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Title to Accrued Vacation Pay: The Bankrupt's or the Trustee's in Bankruptcy

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TITLE TO ACCRUED VACATION PAY: THE BANKRUPT'S OR THE TRUSTEE'S IN BANKRUPTCY?

The two fundamental purposes of the Bankruptcy Act[1] are to liquidate and distribute assets of the debtor in a manner which is "equitable to the debtor, to the creditor, and among the creditors";[2] and to "leave the bankrupt free after the date of his petition to accumulate new wealth in the future."[3] To carry out these objectives the act specifies the *date of bankruptcy* as a general time-pivotal or point of cleavage throughout its provisions. Section 70a provides that as of the date of the filing of the petition, the trustee of the estate of a bankrupt shall be vested by operation of law with the title of the bankrupt to all classes of property enumerated in its subdivisions, but that the bankrupt shall be free of creditors' claims to property acquired thereafter.[4] Of the eight separate classes of properties, interests or rights which may come into the estate in bankruptcy as assets and thereby vest in the trustee, the most general classification is that created by the fifth clause.[5]

This clause, subject to provisos as to certain rights of action for wrongs to the person and as to life insurance policies, vests the trustee with the title of the bankrupt as of the date of the filing of the petition in bankruptcy to

> property, including rights of action, which prior to the filing of the petition [the bankrupt] 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. . . .[6]

By fixing a definite time when the estate of the bankrupt is considered subject to the act—and thereby delineating the rights and status of those claiming against the estate—the two underlying themes of equality of distribution and rehabilitation of the debtor have been consistently maintained. But no matter how suitable the date of bankruptcy might be as a means of maintaining and harmonizing these two goals, there will still be conflicting claims to specific forms of property

1. 11 U.S.C. §§ 1-1103 (1964).

2. 3 J. COLLIER, COLLIER ON BANKRUPTCY ¶ 60.01 (14th ed. J. Moore & L. King, 1962) [hereinafter cited as COLLIER].

3. Segal v. Rochelle, 382 U.S. 375, 379 (1966).

4. Bankruptcy Act § 70a, 11 U.S.C. § 110(a) (1964); 4A COLLIER ¶ 70.07.

5. 3 H. REMINGTON, BANKRUPTCY §§ 1177-269 (J. Henderson ed. 1957).

6. Bankruptcy Act § 70a(5), 11 U.S.C. § 110(a)(5) (1964).

involving both present and future interests which do not fall neatly on either side of the cleavage point. Such a conflict arose as to title to a wage earner's accrued and unpaid vacation pay in *Frederick v. Lines.*[7]

In *Lines* two wage earners, Frederick and Harris, filed separate petitions in bankruptcy in the United States District Court for the Northern District of California during 1967. Lines was appointed trustee of the bankrupts' estates in both proceedings at the First Meeting of Creditors.[8] Sometime thereafter the trustee filed an Application for Turnover Order, alleging that he was entitled to receive as an asset of the bankrupts' estates that portion of the appellants' accrued vacation allowance earned as of the date of filing.[9] After hearings before the referee in bankruptcy, the bankrupts were ordered to turn over to the trustee the unexempt portion of their vacation pay earned as of the bankruptcy date at such future time as each received that pay.[10]

The facts stipulated on appeal indicated that the two cases were quite similar. Both appellants were California residents and derived their support from wages. The only significant difference between the two cases was the manner in which the two employers handled vacation pay. Appellant Frederick's employer, a large manufacturer, gave "vacation" with full pay during plant closings which occurred for a week twice each year, once during summer and again at year's end. Employees could not draw vacation pay until plant closings unless earlier terminated. Appellant Harris' employer, Pacific Gas and Electric Company, used a voluntary vacation plan rather than the compulsory layoff plan as provided for in the case of appellant Frederick. Under the voluntary plan employees could not draw vacation pay until they took a vacation or were earlier terminated. Both employers had credited vacation pay on account in amounts which were similar.[11]

Upon these stipulated facts the district court denied the appellants' petition to review the turnover orders of the referee in bankruptcy. From the order of the district court the appellants appealed to the Court of Appeals for the Ninth Circuit. Appellants contended

7. 425 F.2d 215 (9th Cir.), *aff'd*, 91 S. Ct. 113 (1970).

8. Bankruptcy Act § 44a, 11 U.S.C. § 72(a) (1964), provides that the creditors of a bankrupt shall at first meeting of creditors appoint a trustee. Although it is not permissible to appoint a "general trustee" to act in a certain class of cases, it is proper for courts to allow the same trustee to administer cases of a similar nature on the basis of its power to control the appointment of trustees. *Compare* GENERAL ORDER IN BANKRUPTCY 14 *with* Bankruptcy Act § 2a(17), 11 U.S.C. § 11(a)(17) (1964).

9. Brief for Appellant at 2, Frederick v. Lines, 425 F.2d 215 (9th Cir. 1970). Bankruptcy Act § 2a(21), 11 U.S.C. § 11(a)(21) (1964), provides for the turnover order.

10. Record, vol. 1, at 51, Frederick v. Lines, 425 F.2d 215 (9th Cir. 1970).

11. 425 F.2d at 216.

first of all that the claimed vacation pay was not "property" as defined by section 70a of the Bankruptcy Act and therefore was not subject to bankruptcy administration.[12] Secondly, the appellants argued that the referee's order violated equitable principles which govern administration of the Bankruptcy Act. Such an order, so the argument ran, denied appellants a "fresh start" and imposed hardship on the bankrupts without affording any compensating benefit to the creditors.[13]

In their brief, appellants first maintained that accrued vacation pay was "nothing more than an internal bookkeeping entry made by the employer[s] for [their] own purpose[s]" which, unless certain future events occurred, "remain[ed] as lifeless and inert as the printed numerical characters" in which form it existed.[14] In sharp contrast to appellants' characterization, the trustee-appellee contended:

> The bankrupt has a vested right in the vacation pay accrued and earned at the date of bankruptcy; . . . the enjoyment of vacation pay may be postponed, but the bankrupt[s'] right[s] to it [are] fixed at the time of bankruptcy when it had accrued in [their] favor.[15]

Secondly, appellants contended that

> [o]ne of the primary purposes of the bankruptcy act is to 'relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh. . . .'[16]

and that *as a matter of equity* the referee's order "would create injustice and unfairness by depriving appellant[s] and [their families] of wages needed to support them. . . ."[17] The appellee countered that the real basis of the "fresh start" was the benefit the bankrupt obtained through discharge of his debts; that "[i]t is the right and duty of the trustee to collect and marshall all assets of the bankrupt"; and that therefore there was no hardship since "[a]ppellant[s] must relinquish [all] assets . . . whether or not the asset is subject to immediate enjoyment or physical receipt."[18]

The final argument of the appellants was that in return for imposing hardship on the bankrupts, the referee's order offered almost no compensating benefit to the creditors. To support this contention, appellants offered statistics which showed that nonbusiness wage earner

12. Brief for Appellant at 4-5, Frederick v. Lines, 425 F.2d 215 (9th Cir. 1970) [hereinafter cited as Appellant's Brief].

13. *Id.* at 7-11.

14. *Id.* at 4.

15. Brief for Appellee at 3, Frederick v. Lines, 425 F.2d 215 (9th Cir. 1970) [hereinafter cited as Appellee's Brief].

16. Local Loan Co. v. Hunt, 292 U.S. 234, 244-45 (1934), *quoting* Williams v. United States Fid. & Guar. Co., 236 U.S. 549, 554-55 (1914).

17. Appellant's Brief 9.

18. Appellee's Brief 3.

bankruptcy proceedings had offered dividends to creditors in only one out of nine cases.[19]

The Ninth Circuit unanimously accepted the appellants' contentions and reversed the district court's order. The court reasoned that an asset could not be deemed "property" for the purposes of section 70a(5) "if a transfer of that asset to the trustee interferes with the bankrupt's freedom after the date of his petition to accumulate new wealth."[20] Since vacation pay was analogous to future wages, which do not constitute "property" at the time of bankruptcy, the court concluded that vacation pay credited to the employees' accounts before bankruptcy was also not "property" within 70a(5). As Judge Hufstedler noted,

> The overriding reason for [this] view is that an employee who will be without wages or on reduced wages during future layoffs or who will be without a vacation cannot be said to have been given the fresh start Congress intended him to have.[21]

To support its decision the court relied on *Segal v. Rochelle*,[22] and *Tennessee Valley Authority v. Kinzer*[23] while disapproving contrary views in *Kolb v. Berlin*,[24] *In re Cohen*,[25] and *In re Keuther*.[26]

Analysis of the Ninth Circuit's Case Authority

A close examination of the supporting cases reveals that they are distinguishable on their facts from *Lines*. In *Kinzer*, the Ninth Circuit's principal authority, an appeal was taken from a judgment that vacation pay standing to the credit of a bankrupt passed to the trustee. At the time of bankruptcy the employee in this case had no interest or right which he could enforce or transfer or which his creditors could reach. In order to receive vacation pay the bankrupt, as an employee of Tennessee Valley Authority, had to comply with a federal statute covering employees of corporations created under authority of Congress.[27] The vacation pay or annual leave was earned for all days an employee was in a pay status, regardless of whether he was actually on duty or on leave of absence with pay.[28] However, the annual leave did not *accrue* until the employee was on "terminal leave"; that is, on

19. Appellant's Brief 9.
20. 425 F.2d at 217.
21. *Id.*
22. 382 U.S. 375 (1966).
23. 142 F.2d 833 (6th Cir. 1944).
24. 356 F.2d 269 (5th Cir. 1966).
25. 276 F. Supp. 889 (N.D. Cal. 1967).
26. 203 F. Supp. 223 (N.D. Cal. 1962).
27. 142 F.2d at 838.
28. *Id.*

annual leave taken immediately prior to final separation from employ.[29] Moreover, there were numerous contingencies, upon the happening of which the employee would not receive his pay during leave of absence, including employment with other federal agencies during his period of leave, misconduct or participation in political activity.[30] As described by the court in *Kinzer*,

> Vacation pay was not due the bankrupt, or earned by him, prior to bankruptcy. He had only earned the right to such pay, at a subsequent period, provided that he continued in the employ of the Authority, in a duty status, during the time the pay accrued; he could not have received it unless he took the leave; he would not have been entitled to it, after his separation from service, whether he had otherwise earned the right to it or not; and, in any case, it was dependent on various contingencies.[31]

In summary, *Kinzer* is factually distinguishable from the present case because the bankrupt's right to receive accumulated pay had not accrued as of the date of bankruptcy and was wholly dependent upon contingencies, several of which might have deprived the bankrupt of his accumulated vacation pay altogether.[32]

In *Segal v. Rochelle*[33] voluntary petitions in bankruptcy were filed in a Texas federal court by the two Segal brothers, Sam and Gerald, and their partnership, Segal Cotton Products. During the year prior to bankruptcy the partnership had suffered severe losses. Because of the losses the trustee sought and obtained loss-carryback tax refunds from the United States on behalf of the Segals under Internal Revenue Code section 172.[34] These losses were carried back to offset net income on which the Segals had both paid taxes in prior years. By agreement the trustee placed the tax refunds in a special account; the Segals applied to the referee in bankruptcy to award the refunds to them on the ground that bankruptcy had not passed the refund claims to the trustee. The primary question for the Court on appeal was whether loss-carryback refunds constituted property within the meaning of 70a(5). The Court held that it was property, reasoning that the loss-carryback refund 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 [so] regarded.[35]

The case, though eminently sound, may be distinguishable from *Lines*.

29. *Id.*
30. *Id.*
31. *Id.*
32. *See also In re* Palifika, 42 REF. J. 126, 127 (1968).
33. 382 U.S. 375 (1966).
34. *Id.* at 376.
35. *Id.* at 380.

> Temporally, two key elements pointing towards realization of a refund existed at the time the bankruptcy petition was filed: taxes had been paid on net income within the past three years, and the year of bankruptcy at that point exhibited a net operating loss.[36]

In *Lines* the only fact which could connect vacation pay with the pre-bankruptcy past is the accrual of that pay. If accrual were clearly established as being in the past, *Lines* and *Segal* would be analogous. However, since accrual in the past is not *definitely* established in *Lines*, the facts of *Segal*, if not distinguishable, at least demonstrate a stronger nexus with the past than do the facts of *Lines*.

Contrary Authority

In order to analyze the result in *Lines* objectively, it is necessary to discuss briefly the authorities that the court cited but disapproved. The three cases—*Kolb*,[37] *Cohen*[38] and *Keuther*[39]—upon which the district court and the appellee placed heavy emphasis in *Lines* seem contrary to the Ninth Circuit's position in the latter case. *Keuther* appears to be the first reported case to hold that vacation pay was property subject to bankruptcy administration. In that case review was sought of a referee's order denying the trustee's petition for directions that the bankrupt turn over to him vacation pay which she had earned at the time of the filing of her petition and which she subsequently received. At the time of filing the bankrupt had been employed as a waitress a few days short of 2 years.[40] Her union's contract provided:

> After a regular or relief employee has been in the service of an employer for twenty-four (24) months, he shall be entitled to two (2) week's [*sic*] vacation with pay [which] shall be the average weekly pay received by such employee during the year preceding the vacation. When employment is severed, an employee shall be entitled to vacation pay prorated according to the actual weeks of work and upon the basis of two (2) weeks [*sic*] pay. . . .[41]

The court held that immediately prior to the filing of the petition the bankrupt was vested with an absolute right to receive the prorated portion of two weeks' vacation pay. Since the right of the bankrupt was not dependent on any contingency and she was certain to receive payment by the end of the 2 years or sooner in the event of an earlier termination of her employment, this was a property right and title to such vacation pay passed to the trustee.[42] Although *Keuther*

36. *Id.*
37. Kolb v. Berlin, 356 F.2d 269 (5th Cir. 1966).
38. *In re* Cohen, 276 F. Supp. 899 (N.D. Cal. 1962).
39. *In re* Keuther, 203 F. Supp. 223 (N.D. Cal. 1962).
40. *Id.* at 223.
41. *Id.* at 223-24.
42. *Id.* at 224.

appears quite similar to *Lines*, it dealt only with the question whether vacation pay was "property" within 70a(5) as a matter of law. Since it disregarded the equitable matter of providing a "new opportunity in life and clear field for the future, . . ."[43] the *Keuther* opinion lacks the comprehensiveness of *Segal* and is severely weakened by that case.

Both *Kolb* and *Cohen* are similar to *Keuther* on their facts and both rely so heavily on that decision that a detailed factual exposition would not aid the present inquiry. Each decision is, as aptly suggested by the appellant in *Lines*, a "classic case of 'judicial bootstrapping' originating from a highly questionable case."[44]

In summary it appears that the Ninth Circuit's holding may not in fact find support in the cases it cites as authority. It seems, paradoxically, that the disapproved cases are more akin to the fact situation in *Lines*. Before condemning this seemingly illogical result, however, it is necessary to determine what factors went into Ninth Circuit's decision.

A Case for the Bankrupt

In reaching a conclusion contrary to that reached in prior cases by two district courts and other courts of appeal, the Ninth Circuit relied heavily on the *ratio decidendi* of *Segal*. That decision identified the competing policy considerations that underlie a determination of what constitutes property for purposes of 70a(5):

> The 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. . . . However, limitations on the term property do grow out of other purposes of the Act; one purpose which is highly prominent . . . is to leave the bankrupt free after the date of his petition to accumulate new wealth in the future.[45]

By holding that 70a(5) does not include accrued vacation pay, the Ninth Circuit attempted to strike a balance between these competing purposes. What is not evident, however, are the considerations that went into the court's balancing process, considerations which may reconcile the conflicting decisions.

One question facing the court was whether the particular interest involved—accrued but unpaid vacation pay—could be regarded as "property" as a matter of law. This inquiry is wholly distinguishable

43. Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1933); *accord*, Stellwagon v. Clum, 245 U.S. 605, 617 (1918).

44. Appellant's Brief, *supra* note 12, at 12.

45. Segal v. Rochelle, 382 U.S. 375, 379 (1966).

from the question whether such an interest *should* be so regarded for bankruptcy purposes. The distinction is that the latter question involves both matters of law and equity while the former only involves the narrow issue of whether the statutory language of 70a indicates a clear intent to exclude the interest from the trustee's control. The purpose of the enumeration in 70a is an exclusionary one; if the interest is clearly outside the ambit of that section, the trustee cannot gain title no matter what equitable considerations are present. In other words, the numerous subdivisions and provisos of 70a give rise to a negative implication that any interest not listed is not to pass to the trustee.[46]

Under 70a(5), the guiding criterion is transferability or leviability.[47] If the particular interest is subject to sale or judicial process, then it may be regarded as property. But even if the interest passes this test, other relevant considerations may dictate that it should not be so regarded. In early cases such as *Kinzer*, the initial criterion—transferability—was the sole concern of the courts.[48] By overemphasizing the statutory language of section 70a, the courts became caught in a semantic tangle and lost sight of relevant equitable factors. Decisions in similar cases began to go both ways with anomalous and irreconcilable results.[49] *Lines*, by contrast, deferred the question of transferability until after the equitable matters were examined. The ultimate result was that the Ninth Circuit in *Lines* found it unnecessary to decide whether, under California law, either bankrupt could have transferred his right to receive vacation pay or whether creditors could have reached those expectancies.[50] It is fairly certain, however, from both the statutes and decisions cited by counsel that the court would have decided that vacation pay was both transferable and leviable and therefore within the ambit of 70a(5).[51]

The primary concern of the Ninth Circuit was whether the bankrupts' interests in accrued unpaid vacation pay *should* be regarded as "property" within section 70a. Involved here are equitable matters. These may be divided into three separate points, each of which was ar-

46. 4A COLLIER ¶ 70.09.

47. Chicago Bd. of Trade v. Johnson, 264 U.S. 1, 12 (1924).

48. *In re* Coleman, 87 F.2d 753 (2d Cir. 1937); Equitable Life Assurance Soc'y v. Stewart, 12 F. Supp. 186, 192-93 (W.D.S.C. 1935).

49. *Compare* Tennessee Valley Authority v. Kinzer, 142 F.2d 833 (6th Cir. 1944), *with In re* Willow Cafeterias, 111 F.2d 429 (2d Cir. 1940).

50. Frederick v. Lines, 425 F.2d 215, 217 (9th Cir. 1970).

51. Medical Ass'n v. Rambo, 33 Cal. App. 2d 756 (App. Dep't Super. Ct. 1938); CAL. CODE CIV. PROC. § 690.6. Although *Rambo* deals with earnings and not with vacation pay, the decision would support a finding that vacation pay is transferable in California because, as the Ninth Circuit stated, "[V]acation pay is analogous to future wages." Frederick v. Lines, 425 F.2d 215, 217 (9th Cir. 1970).

gued[52] and carefully considered by the court in *Lines*.[53] They are: 1) hardship to the debtor, 2) benefit to the creditors and 3) feasibility of administration.

The hardship factor. Once the court has determined that the interest in question may fairly be regarded as the trustee's property under the transferability test, it must decide whether an overriding hardship to the debtor is thereby created. This was the Supreme Court's major concern in *Segal*. It is a matter of equity for which no precise test can be stated. Basically, the question is whether the turnover order will create injustice and unfairness by depriving the bankrupt of a resource needed to support the bankrupt and his family. If it is found that such deprivation will render the rehabilitative purpose of the act ineffective, the order should be denied whether or not the interest falls within 70a(5) under the transferability test. This is the meaning of *Segal* and the holding of *Lines*.

The benefit factor. Secondly, the court must carefully determine whether the creditors will materially benefit by having the assets include the particular interest. One measure of this benefit is a comparison of transfer value and costs of administration. If the saleability is negligible so that the transfer value will be entirely consumed by fees and costs of administration, then the interest should not pass to the trustee. Since this is generally the case with respect to accrued vacation pay interests, the court should carefully analyze this consideration. The court in *Lines* did so, and stated that "[i]n reaching [our] conclusion . . . we are mindful that a contrary view would rarely benefit creditors."[54]

The feasibility factor. The third factor that a court must consider is the feasibility of bankruptcy administration. A rule developed by the courts with respect to section 70a permits a trustee to refuse to administer burdensome assets. While the matter is generally left to the trustee's discretion, the courts retain jurisdiction to supervise the exercise of this discretion. Considerable time may elapse before the order can be carried out, causing the court to keep a bankrupt's estate open for an excessive length of time. In most cases trusts continuing after the close of the estate would be impractical from the standpoint of expense. Although this is certainly not the paramount consideration, every increase in the length of administration of an estate defeats both the purpose of maximum distribution and the purpose of freeing the bankrupt from the burden of the bankruptcy proceeding itself. This was clearly recognized by the court in *Lines*:

52. Appellant's Brief, *supra* note 12, at 7-11.
53. 425 F.2d at 216-17.
54. 425 F.2d at 217.

> Instead of benefiting bankruptcy administration . . . such funds, when, if ever received by the employee would usually be consumed by the expenses of administration incurred to keep the estate open awaiting the employee's vacation or his unemployment.[55]

Conclusion

What initially appeared to be an irreconcilable conflict between courts of appeals may not be a conflict at all. Throughout the decisions the courts prior to *Lines* have dealt with vacation pay as if the only question were an interpretation of 70a(5). After the Supreme Court's *Segal* decision, a new emphasis was placed on the bankruptcy court's equity powers. It is evident that the Ninth Circuit made extensive use of this power in deciding *Lines*. By doing so, they not only avoided a semantic snare that has entrapped previous courts, but reasserted the role of equity in bankruptcy matters and gave full effect to the mandate of the Supreme Court in *Segal*.[56]

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55. *Id.*

56. In Lines v. Frederick, 91 S. Ct. 113 (1970), the Supreme Court granted certiorari and in a three page per curiam opinion affirmed the Ninth Circuit's decision. In resolving the conflict between the Fifth and Ninth Circuit, the Court did little more than reiterate what had been said in *Segal* and the Ninth Circuit's opinion. However, the decision clearly supports the thesis that the Supreme Court has given renewed emphasis to the role of equity in bankruptcy matters, for as the Court points out: "The most important of the considerations limiting the breadth of the definition of property lies in the basic purpose of the Bankruptcy Act to give the debtor 'a new opportunity in life.'" *Id.* at 114. Justice Harlan dissented in a brief three-paragraph opinion which is reminiscent of the reasoning of cases prior to *Segal*. The inference from Harlan's dissent is that he would decide the case on the transferability of the pay rather than the equitable matter of whether the bankrupt was deprived of a fresh start. This was the practice in prior cases such as *Kolb*, *Keuther* and *Cohen*, but apparently Justice Harlan saw no difficulty in sorting through the semantic differences.

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