fraud. Instead, it held that since the trustee failed to assert his claim of fraud in the bankruptcy court, he is estopped to adjudicate the matter. The court relied on the compulsory counterclaim provision of Rule 13 of the Federal Rules of Civil Procedure, which provides that if a counterclaim arises out of the transaction or occurrence that is the subject matter of the opposing party's claim, the counterclaim must be set up.² Since trustee's claim did arise out of the claim which the creditors (Haley and Johnston) filed in the bankruptcy court, the Court of Appeals held that it came within the scope of the compulsory counterclaim provisions of the federal rules and thus trustee was precluded from asserting it later.

At the outset, it seems clear that the compulsory counterclaim provision of Federal Rule 13 does apply to bankruptcy cases, so long as not inconsistent with the Bankruptcy Act or the General Orders.³ It

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1. 270 S.W.2d 503 (Tenn. App. M.S. 1954).

2. FED. R. CIV. P. 13. Although Rule 13 does not expressly provide that failure to assert a compulsory counterclaim will prevent its later assertion, such a result has been reached in accordance with the reasoning that the principle of res adjudicata applies to all issues that should have been raised even though omitted. See 3 MOORE, FEDERAL PRACTICE ¶ 13.12, pp. 27-28 (1948).

3. Supreme Court, General Orders in Bankruptcy, Order 37 (1939), 11 U.S.C.A. following § 53 (1943). See 4 COLLIER, BANKRUPTCY § 68.21, pp. 780-91 (14th ed., Moore 1942).

seems equally clear that the claim that trustee asserted would fall within the compulsory counterclaim provisions of Rule 13 since it arose out of the same transaction. Having reached that conclusion, the court stops there and concludes that trustee's claim is barred.

There is one aspect of the case, however, which bears closer inspection. If the bankruptcy court had jurisdiction to give the trustee complete relief, then it would seem that the court is on solid ground in holding that trustee's claim would be barred because of his failure to assert it in the bankruptcy proceeding. However, if there was no jurisdiction in the bankruptcy court to give complete relief to trustee, then it is extremely difficult to understand how trustee could be barred by failure to assert a claim in a court without the necessary jurisdiction. Suppose we examine the case at hand in light of these premises.

Often a creditor will institute some kind of proceeding in the bankruptcy court, whereupon the trustee has a right to interpose a set-off, recoupment or counterclaim in that proceeding. If the trustee's claim is asserted only to reduce or extinguish the creditor's claim, it is clear that the bankruptcy court has jurisdiction to entertain it.⁴ That is the situation, too, where there is only a proof of claim by a creditor, as in the instant case.⁵ However, if the counterclaim happens to be larger in amount than the creditor's claim and the trustee attempts to obtain, by virtue of a set-off or counterclaim, a judgment for a balance against the filing creditor, then troublesome problems arise. Two questions present themselves: (1) does the bankruptcy court have power to grant an affirmative judgment in such a summary proceeding, where the claimant creditor is denied a jury trial, or is creditor entitled to a plenary suit, the bankruptcy court not being endowed with plenary jurisdiction;⁶ and (2) has creditor by filing his claim consented to the exercise of such summary jurisdiction?

It is settled law that a bankruptcy court does not have the jurisdiction to render such an affirmative judgment in favor of the trustee without the consent of the claimant creditor.⁷ Also, it is settled that the creditor may waive his right and consent to summary litigation of the matter in bankruptcy.⁸ There is considerable lack of unanimity

4. This right is conferred by Section 68a of the Bankruptcy Act, 11 U.S.C.A. § 108a (1953). See *Morton G. Thalheimer, Inc. v. Florance*, 58 F.2d 23, 26 (4th Cir. 1932); *Metz v. Knobel*, 21 F.2d 317, 318 (2d Cir. 1927); *Fitch v. Richardson*, 147 Fed. 197, 199 (1st Cir. 1906).

5. See *In re House of Gus Holder, Inc.*, 91 F. Supp. 841, 843 (D.N.J. 1950).

6. See 2 COLLIER, BANKRUPTCY §§ 23.03-23.11 (14th ed., Moore 1940). Except for the informality of the summary proceeding, probably the major distinction between a summary proceeding and a plenary suit is that the litigant in a plenary suit (in a matter of a legal nature as opposed to equitable) may request a jury trial, as secured him by the Seventh Amendment of the United States Constitution. See *American Mills Co. v. American Surety Co.*, 260 U.S. 360, 364-65 (1922).

7. *Metz v. Knobel*, 21 F.2d 317 (2d Cir. 1927); *In re Continental Producing Co.*, 261 Fed. 627 (S.D. Cal. 1919).

8. *Harris v. Brundage Co.*, 305 U.S. 160, 164 (1938).

among the courts as to the kind of consent required.

By filing a claim in bankruptcy, creditor impliedly consents to an adjudication of any defenses of the trustee.⁹ However, the so-called majority rule holds that by merely filing a claim for allowance against the bankrupt's estate, a creditor does not thereby waive his right to a plenary suit on the trustee's counterclaim where trustee asks for an affirmative judgment against the creditor for the balance of the counterclaim.¹⁰ Under this view, the trustee can defeat the creditor's claim by his counterclaim, but in order to recover an affirmative judgment against the creditor, trustee must resort to a plenary suit.¹¹

Other courts have been of a persuasion different from the so-called majority view. This opposing view takes the position that where a trustee's counterclaim arises out of the same transaction as the creditor's claim, consent to summary jurisdiction of the bankruptcy court is deemed to be given by the creditor upon his filing of the claim.¹² Cases sustaining jurisdiction find judicial precedent in the language of the United States Supreme Court in *Alexander v. Hillman*,¹³ which held that creditors, by filing claims in an equity receivership proceeding, subjected themselves to an adjudication of all counterclaims interposed by the receiver.¹⁴

9. *In re Bowers*, 33 F. Supp. 965 (S.D. Cal. 1940); *In re Continental Producing Co.*, 261 Fed. 627 (S.D. Cal. 1919).

10. *Morton G. Thalheimer, Inc. v. Florance*, 58 F.2d 23 (4th Cir. 1932); *Fitch v. Richardson*, 147 Fed. 197 (1st Cir. 1906); *In re Bowers*, 33 F. Supp. 965 (S.D. Cal. 1940) (affirmative judgment for \$728.98 in excess of claim not allowed); *In re Florsheim*, 24 F. Supp. 991 (S.D. Cal. 1938) (claim for \$482.25 and trustee sought recovery of \$2,125 received by creditor as voidable preferences); *In re Patterson-MacDonald Shipbuilding Co.*, 284 Fed. 281 (W.D. Wash. 1922), *aff'd*, 293 Fed. 192 (9th Cir. 1923) (trustee not allowed to recover in excess of claim); *In re Continental Producing Co.*, 261 Fed. 627 (S.D. Cal. 1919). In addition see cases cited note 4 *supra*.

11. It has been said that a plenary suit is the only remedy, unless the trustee waives all right to the excess. *In re Continental Producing Co.*, 261 Fed. 627, 630 (S.D. Cal. 1919). There are decisions to the effect that there cannot be any judgment in bankruptcy proceedings against the claimant where the trustee's offset exceeds the creditor's claim, and that the trustee must seek his remedy by plenary action. *In re Bowers*, 33 F. Supp. 965, 967 (S.D. Cal. 1940).

12. *Columbia Foundry v. Lochner*, 179 F.2d 630 (4th Cir. 1950) (filing of claim by creditor held to be consent to summary jurisdiction for rendering affirmative judgment where counterclaim related to same subject matter as claim); *James Talcott, Inc. v. Glavin*, 104 F.2d 851 (3d Cir. 1939) (affirmative judgment rendered for trustee on his counterclaim for preferences when it arose out of transaction closely related to the claim).

13. 296 U.S. 222 (1935); See also *Florance v. Kresge*, 93 F.2d 784 (4th Cir. 1938); *In re Pennsylvania Coffee Co.*, 8 F.2d 98 (W.D. Pa. 1925).

14. However, *Alexander v. Hillman* cannot serve as direct authority to sustain jurisdiction of the bankruptcy court to render affirmative judgment upon trustee's counterclaim in the case at hand for two reasons. First, the court of equity in *Alexander* was exercising general equity jurisdiction; whereas the jurisdiction of the bankruptcy court, while equitable in nature, is purely statutory, [*Taubel-Scott-Kitzmiller Co. v. Fox*, 264 U.S. 426, 431 (1924)], and being summary in character must rest upon the consent of the creditor. Bankruptcy Act § 23(b), 11 U.S.C.A. § 46(b) (1953). Second, the counterclaim is a legal one for which the creditor may, without waiving it, have his action at

Unfortunately, in the case at hand the opinion does not disclose whether the amount of the claim and the counterclaim were such that trustee could have asked for a judgment for a balance against the creditor had trustee interposed his counterclaim in the bankruptcy proceedings. Hence we do not know whether the court was faced with the choice of following the majority which would deny trustee an affirmative judgment, or the other view which says the creditor consents to an affirmative judgment against him on a counterclaim when he files his claim. The decision by the Tennessee court, even if trustee's counterclaim was large enough to have supported an affirmative judgment against creditor, in the light of expeditious administration of bankrupt's estate, and the avoidance of multiplicity of litigation, has much to recommend it.¹⁵ It would further serve to reduce the operation of the "absurdity of making A pay B when B owes A."¹⁶

Effect of Tennessee Motor Vehicle Title and Registration Law on Conditional Sales of Automobile Tires: The question whether a conditional vendor of automobile tires is required to register his claim under the Tennessee Motor Vehicle Title and Registration Law, was before the Tennessee Court of Appeals in *Free Service Tire Co. v. Manufacturers Acceptance Corp.*¹⁷ Plaintiff, Free Service Tire Company, sold tires for use on an automobile which was sold under a conditional sale and which was financed with the defendant Manufacturers Acceptance Corporation. It seems that defendant had no knowledge of the purchase of the tires and that plaintiff did have good reason to believe that the automobile purchaser was only a conditional vendee.

The conditional vendee defaulted in his payments on the automobile, which was sold, and the defendant bought it in at the sale. When the defendant refused to surrender the tires to plaintiff, plaintiff sued for conversion. Defendant took the position that registration of the conditional sale of the tires on the certificate of title was the sole and exclusive method by which a conditional vendor of automobile accessories could protect its right when such accessories had become attached to the automobile. Plaintiff did not register the sale of the tires on the certificate of title.

The pertinent parts of the Tennessee Motor Vehicle Title and Registration Law¹⁸ seem to be Sections 68, 69 (a) and 69 (b). Section 68 provides:

law and a trial by jury. See *In re Nathan*, 98 F. Supp. 686, 690 (S.D. Cal. 1951). See note 6, *supra*.

15. See COLLIER, BANKRUPTCY § 68.20, pp. 788-90 (14th ed., Moore 1942).

16. *Studley v. Boylston Nat. Bank*, 229 U.S. 523, 528 (1913).

17. 277 S.W.2d 897 (Tenn. App. E.S. 1955).

18. For earlier comments on other facets of this registration statute see 6 VAND. L. REV. 1048 (1953) and 7 VAND. L. REV. 799 (1954). The statute is found in TENN. CODE ANN. §§ 5538.101-5538.197 (Williams Supp. 1952).

"No conditional sales contract, chattel mortgage, or other lien or encumbrance or title retention instrument upon a registered vehicle, other than a lien dependent upon possession entered into after the effective date of this act shall be valid against the creditors of an owner or subsequent purchasers or encumbrances [sic] until the requirements of this article have been complied with, unless such creditor, purchaser, or encumbrancer has actual notice of the prior lien."¹⁹

Section 69 (a) provides:

"Such filing and the notation of the lien or encumbrance upon the certificate of title as provided in this act shall constitute constructive notice of all liens and encumbrances against the vehicle described therein to creditors of the owner, to subsequent purchasers and encumbrances[sic] except such liens as may be authorized by law dependent upon possession . . ." ²⁰

Section 69 (b)²¹ provides that this method of giving constructive notice of a lien or encumbrance upon a motor vehicle shall be exclusive, except as to liens dependent upon possession.

In affirming a judgment for the plaintiff, vendor of the tires, in the conversion suit, the Tennessee Court of Appeals held that the claim of the conditional vendor of the tires and tubes was a claim against the tires and tubes but not against the automobile upon which they had been mounted and that the claim was valid without registration upon the automobile title certificate.

The court seems to apply here the doctrine that before the conditional vendor of automobile tires loses his claim to the conditional vendor of an automobile to which the tires are attached, it must first be shown that the tires became a component part of the automobile to which they were attached and incapable of separation without material injury to the automobile. This holding seems to represent no departure from well-settled doctrine in the field of conditional sales law.²²

Tennessee, unfortunately, has no statute requiring conditional sales to be recorded in order to be valid against third parties, although she does have such a statute governing chattel mortgages.²³ For the pur-

19. *Id.* § 5538.168.

20. *Id.* § 5538.169(a).

21. *Id.* § 5538.169(b).

22. See OSBORNE, MORTGAGES § 218, pp. 581-88 (1931), which treats of land mortgages executed prior to the conditional sale of a fixture to the real estate. There Professor Osborne states that where the real estate mortgage precedes the conditional sale of the fixture, the conditional vendor prevails by the weight of authority, if removal of the chattel will not substantially damage the premises. He says, however, that courts differ as to what constitutes damage. See also, BROWN, PERSONAL PROPERTY § 156, pp. 788-98 (2d ed. 1955).

23. TENN. CODE ANN. § 7192 (Williams 1934). Conditional sales recording acts exist in a majority of states, protecting purchasers and sometimes also protecting creditors. See 2 WILLISTON, SALES § 327 (rev. ed. 1948); 3 JONES, CHATEL MORTGAGES AND CONDITIONAL SALES cc. 22, 23 (6th ed. 1933). In Tennessee where there is no such recording statute, the title of a vendor retained in a written sales contract, although unregistered, is superior to any right acquired by a purchaser for value and without notice. See Knoxville

pose of sound commercial practice it might be well for the present Tennessee Motor Vehicle Title and Registration Law to be amended so as to require the conditional sale of such accessories as tires and tubes to be recorded on the certificate of title. At least in so far as automobiles are concerned such amendment would give prospective purchasers and creditors a single, certain place to look in order to determine whether such items had conditional sales strings attached.

Materialman's Lien—When Building Is Deemed Complete for Purpose of Giving Notice: The case of *Dealers Supply Co. v. First Christian Church*,²⁴ involved a bill to enforce a furnisher's lien for materials furnished in the construction of a church building. The chancellor held that the claimant materialman was entitled to a lien. The church appealed and contended, as two grounds for reversal, that the chancellor erred in holding that the materialman gave notice of its lien claim after the completion of the building, and that the materials were shipped by claimant contractor to a subcontractor at a place of business which was not on the church property. Claimant's contract apparently was with either the contractor who built the church or a subcontractor, and not directly with the church.

The Tennessee Court of Appeals affirmed the chancellor. These mechanics' and furnishers' liens are not limited to those with whom the owner dealt directly; the statute extends the coverage to persons who had no direct dealings with the owner. The liens thus give protection to subcontractors.²⁵ In Tennessee a mechanics' and furnishers' lien attaches from the time of visible commencement of operations.²⁶ In order to preserve the lien, however, certain notification and recordation²⁷ requirements may have to be met. The requirement in the case at hand concerned notification of the owner by claimant subcontractor concerning the existence of the lien. Any laborer or materialman whose contract is not with the owner, but with the original contractor

Outfitting Co. v. Storage Co., 160 Tenn. 203, 22 S.W.2d 354 (1929). Fortunately, if goods are sold under a conditional sale for the purpose of resale, the bona fide purchaser of the goods prevails over the conditional vendor. The power of resale is held to be repugnant to a reservation of title with the result that the buyer gets an unqualified title. *Manufacturing Co. v. Nordeman*, 118 Tenn. 384, 100 S.W. 93 (1906).

24. 276 S.W.2d 769 (Tenn. App. E.S. 1954).

25. TENN. CODE ANN. § 7927 (Williams 1934). Code Section 7914 provides for the lien when the claimant contracted directly with the owner.

26. TENN. CODE ANN. § 7915 (Williams 1934).

27. The Tennessee statute provides that as the lien applies to the owner it need not be recorded; but as concerns subsequent purchasers and encumbrancers for valuable consideration without notice, the lien must be recorded within ninety days after the building is completed, or after the contract of the lienor is terminated. TENN. CODE ANN. §§ 7927, 7929 (Williams 1934). The place of recordation is the office of the county register. TENN. CODE ANN. §§ 7918, 7929 (Williams 1934). For a general treatment of mechanics' liens, with particular emphasis on the subject of priority between mechanics' liens and mortgages, see Hartman, *Creditors' Rights and Security Transactions—1954 Tennessee Survey*, 7 VAND. L. REV. 799 (1954).

or an immediate or remote subcontractor, shall have his lien only if he notifies the owner in writing ninety days after the demolition or completion of the building or within ninety days after the completion of his performance of his contract or his discharge.²⁸ Notice given before completion of the building is premature and is not effectual to perfect the lien.²⁹

The defendant church took the position that the church had not been finished and therefore the owner had not been notified within ninety days after the completion of the building. A few odds and ends remained to be finished, but the evidence showed that the church was sufficiently completed to justify dedication. Although the court thought the evidence as to the completion was meager, nevertheless it felt that there was enough evidence to sustain the chancellor's finding that it was completed within the meaning of the act requiring notification. The decision on this point seems in line with earlier Tennessee decisions to the effect that trivial things left undone will not prevent the running of the period within which notification must be given in order to preserve the lien.³⁰

Materialman's Lien—Furnishing Materials Through Subcontractor: In the *Dealers Supply* case the defendant church also insisted that complainant's claim to a lien on the building must fail for the reason that the materials were sold on open account and shipped to a subcontractor at its place of business which was not on the church property. The Tennessee court overruled this assignment of error also. The court found from the evidence that the materials were furnished for the particular job in question. While the materials were not shipped directly to the job, but were shipped to the subcontractor's place of business, there was no proof that they were intermingled in a general stock of supplies on hand in the storeroom of the subcontractor. Moreover, the delivery was made to the subcontractor with the intent that the materials would later be delivered to the job by the contractor; the materials were so delivered later and were used in the church.

It seems to be the law in Tennessee that where materials are furnished to the contractor on general account for use in any and all buildings, and not on special order for the use in a particular building, no lien can be perfected.³¹ The facts showed that such was not the situation in the case at hand. It is not crucial that the materialman did

28. TENN. CODE ANN. §§ 7927, 7929 (Williams 1934).

29. See *East Lake Lumber Box Co. v. Simpson*, 5 Tenn. App. 51, 57 (M.S. 1927).

30. *Luter v. Cobb*, 41 Tenn. 525 (1860); *Dunn v. McKee*, 37 Tenn. 657 (1858). Nor can a lien be revived or affected by the doing of an insignificant act not originally contemplated. *East Lake Lumber Box Co. v. Simpson*, 5 Tenn. App. 51 (M.S. 1927); *Wood v. Haney*, 41 S.W. 1072 (Tenn. Ch. App. 1897).

31. *Mills v. Terry Mfg. Co.*, 91 Tenn. 469, 19 S.W. 328 (1892).

not himself deliver the materials at the site of the improvement.³² The important factor seems to be whether the materials were delivered with the intent that they be used in the particular job and they are later so used.³³

32. *Standard Lumber Co. v. Fields*, 29 Wash.2d 327, 187 P.2d 283 (1947).

33. *Bassett v. Bertorelli*, 92 Tenn. 548, 22 S.W. 423, 424 (1893). The definitional section of the Tennessee mechanics' lien statute defines "materialman" or "furnisher" as follows: "Materialman" or "furnisher" means any person who, under contract, furnishes material to the owner, contractor, or subcontractor of any degree, on the site of the improvement, or who specially fabricates materials for the improvement and who performs no labor in the installation thereof." TENN. CODE ANN. § 7913 (Williams 1934).