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Bankruptcy - Uniform Trust Receipts Act - Rights of Entruster to a Lien Interest in the General Assets of Bankrupt Trustee

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BANKRUPTCY—UNIFORM TRUST RECEIPTS ACT—RIGHTS OF ENTRUSTER TO A LIEN INTEREST IN THE GENERAL ASSETS OF BANKRUPT TRUSTEE—Plaintiff, a credit corporation, used a trust receipt arrangement to finance a car dealer, who thereafter sold a number of the entrusted cars (out of trust sales) without remitting the proceeds to plaintiff. In order to restore some of these proceeds, which had been dissipated in the course of running his business, the car dealer gave plaintiff a trust receipt on ten unencumbered trucks in its possession, in release of part of plaintiff's security interest under the first trust receipts. Plaintiff later sold these ten trucks. Subsequently, in the course of bankruptcy proceedings filed against the car dealer, plaintiff sought to assert a prior lien on the bankrupt's general assets to recover the value of the dissipated proceeds from the original out of trust sales, minus the value it sought to retain from the sale of the ten trucks. On appeal from an order denying plaintiff's claim, *held*, affirmed. A trust receipt gives no *lien* interest in the proceeds of out of trust sales under section 175 of the Illinois Trust Receipts Act.¹ The act creates merely a *priority* interest in an entruster as to proceeds, which is denied preferential status under the Bankruptcy Act.² Furthermore, because the second trust receipt covering the ten trucks was given for the release of such a priority interest, it constituted a transfer of property for an antecedent debt within the prohibition of section 60a of the Bankruptcy Act.³ *In the Matter of Crosstown Motors, Inc.*, (7th Cir. 1959) 272 F. (2d) 224.

One of the fundamental purposes of the trust receipt, under the widely adopted Uniform Trust Receipts Act,⁴ is to provide lenders of certain types of short term credit with a predominant security interest⁵ that will afford protection against most other types of creditors in cases of

1 ". . . the entruster shall be entitled, to the extent to which and as against all classes of persons as to whom his security interest was valid at the time of disposition by the trustee, as follows . . . (b) to any proceed or value of any proceeds (whether such proceeds are identifiable or not) of the goods, documents or instruments, if said proceeds were received by the trustee within ten days prior to . . . the filing of a petition in bankruptcy. . . ." Ill. Rev. Stat. (1957) c. 121½, §175; UTRA, §10, 9C U.L.A. 220. The Illinois Trust Receipts Act is an incorporation into the laws of Illinois, with some minor changes, none of which have any bearing on the principal case, of the Uniform Trust Receipts Act; Ill. Rev. Stat. (1957) c. 121½, §§166-187; 9C U.L.A. 220.

2 52 Stat. 840 (1938), as amended by 66 Stat. 426 (1952), 11 U.S.C. (1958) §104 (Chandler Act); *Strom v. Piekas*, (2d Cir. 1941) 123 F. (2d) 1003. See note, 66 YALE L. J. 567 (1957). See, generally, Hanna, "Preferences as Affected by Section 60c and 67b of Bankruptcy Law," 25 WASH. L. REV. 1 (1950).

3 30 Stat. 544, c. VI, §60 (1898), as amended, 11 U.S.C. (1958) §96. See note 17 *infra*.

4 UTRA, 9C U.L.A. 220. This act has now been adopted in 35 states, according to 9C U.L.A. (1957; Supp. 1959) at 59.

5 See *Commercial Credit Corp. v. Horan*, 325 Ill. App. 625, 60 N.E. (2d) 763 (1945); *Donn v. Auto Dealers Investment Co.*, 385 Ill. 211, 52 N.E. (2d) 695 (1944); *Commercial Discount Co. v. Los Angeles County*, 16 Cal. (2d) 158, 105 P. (2d) 115 (1940); *General Finance Corp. v. Krause Motor Sales*, 302 Ill. App. 210, 23 N.E. (2d) 781 (1939). See Bogert, "Effect of Uniform Trust Receipts Act," 3 UNIV. CHI. L. REV. 26 (1935).

the debtor's insolvency.⁶ Unfortunately, because of the varying language used in the act, it is not explicit whether the denominated "security interest" was to be in the nature of a lien or merely to provide a priority interest.⁷ Since the passage of the Chandler Amendment to the Bankruptcy Act in 1938, state-created priorities, but not state-created liens, are refused preference in bankruptcy proceedings.⁸ Consequently, the determination of the exact nature of the trust receipt security interest under state interpretations has become an issue of crucial importance to the entruster. Prior Illinois decisions have consistently held that the trust receipt, under the Illinois Trust Receipts Act, creates in the entruster a *lien* interest in the entrusted goods.⁹ The Illinois courts have not yet faced the problem of deciding whether this type of lien extends to the proceeds of out-of-trust sales; but from the basic nature of the trust receipt transaction, which anticipates a sale of the entrusted goods, it would seem reasonable that the lien interest afforded the entruster should extend at least as far as the identifiable proceeds from the out-of-trust sales.¹⁰ If this hurdle can successfully be cleared there is no

⁶ The only type of lien which can be perfected against the interest of the entruster is a special statutory lien. Ill. Rev. Stat. (1957) §176; UTRA, §11, 9C U.L.A. 220 at 263. "Special liens arising out of contractual acts of the trustee with reference to the processing, warehousing, shipping or otherwise dealing with specific goods in the usual course of the trustee's business preparatory to their sale shall attach against the interest of the entruster in said goods as well as against the interest of the trustee. . . ." See, generally, comment, 49 MICH. L. REV. 243 at 248 (1950), where, in discussing the effect of such a lien on the entruster's interest in a bankruptcy proceeding as affected by §60a of the Bankruptcy Act, the author states: "The primary rule is that a transfer shall be deemed to have been made at the time when it became so far perfected that no one subsequently acquiring a lien on the property transferred would thereby acquire rights therein superior to those of the transferee. This is the test to be applied to all property other than realty. A further limitation is found in the stipulation that the lien which is to be used as the test of perfection is such as is obtainable 'by legal or equitable proceedings on a simple contract. . . .' This provision excludes the possibility of a challenge on the basis of hypothetical statutory liens granted special priority by the applicable state law. These statutory liens are expressly excluded in the definitions of a lien contained in the section."

⁷ A lien is a right independent of bankruptcy and is a charge against assets which must be met before distribution to unsecured creditors. A priority is a creature of the Bankruptcy Act and is an unsecured claim over other claims in the distribution of the bankrupt's remaining assets. 3 COLLIER, BANKRUPTCY, Moore ed., ¶64.02, pp. 2054-2055 (1941).

⁸ See note 2 *supra*. The statute was intended only to affect those rights which were acquired under an equitable or common law lien, as opposed to statutory lien. See note 6 *supra*. See also 4 COLLIER, BANKRUPTCY, Moore ed., ¶¶67.12, 67.20 et seq. See, generally, Hanna, "Preferences as Affected by Section 60c and 70b of Bankruptcy Law," 25 WASH. L. REV. 1 (1950).

⁹ "Under the terms of the Act where the trustee (borrower) has in his possession goods which are the subject matter of the trust receipt transaction and retains same in his possession, the security interest or lien of the entruster (lender) attaches to such goods when the trust receipt is executed. . . ." Commercial Credit Corp. v. Horan, note 5 *supra*, at 628; Donn v. Auto Dealers Investment Co., note 5 *supra*; General Finance Corp. v. Krause Motor Sales, note 5 *supra*.

¹⁰ See, e.g., A.L.I., Uniform Commercial Code, §9-306, p. 652 at 654 where it is stated: "Whether a debtor's sale of collateral was authorized or unauthorized, prior law [referring to §10 of the UTRA] generally gave the secured party a claim to the proceeds." See

interpretative problem in extending the entruster's interest beyond identifiable proceeds to the debtor's general assets.¹¹ Section 175 expressly states that the entruster's interest is valid as ". . . to any proceed or value of any proceeds (whether such proceeds are identifiable or not) of the goods. . . ."¹² But the court in the principal case, without express reference to any Illinois decisions, found (1) because §175 of the act contains the word "priority" rather than "lien" and, (2) since the act was enacted before state-created priorities were cut off in bankruptcy proceedings, that the drafters of the act actually intended to give the entruster a priority interest rather than a lien interest.¹³ The second of these points, however, in fact presents a sound basis for explaining away the use of the word priority when a lien interest was intended.¹⁴ And this conclusion is further buttressed by the expressed intent of the drafters of the Uniform Trust Receipts Act¹⁵ and by Illinois decisions¹⁶ which indicate the trend of the state law. Since the drafters intended that the entruster should receive a lien interest the court has failed to interpret the statute with reasonable insight into the purpose underlying its enactment.

Finally, the result that the second trust receipt, covering the ten trucks, constitutes a voidable preference under the Bankruptcy Act, section 60a is plausible only upon acceptance of the court's determination that a trust receipt transaction affords a mere priority interest to the entruster.¹⁷

also authorities cited in note 11 *infra*, where a majority of cases facing the problem have allowed a lien interest to attach to the proceeds.

¹¹ This problem has been considered in other jurisdictions, which have held that a lien interest created under a trust receipt transaction extends to the general assets of the trustee. *Commercial Union Bank of Nashville v. Alexander*, (Tenn. App. 1958) 312 S.W. (2d) 611; *In re Harpeth Motors*, (D.C. Tenn. 1955) 135 F. Supp. 863; *Universal Credit Corp. v. Citizen State Bank*, 224 Ind. 1, 64 N.E. (2d) 23 (1945). See Bogert, "Effect of Uniform Trust Receipts Act," 3 *UNIV. CHI. L. REV.* 26 (1935); Hendl, "Trust Receipt Financing," 26 *CHI-KENT L. REV.* 197 (1948).

¹² See note 1 *supra*.

¹³ See principal case at 226.

¹⁴ That is to say if the court recognizes that the drafters intended to give the entruster the equivalent of a lien interest, despite the use of the word priority, then the court should have given weight to such intent.

¹⁵ "In the event of the trustee's insolvency, it [referring to the UTRA] simplifies the proof in administration proceedings by allowing a preference for any proceeds of released security which have been received by the trustee within ten days, so far as the trustee was under a duty to account for such proceeds." *HANDBOOK, NAT. CONF. OF COMMRS. ON UNIFORM STATE LAW* 251 (1933); 9C *U.L.A.* 225 (1957).

¹⁶ See note 9 *supra*.

¹⁷ The court, principal case at 227, accepts Commercial's contention that the second trust receipt was given in release of the prior trust receipt. In view of the court's construction of the interests created by the first trust receipt it rightly concludes that the transaction is a voidable preference under §60a of the Bankruptcy Act, note 3 *supra*. However, accepting the contention that the trust receipt creates a valid lien interest in the debtor's general assets, §60a does not apply. To constitute a voidable preference the bank must dispose of property so as to diminish the estate against which his creditors can claim; a transfer of proceeds to which the bankrupt is not entitled does not have such

The court's failure to interpret the word priority in the context apparently intended by the drafters of the act results in the serious impairment of the trust receipt as a mode of commercial security and seems to place a greater weight on semantics than on reality.

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an effect and therefore is not a preferential transfer. *In re Loring*, (D.C. Mass. 1939) 30 F. Supp. 758; *Bielaski v. Nat. City Bank of New York*, (2d Cir. 1934) 68 F. (2d) 723; *Crosby v. Sproul*, (D.C. Mass. 1927) 17 F. (2d) 325, *affd. sub nom. Crosby v. Packer*, (1st Cir. 1929) 22 F. (2d) 611; *Nat. Bank of Newport, N.Y. v. Nat. Herkimer County Bank of Little Falls*, 225 U.S. 178 (1912); *Western Tie & Timber Co. v. Brown*, 196 U.S. 502 (1905). The transfer of a second lien interest to the entruster for a release of a prior valid lien interest does not deprive the bankrupt's estate of any assets, against which his creditors can claim; hence, the transaction lies outside the thrust of §60a of the Bankruptcy Act. Cf. *Walker v. Clinton State Bank*, (8th Cir. 1954) 216 F. (2d) 165; *Pearson v. Rapstine*, (5th Cir. 1953) 203 F. (2d) 313.