BANKRUPTCY-THE NEW TEST OF PERFECTION UNDER SECTION 60A-EFFECT OF PUBLIC LAW 461

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Bankruptcy—the New Test of Perfection Under Section 60a—Effect of Public Law 461—A preference given to a creditor by an insolvent debtor is not a fraud on his other creditors, regardless of the fact that such payment reduces the share that they would be able to obtain upon an orderly liquidation and pro rata distribution of his estate.¹ This simple principle has caused great confusion and trouble in the development of collective procedures for the satisfaction of the claims of creditors. It led through various channels to a very sweeping definition of preferences and provision for their avoidance in the Chandler Act of 1938, and has now produced, by a process of reaction from that step, the enactment of Public Law 461, amending sections 60a and 70c of the Bankruptcy Act.

¹ Glenn, Fraudulent Conveyances and Preferences, rev. ed., §289 (1940).
A. The Old Section 60a

The Bankruptcy Act of 1938 followed the lead of previous statutes in declaring that preferences given to an individual creditor at the expense of others were undesirable, and were therefore to be voidable as against the trustee in bankruptcy. Section 60a defined a preference as “a transfer . . . of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing . . . of the petition in bankruptcy . . . the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.”

This much in itself represented no new addition to the law of preference. But Congress, determined to put an end to the secret liens which had flourished under such decisions as Sexton v. Kessler3 and Carey v. Donohue,4 went further, providing that: “A transfer shall be deemed to have been made at the time when it became so far perfected that no bona-fide purchaser from the debtor and no creditor could thereafter have acquired any rights in the property so transferred superior to the rights of the transferee therein, and, if such transfer is not so perfected prior to the filing of the petition . . . , it shall be deemed to have been made immediately before bankruptcy.”5 This concluding sentence proved admirably suited to the attainment of the legislative purpose. The test of perfection, although phrased in the conjunctive, was read in the alternative, so that, due to the universally greater protection accorded by state law

3 225 U.S. 90, 32 S.Ct. 657 (1912). In this case the Supreme Court held that an equitable lien subsequently perfected by taking possession two weeks before bankruptcy was valid as against the trustee, relating the transfer back to the creation of the equitable lien.
4 240 U.S. 430, 36 S.Ct. 386 (1916). Here the Court held that recording a conveyance at any time before bankruptcy made it good as against the trustee, in states where an unrecorded conveyance could not be challenged by creditors. The bankruptcy law at that time made a preferential transfer void if a bankruptcy petition was filed within four months of the time of recording “if by law such recording is required.”
5 11 U.S.C.A., §96a. The primary purpose of this amendment was to give the trustee an effective weapon against secret liens. H. Rep. 1409, 75th Cong., 1st sess., p. 30 (1937); 3 COLLIER, BANKRUPTCY, 14th ed., §60.38 (1941); 2 GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES, 2d ed., §487 (1940). See 3 COLLIER, BANKRUPTCY, §60.37, for the history of the long fight against secret liens. The draftsmen of the Chandler Act felt at that time that the conservatism of the Supreme Court made it necessary to use strong language if even moderate results were to be obtained. See the statement of the American Bar Association in support of H.R. 2412, Hearings Before Subcommittee on Bankruptcy and Reorganization of the Committee on the Judiciary of the House, Serial No. 19, 80th Cong., 2d sess., p. 15 (1948).
to a bona fide purchaser, it established the critical date as that when the transaction became invulnerable as against a bona fide purchaser.\(^6\)

All elements of a preferential transfer are to be checked as of the date of perfection,\(^7\) so that a transfer to a creditor, unless immediately perfected, will necessarily be one for an antecedent debt, regardless of the fact that credit is extended contemporaneously with the \textit{de facto} transfer of property as security. Similarly, if perfection is not made before the four-month period, the \textit{de jure} transfer is considered to have occurred at a time such as to make it susceptible to challenge by the trustee. Thus a creditor was faced with the choice of immediately disclosing his interest to the world or running the risk of having it later defeated by the statutory postponement of the effective date of the transfer. The sweep of this section across what had previously been considered perfectly legitimate security transactions soon became apparent. In \textit{Corn Exchange Bank v. Klauder},\(^8\) credit had been extended to the bankrupt in exchange for concurrent assignments of accounts receivable as security, but the creditor had neglected to give notice of the assignments to those who owed the accounts. Under the applicable state law, the failure to give notice permitted a subsequent good-faith assignee to acquire a superior right by giving prior notice. Although in this case the transaction had been carried through at the request of the creditors of the bankrupt, it was held that the statute converted the transfer from one concurrent with the advance of money to one securing an antecedent debt, and made it voidable for the benefit of the unsecured creditors. The test was further broadened by the decision of the district court in \textit{In re Vardaman Shoe Co.}.\(^9\) The majority of American jurisdictions follow the Massachusetts rule that prior notice alone is insufficient to give a subsequent assignee good title to assigned accounts.\(^10\) A superior right is acquired by a subsequent assignee only if

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\(^{7}\) "The test is drawn so as to direct judicial investigation of the transfer to a time when such transfer has become, legally speaking, notorious or publicly known, and has lost any aspects of secrecy such as lack of recording or change of possession." 3 \textit{Collier, Bankruptcy}, 14th ed., \textsection 60.38 (1941). See also \textit{Collier}, \textsection 60.39; comment, 41 \textit{Mich. L. Rev.} 473 (1942).

\(^{8}\) 318 U.S. 434, 63 S.Ct. 679 (1943).

\(^{9}\) (D.C. Mo. 1943) 52 F. Supp. 562.

he obtains payment, judgment against the obligor, a novation, or delivery of some object which must be surrendered to the obligor at the time of payment.  

The Court, when faced in the *Vardaman* case with the question of whether Missouri or Illinois law should govern, held that the answer was immaterial to the power of the trustee to attack the transaction, even though Illinois followed the majority rule. A later decision in the Third Circuit questioned this holding and ruled that an assignment of accounts receivable was not vulnerable to the trustee's attack in the states following the Massachusetts rule, on the ground that in those states the right of a hypothetical triumphant second assignee stems not from his status as a bona fide purchaser, but from his activities following his belated assignment. However, in the absence of a Supreme Court ruling on the issue, accounts receivable financing remained a decidedly unsafe practice even in these states.

Other security transactions were even easier prey to the bona fide purchaser test for the simple reason that they are designed to finance distribution for resale and are inherently incapable of being perfected against the claim of a bona fide purchaser. The recent decision of the district court in *In re Harvey Distributing Co., Inc.* is an excellent illustration. In that case the bankrupt had financed his business of selling coin operated machines by the execution of notes and trust receipts under the Virginia Uniform Trust Receipts Act. All provisions of the state law were complied with, the final steps being taken almost a year before the petition in bankruptcy was filed. However, section 9 of the Uniform Trust Receipts Act provides that if the trustee has liberty of sale and sells to a buyer in the ordinary course of trade, such buyer takes free of the entruster's security interest, regardless of filing under the act. The Court reasoned that since a purchaser could have acquired rights superior to those of the entruster at any time, the transfer must be deemed to have been made immediately before bankruptcy and was therefore invalid as a preference. It might be

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11 *Contracts Restatement* §173 (1928); Salem Co. v. Manufacturers' Co., 264 U.S. 182, 44 S.Ct. 266 (1924).
12 *In re Rosen,* (3d Cir. 1946) 157 F. (2d) 997, cert. den. 330 U.S. 835, 67 S.Ct. 972 (1946). Professor McLaughlin suggested that the Klauder and Rosen cases might be reconciled on a theory that the transfer remains incomplete so long as it is vulnerable to a subsequent assignee aided only by a subsequent event solely within his control. McLaughlin, "Defining a Preference in Bankruptcy," 60 Harv. L. Rev. 233 (1946). This is the test that was finally written into the amended section. P.L. 461, §1, §5, 81st Cong., 2d sess. (1950).
questioned whether a "bona fide purchaser" under the Federal Bankruptcy Act should be regarded as the equivalent of a "buyer in the ordinary course of trade" under a state statute dealing with a specific method of financing, but this was not considered. Among other types of security devices similarly vulnerable to section 60a are conditional sales with consent to resale before title vests in the vendee and chattel mortgages taken under a statute providing for the filing of a mortgage statement when a series of mortgages is contemplated.

The impact of the bona fide purchaser test as reflected in such decisions as the Klauder and Vardaman cases resulted in a flood of more or less critical commentaries by legal writers, pointing out the effect that the test must necessarily have on the ability of a temporarily distressed businessman to obtain credit and on the feasibility of previously useful security devices. Of more immediate effect was the action of the state legislatures, many of which enacted legislation designed to remove the shadow of section 60a from financing via assignments of accounts receivable by withdrawing what protection had previously been accorded subsequent bona fide assignees. Another result was a proposed Uniform Assignment of Accounts Receivable Act making an assignment complete as against all parties at the time of execution, and declaring a second assignee who received payment a trustee of the money so paid for the benefit of the prior assignee. A more direct attack was started by private groups seeking a change in the federal law, which culminated in Public Law 461.

15 Sec. 9, Uniform Cond. Sales Act, 2 U.L.A. 15 (1922).
16 For example, the New York law provides: "A buyer in the ordinary course of trade, purchasing from a dealer any motor vehicle or motor vehicles covered by any such chattel mortgage or mortgages shall acquire such vehicle or vehicles free and clear of the lien or encumbrance of said chattel mortgage or mortgages." N.Y. Lien Law, §230-c-6.
18 These statutes were of roughly three types: book-marking, recording, and validation. For a discussion and analysis of this movement, see two articles by Koessler: "Assignment of Accounts Receivable," 33 Calif. L. Rev. 40 at 86-103 (1945); "New Legislation Affecting Non-Notification Financing of Accounts Receivable," 44 Mich. L. Rev. 563, esp. 584-604 (1946).
19 This proposed act is set out in full in a foreword by Professor Hanna to Koessler's article in 33 Calif. L. Rev. 40 at 45-46 (1945).
20 The bill was jointly sponsored by the American Bar Association, the National Bankruptcy Conference, and the Chicago and New York City Bar Associations, and was actively supported by many financial organizations. H. Rep. 1293, p. 3, 81st Cong., 1st sess. (1949).
B. Section 60a As Amended

The general purpose of the amendment, as reflected in the House Report, is to eliminate the impact of the law of preference upon security transactions which have been entered into in good faith and for what is in fact a present consideration, while retaining the bar against the acquisition of secret liens and forcing strict compliance with the rules laid down by the various states for the protection of creditors in general.21 It was felt that the bona fide purchaser test had gone too far towards protecting the general creditor at the expense of the secured creditor, and had resulted in an impediment of the flow of credit when it was most needed. At the same time, the dangers of reversion to the “pocket lien” and “relation back” doctrines which had prompted the 1938 amendments were sufficiently apparent to lead Congress to insert certain safeguarding provisions.

Probably the most important alteration of the law is the substitution of the rights of a lien creditor for those of a bona fide purchaser as the yardstick by which the time of making of a given transfer is to be determined.22 The general structure of the section has been retained, with the first paragraph defining a preference as before, and succeeding paragraphs laying down the rules that are to be applied in determining the time at which a transfer was made. 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. . . .”23 This pro-

21 H. Rep. 1293, 81st Cong., 1st sess. (1949). There was practically unanimous agreement at the subcommittee hearings as to the desirability of changing §60a and the necessity of care to avoid too great a relaxation. The testimony is, however, singularly unhelpful in the determination of the meaning of specific provisions, since by far the greater part of the discussion concerned the propriety of including in the amended section a rider establishing a national recordation system for assignments of accounts receivable. Hearings before Subcommittee No. 2 of the Committee on the Judiciary of the House, Serial No. 7, 81st Cong., 1st sess. (1949); Hearings before Subcommittee on Bankruptcy and Reorganization of the Committee on the Judiciary of the House, Serial No. 19, 80th Cong., 2d sess. (1948). This provision was not included in the amendment. P.L. 461, 81st Cong., 2d sess. (1950).

22 “A transfer of property other than real property shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee.” P.L. 461, §1, ¶2, 81st Cong., 2d sess. (1950).

23 Id. at p. 1.
vision 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 definition of a lien contained in the section. The amendment also provides that a lien is to be considered as creating rights superior to those of a transferee only if such rights are obtainable by unilateral action by the lienholder, assisted only by ministerial acts of public officials. This was apparently inserted to avoid judicial liberalization such as was indulged in in the Vardaman case, limiting the measurable rights to those stemming solely from the hypothetical creditor’s status as a lienholder and subsequent events wholly within such lienholder’s control.

The bona fide purchaser test has been retained for the purpose of fixing the time of transfer of real estate, it being felt that such retention will not materially hamper legitimate transactions. The business purposes connected with the acquisition of a security interest in real estate are not normally such as to require that the transfer be left vulnerable to an intervening purchaser, nor does it seem unduly burdensome upon a creditor to compel him to comply with an established method of self-protection that has been set up by local law. Another provision that has been retained is that dating a transfer which has not been perfected by the applicable standard prior to bankruptcy as of a time immediately preceding bankruptcy. After setting up the applicable tests, the amendment expressly provides that they are made in terms of hypothetical creditors or purchasers, precluding any possibility that the right to set aside a preference might be conditioned on the attributes of the persons actually represented by the trustee.

The equitable lien obtained through an ineffectual attempt to create a legal lien has been written off the books for the purpose of bankruptcy proceedings. The new act contains an express declaration that the recognition of equitable liens where the parties could have per-
fected a legal lien is against the policy of the section, and a further provision that the failure to take a final step in a transfer precludes the creation of a perfected interest, even though local law may provide that the equitable lien thereby created is superior to liens subsequently acquired by proceedings on a simple contract. 29 This is another precaution against a reversion to the pre-1938 rule permitting secret equitable liens. However, the declaration of policy is modified by a clause permitting the effective transfer of an equitable interest when that is all the debtor has, and is expressly subordinated to the provision for recorded interests discussed below.

Paragraph 7 of subsection a establishes a limited relation back doctrine for the protection of those transfers which are not perfected simultaneously with the passing of the consideration. It provides that where the state law requires that certain acts be performed within a period not exceeding 21 days after the de facto transfer, in order to attain the requisite degree of perfection, the performance of such acts within the period established by state law will lead to a holding that the transfer was perfected at the time of the actual transfer. However, the necessary perfection must in no case be delayed more than 21 days, as performance after that period, even though allowed by state law, will not be related back to the actual transfer. 30 Procrastination beyond the federally-established limit of permissibility will necessarily result in the transfer being one for an antecedent debt. This provision is designed to make allowance for the gaps in time required by the nature of business transactions, and is a statutory declaration of what may be considered a "single transaction." The door to a further revival of the relation back doctrine may also have been opened by paragraph 8, which provides that where a transfer is fully perfected for actually contemporaneous consideration, it shall be deemed to have been made at the time of the transfer to the extent of such consideration and "the other obligations of the transferor connected therewith..." 31 This provision will not move the transfer out of the crucial four-month period but may well move debts incurred before the transaction forward in time so that they will be deemed present value. However, the

29 Id., §6. The purpose of this paragraph is "to make it certain that the amendment will not validate, in the hands of a secured creditor, equitable liens where available means of perfecting legal liens have not been employed by him." H. Rep. 1293, p. 7(3), 81st Cong., 1st sess. (1949). The express subordination to paragraph 7, however, may permit a transfer which at the time of bankruptcy had created only an equitable lien to be subsequently made good as against the trustee.

30 P.L. 461, §1, §7, 81st Cong., 2d sess. (1950).

31 Id., §8 at p. 3.
sentence itself seems to read in a circle. The transfers governed by this paragraph are those capable of being perfected both as between the parties and as against lien creditors by one act, and therefore will not fall within the scope of paragraph 7—or be affected by paragraph 2 if the transaction is properly handled. Thus all it apparently says is that a transfer is perfected when it is perfected, which would be meaningless surplusage.\(^{32}\)

All in all, the amendment of section 60a appears to do away with the objectionable bona fide purchaser test in those cases where its influence was most felt and its application most artificial, while retaining restrictions against the secret equitable liens which had led to the 1938 enactment. The careful definition of the type of lien to be used as a test, the restriction as to the appurtenant rights gauged by the manner of acquisition, and the setting up of a fixed period in which relation back will be allowed should permit any careful creditor to predict the value of his security.

C. Amendment of Section 70c

Section 70c\(^{33}\) of the Bankruptcy Act confers on the trustee in bankruptcy those powers which he possesses solely by virtue of that status, independent of the creditors which he may represent or the transactions which the bankrupt may have carried on prior to the filing of the petition. Before the enactment of Public Law 461, the section gave him two separate sets of rights, the dividing line being drawn on the basis of whether the property involved was in the custody of the bankruptcy court or was in the possession of another person under a claim of right. The statute gave the trustee, as to all property within the custody of the court, all the rights and powers of a creditor acquiring a lien on said property at the time of bankruptcy. The extent of those rights was determined by the law of the jurisdiction governing the property in question.\(^{34}\) As to all other property, a different standard was set up. When there was property involved which was not in the custody of the court but to which the bankrupt or his creditors had some claim, the trustee was, under this section, given the rights and powers of a "judgment creditor then holding an execution duly returned unsatisfied." What these rights were was again left up to state law.\(^{35}\)


\(^{34}\) 4 COLLIER, BANKRUPTCY, 14th ed., §70.49 (1942).

\(^{35}\) Vincent v. Tafeen, (1st Cir. 1930) 40 F. (2d) 823; Janney v. Bell, (4th Cir. 1940) 111 F. (2d) 103. Under the various local laws, this resulted in great variation
The amendment of section 70c did away with this double standard, providing instead:

"The trustee, as to all property of the bankrupt at the date of bankruptcy whether or not coming into possession or control of the court, shall be deemed vested as of the date of bankruptcy with all the rights, remedies, and powers of a creditor then holding a lien thereon by legal or equitable proceedings, whether or not such a creditor actually existed." 36

This amendment was apparently not prompted by any deep-rooted dissatisfaction with the way the clause had previously functioned, but was instead inspired only by a desire for greater correlation among the various sections of the Bankruptcy Act plus a feeling that some compensation should be given to the trustee after the whittling-down that his powers had undergone via the change in section 60a. 37 The assertions that the policy of the bankruptcy system of collection and distribution of assets requires that the trustee be given the rights of a lien creditor exclusively, which had been made as a doctrinaire basis for the amendment of section 60a, were here utilized to justify the expansion of his powers. 38 These rights will undoubtedly still be measured by state law, so that it will be essentially a local matter as to whether the trustee will be empowered to employ ex parte procedures to seize property held by a third person under a claim of right. There seems to be no reason to import the provision of section 60a as to transfers not perfected before bankruptcy into this section, so the trustee may be able to challenge non-preferential transfers by virtue of his new status as a lien creditor. Any other ruling would virtually denude the trustee of all power as to of the trustee's rights, depending on the jurisdiction in which he was operating, and frequently permitted the immunization of faulty transfers from the claims of creditors. For examples of variability, see Lewin v. Telluride Iron Works Co., (8th Cir. 1921) 272 F. 590; Southern Dairies v. Banks, (4th Cir. 1937) 92 F. (2d) 282, cert. den. 302 U.S. 761, 58 S.Ct. 368 (1937); In re Rigney, (D.C. Mo. 1942) 45 F. Supp. 845; United States v. 13, 255.53 Acres of Land, (D.C. N.J. 1944) 55 F. Supp. 334.

38 "Bankruptcy may be regarded as a levy on all the property of the debtor for the benefit of creditors holding provable claims. The broad scope of the proceeding, its notoriety, and considerations of effective administration support the proposal to regard the trustee as obtaining a lien by legal or equitable proceedings on all the property of the debtor wherever situated and by whomsoever possessed. . . . The trustee is . . . entitled to the protection of a holder of a lien by legal or equitable proceedings, not only to take advantage of recording acts or the like, but to take advantage of any rules of State law rendering transfers vulnerable to attack by such holders, and the seniority of his lien should date from the date of his petition in bankruptcy." Testimony of Peter B. Olney, Hearings Before Subcommittee on Bankruptcy and Reorganization of the Committee on the Judiciary of the House, Serial No. 19, 80th Cong., 2d sess., pp. 49-50 (1948).
property not in the control of the bankrupt at the time of bankruptcy, provided the imperfect transfer was not preferential. However, the use of the words "property of the bankrupt" may be construed to leave the trustee to his former remedies against property which is owned by a third person as against the bankrupt.\textsuperscript{39}

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\textsuperscript{39} Under the act prior to the amendment, the trustee had the status of an ideal lien creditor as to all property in the custody of the bankruptcy court. Hoffman v. Cream-O-Products, (2d Cir. 1950) 180 F. (2d) 649. If the construction above suggested is adopted, the powers of the trustee would be greatly diminished. It would seem, therefore, that the announced intent of Congress backing the enactment should lead to a contrary interpretation.