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BANKRUPTCY - VOIDABLE PREFERENCES - TRANSFER PERFECTED WITHIN FOUR MONTHS OF BANKRUPTCY

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COMMENTS

BANKRUPTCY — VOIDABLE PREFERENCES — TRANSFER PERFECTED WITHIN FOUR MONTHS OF BANKRUPTCY — Two recent cases, *Adams v. City Bank & Trust Co.*,[1] and *In re Quaker City Sheet Metal Co.*,[2] both involving section 60 of the Chandler Act, bring to the fore a question of interpretation of that section which has bothered Congress and courts and lawyers for some forty years. The bankrupt executes a mortgage to secure repayment of a present loan, but the recording of the mortgage is withheld until a later date, and finally takes place within four months of bankruptcy. Or, as in the *Quaker City* case, he assigns a chose in action to the creditor in a state requiring notice to the obligor in order to cut off the rights of subsequent as-

[1] (C. C. A. 5th, 1940) 115 F. (2d) 453.

[2] (C. C. A. 3d, 1942) 129 F. (2d) 894.

signees, and such notice is given after the assignment and within the four-month period. Both situations present the same problem. For the sake of simplicity, however, this comment will be confined to the case of recording. The transfer, of course, is good as between the parties, and after the recording it is good as to the rest of the world (with certain exceptions immaterial for our purposes) unless section 60 of the Chandler Act makes it a voidable preference. The applicable part of this section reads as follows:

> "a. A preference is a transfer, as defined in this title, 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 by or against him of the petition in bankruptcy, or of the original petition under chapter 10, 11, 12, or 13 of this title, 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. For the purposes of subdivisions a and b of this section, 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 in bankruptcy or of the original petition under chapter 10, 11, 12, or 13 of this title, it shall be deemed to have been made immediately before bankruptcy.
>
> "b. Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent."[3]

It will be seen that when the trustee attacks a transfer under section 60 there are four questions which are of such nature that they must be answered with reference to some point of time. (1) Was this a transfer for an "antecedent" debt, that is, a debt contracted before the transfer? (2) Was the transfer made "while" the debtor was insolvent? (3) Was the transfer made "within four months before" the filing of the petition? (4) Did the creditor, "at the time when the transfer is made," have reasonable cause to believe the debtor was insolvent? It will also be seen that the last sentence of section 60a says that "for the purposes of subsections a and b of this section" the given transfer "shall be deemed to have been made" when perfected as against bona fide purchasers and creditors.

[3] 52 Stat. L. 869 (1938), 11 U. S. C. (1940), § 96 (a), (b).

The question of construction, put in its broadest form, is whether the last sentence of section 60a means what it says, viz. that "for the purposes of subdivisions a and b" a given transfer "shall be deemed to have been made" when perfected against purchasers and creditors, so that the four essentials must be answered as of that time, or whether it means that it shall be so deemed only for some of the purposes of subdivisions *a* and *b*. If the latter answer be given, then another question follows: for which of these purposes shall the transfer "be deemed to have been made" when perfected? The two cases referred to above reached opposite conclusions on this problem. The fifth circuit, in the *Adams* case,[4] held that the date of original transfer was the significant date so far as the question of antecedent consideration is concerned, since section 60 had been so interpreted by the fifth circuit prior to the Chandler Act, and the court felt that Congress in enacting the Chandler Act did not intend to effect a change. The third circuit, on the other hand, reached a contrary result in the *Quaker City* case.[5] After finding a legislative intent to avoid secret liens, the court held that the last sentence of subsection *a* does mean what it says, and that the date of perfection of the transfer is the crucial point of time for all purposes. Since the applicable state law protected bona fide purchasers in case of nonnotice, the transfer was deemed to be perfected only when notice was given. At that date all four essentials of a voidable preference, including antecedent consideration, were present. It therefore constituted a voidable preference.

I.

In the Bankruptcy Act of 1898, subsection *a* of section 60 simply defined a preference as a transfer or judgment when the bankrupt is insolvent, whose effect "will be to enable any one of his creditors to obtain a greater percentage of his debt than any other of such creditors of the same class," and subsection *b* provided that a preference given within four months of bankruptcy should be voidable if the transferee "had reasonable cause to believe that it was intended thereby to give a preference."[6] Strangely enough, while this section made no reference to recording, section 3 of the act, defining acts of bankruptcy, provided that the four months within which an involuntary petition might be filed should not expire until four months after the recording of a preferential transfer when such recording was required or permitted.[7] Whether the inconsistency between this section and section 60 was intentional, or was the result of inadvertence and poor draftsmanship

[4] Adams v. City Bank & Trust Co., (C. C. A. 5th, 1940) 115 F. (2d) 453.
[5] In re Quaker City Sheet Metal Co., (C. C. A. 3d, 1942) 129 F. (2d) 894.
[6] 30 Stat. L. 562, § 60 (1898).
[7] Id. 546.

(with which the act was replete) is lost in the dusts of oblivion, and need not concern us here. For our purposes, it is sufficient to notice that section 60 did not in any way reach the secret lien. This meant that creditors who relied on the apparent assets of the bankrupt were surprised and disappointed to find a lien on these assets, recorded perhaps the day before bankruptcy, yet indefeasible because the transfer took place more than four months before bankruptcy.

Apparently this gap in the statute was early realized, for in 1903 a new sentence was added to section 60a, reading as follows: "Where the preference consists in a transfer, such period of four months shall not expire until four months after the date of the recording or registering of the transfer, if by law such recording or registering is required."[8] So far as the Congressional debates throw any light on the reasons for this amendment, its purpose was to get at secret liens and to provide a method for avoiding them.[9] It is clear that the amendment simply suspended the running of the four-month period when recording was required; hence the cases decided under it do not deal with our question of antecedent consideration, and so do not concern us here. It became apparent that the amendment was not adequate, and Congress further amended the section in 1910. The House Report of this amendment states its purpose thus:[10]

> ". . . as the law stands, even by the amendment of 1903 as construed in many jurisdictions, a debtor may, if solvent at the time or if presently passing consideration be then received, give a chattel mortgage or other lien upon his property requiring recording by the state law, and the creditor receiving it may keep this lien off the record for months, or even years (if not so done by collusive agreement) and file it within a few days of bankruptcy, and yet the lien be held perfectly good. This is so held because the courts rule that the insolvency of the debtor, the exist-

[8] 32 Stat. L. 799, § 13 (1903).

[9] "As the law [§60] now stands, a preferential mortgage may be given and the creditor preferred, by withholding it from record four months, be able to dismiss the trustee's suit to recover the same, though it was recorded within the four months' period." Statement by sponsor of the amendment, 35 CONG. REC. 6941:1 (1902). The Congressional debates also reveal that the bill, as first presented in and passed by the House, read "required or permitted, or, if not, from the date when the beneficiary takes notorious, exclusive, or continuous possession of the property transferred"; but the Senate amended it to read as finally passed. No reason for the change is apparent, but the words "or permitted" were finally inserted in 1926. 35 CONG. REC. 6938 (1902); 36 id. 1036 (1903).

[10] H. REP. 511, 61st Cong. 2d sess. (1910), pp. 7-8, adopted by S. REP. 691, 61st Cong., 2d sess. (1910), p. 8; incorporated into 45 CONG. REC. 2278-2279 (1910), and quoted in In re Bunch Commission Co., (D. C. Ark. 1915) 225 F. 243 at 249.

ence of a preexisting debt, and all the other elements of the preference are to be determined as of the date of the transfer between the parties.[11] The amendment of 1903 . . . evidently attempted to make the date of the recording in such instances the date at which the existence of insolvency, of a preexisting consideration, and of all the other elements of a preference should be taken.

"Nevertheless, the amendment of 1903 did not effectually accomplish this object. . . .

"The real trouble, it seems, is this: There are, in reality, two times of 'transfer' in such cases: As between the transferor and transferee obviously the time of transfer is the time of the original execution and delivery of the instrument to the grantee or transferee, regardless of its registration; but as to other creditors and the rest of the outer world, the 'transfer' is, by the state statute, not a complete 'transfer' nor, perhaps, a 'transfer' at all until recording. . . .

"This proposed amendment squarely and clearly makes the date of the recording (where recording is required under state law to make the lien valid as against levying creditors) the date at which the creditor is to prove the existence of all the elements of a preference. . . ."

The 1910 amendment wrote into subsection *b* a recording requirement similar to that in subsection *a*, and provided that the transfer was voidable "if, at the time of the transfer . . . *or of the recording or registering of the transfer if by law recording or registering thereof is required*, and being within four months" of bankruptcy, "the bankrupt be insolvent and the . . . transfer *then* operate as a preference, and the person receiving it or to be benefited thereby . . . shall *then* have reasonable cause to believe that the enforcement of such . . . transfer would effect a preference. . . ."[12]

In view of the plain legislative intent and of the language of the amendment, it should clearly cover all secret liens; especially plain is the intent that the question of present consideration should be decided as of the date of recording. This problem, however, was usually not raised or discussed in the cases; when it was, most courts decided it as

[11] At this point, the report in 45 CONG. REC. 2278 (1910), inserts a sentence as follows: "Thus, if at the date of the original giving of the chattel mortgage, the debtor was solvent or present consideration were then given, the transfer would not be a preference, no matter if the instrument be not recorded until within a few hours before the bankruptcy and with full knowledge of the debtor's impending failure."

[12] 36 Stat. L. 842, § 11 (1910) (italics supplied).

of the date of recording.[13] The question eventually became almost moot, for the Supreme Court, in a series of three cases, succeeded in virtually reading the recording provisions of section 60 out of existence by holding that recording was not "required" unless the recording statute protected creditors whom the trustee actually represented.[14] In other words, recording was not "required" unless an unrecorded deed was void as against some flesh and blood creditor of the bankrupt estate. But when this condition was fulfilled, the trustee could avoid the transfer by virtue of section 67a or 70e.[15] Therefore the recording provisions of section 60, so interpreted, added nothing whatever to his powers.

The statute was amended again in 1926 by adding the words "or permitted" after "required" in subsection *a*.[16] It was hoped that this would cause the courts to discard their narrow interpretation of "required," but some courts insisted on following the old cases, saying that subsection *a* was merely a defining section, and that subsection *b* stated what preferences might be avoided. Since the magic word "permitted" did not appear in this subsection, the law was not changed.[17] Other courts, attempting to give some meaning to the 1926 amendment, held that both parts of section 60 should be read together, so that if the transfer constituted a preference under section 60a it would be voidable under section 60b.[18]

2.

Such is the background of section 60. Through forty years Congress has tried to reach secret liens, only to have the courts knock down each attempt by an overly narrow and technical interpretation of the statute, ignoring the spirit of the legislation. In 1938 Congress tried again. This time a group of experts, including credit men, referees, and lawyers, made a thorough study of the Bankruptcy Act and prepared

[13] Brigman v. Covington, (C. C. A. 4th, 1915) 219 F. 500; Williams v. German-American Trust Co., (C. C. A. 8th, 1915) 219 F. 507; In re Caslon Press, (C. C. A. 7th, 1915) 229 F. 133; In re Mossler Co., (C. C. A. 7th, 1917) 239 F. 262. Contra, In re Watson, (D. C. Ky. 1912) 201 F. 962.

[14] Bailey v. Baker Ice Machine Co., 239 U. S. 268, 36 S. Ct. 50 (1915); Carey v. Donohue, 240 U. S. 430, 38 S. Ct. 386 (1916); Martin v. Commercial Nat. Bank, 245 U. S. 513, 38 S. Ct. 176 (1918).

[15] 30 Stat. L. 564, 565 (1898), as amended, 11 U. S. C. (1935), §§ 107 (a), 110 (e); Moore v. Bay, 284 U. S. 4, 52 S. Ct. 3 (1931).

[16] 44 Stat. L. 666, § 14 (1926).

[17] First Nat. Bank v. Livestock Nat. Bank, (C. C. A. 8th, 1929) 31 F. (2d) 416; Hirschfeld v. Nogle, (D. C. Ill. 1933) 5 F. Supp. 234.

[18] Foltz v. Davis, (C. C. A. 7th, 1924) 68 F. (2d) 495; In re Jackson, (D. C. Ark. 1935) 9 F. Supp. 717.

carefully drafted amendments which later became the Chandler Act.[19]

Though the local lawmaker has chosen to limit the benefits of the recording system to creditors who have acquired liens before record or even to leave creditors wholly out of the picture, the occurrence of bankruptcy takes the case out of the province of local law and throws it into the lap of the federal government. Moreover, the bankruptcy changes the fact picture so radically that new factors of policy must enter in. Congress' desire to avoid secret liens is bottomed on the two-fold notion that all creditors of a given class should share equally in the assets of the bankrupt estate, and that if one creditor obtains a favored position by virtue of a secret lien it prevents this equality. Regardless of consideration given at the time of the original transfer, if this transfer is kept secret until the eve of bankruptcy the consideration may be—and usually is—consumed long before the other creditors are notified, so that as far as they are concerned there is a very real diminution of the estate; when the world at large learns of the transfer there is no present consideration. Since the transferee usually "perfects" his transfer only because he foresees impending bankruptcy, it becomes a race of diligence unless secret liens are stopped. When a debtor gives security for a loan, it has been common practice for the creditor to refrain from giving notice, in order, it is said, not to hurt the debtor's credit. But this is to urge the very fraud which is aimed at by all the rules protecting creditors against secret liens. It is also argued that the requirement of notice may force the debtor into bankruptcy, a thing dehors the policy of the Bankruptcy Act, and hence to be avoided. But query how much damage will be done to the assignor's credit by giving notice. In any case, the equities must be balanced, and the rights of other creditors considered.

Does the Chandler Act accomplish its purpose? In order to avoid the construction of the old statute, and to bring about the results hoped for, it was necessary to get away from the word "required." It was also necessary to settle the question of the point of time at which the circumstances of the transfer are to be examined. The problem centering around "required" would seem to be laid at rest by the Chandler Act, since the transfer must be perfected as against bona fide purchasers and creditors. If the recording act protects these claimants, an unrecorded transfer is not perfected. Moreover, this broad language refers not only to transfers which are recordable, but also to any transaction in which notice is required in order to cut off bona fide purchasers or creditors. Thus it applies to assignments and equitable liens, since in both types of transaction a bona fide purchaser or a creditor may, in

[19] An interesting account of the work of these men appears in McLaughlin, "Aspects of the Chandler Bill to Amend the Bankruptcy Act," 4 UNIV. CHI. L. REV. 369 (1937).

the absence of notice, be able to assert rights superior to those of the transferee. A possible question of interpretation arises in the use of the phrase "no bona fide purchaser from the debtor *and* no creditor"; in *In re Seim Construction Co.*[20] the creditors argued that notice must be essential as to both types of claimant before the transfer comes within the statutory language, but the court rejected the argument and held that if notice to *either* kind of claimant is essential the transaction falls within section 60.

The real problem, however, appears to center around the date at which the circumstances of the transfer are to be examined. It has been urged[21] that Congress had no intention to postpone the question of antecedent debt to the time of perfection of the transfer, and in support of this statement the House Report and the Congressional debates are cited. True, there is no indication in these sources that Congress was planning a revolutionary change, or any change at all. But it must be remembered that as far back as 1910 Congress had this very question in mind and attempted to settle it at that time; it must further be remembered that several cases make the date of recording the crucial date for all purposes, and that no Supreme Court case has held otherwise. The Chandler Act can hardly be called revolutionary. In view of the language of the section, it may well be said that there was no need to elucidate the point in the House Report and debates.

Let us look again at the language used. Nothing in the statute indicates that the question of consideration is to be segregated from the other elements of preference; rather, the wording points to a similar treatment of all the elements: "for the purposes of subdivisions a and b" is a blanket order to read the last sentence of subdivision a into each clause where time is a factor. If the transfer is "made" only when "perfected," it is necessarily for an antecedent debt at that time, regardless of the circumstances at the time of the original transfer. If, then, the transfer was for an antecedent debt when made—i.e. when perfected—and if the other elements then appear, it is a voidable preference.

No other interpretation can be read into the section except by assigning two meanings to the word "transfer" in the phrase "transfer . . . for an antecedent debt . . . made . . . while insolvent, etc." On the one hand, "transfer for an antecedent debt" would have to refer to the date of the original transaction, while "transfer made while insolvent, etc." would, on the other hand, refer to the date of perfection of the transfer. It is not likely that a single word, not repeated, is to have two meanings. Nor does anything indicate such an intent.

[20] (D. C. Md. 1941) 37 F. Supp. 855.

[21] Neuhoff, "Assignment of Accounts Receivable as Affected by the Chandler Act," 34 ILL. L. REV. 538 (1940).

Assuming that the question of consideration is to be answered as of the date of perfection, the question arises whether the debt becomes antecedent unless recording takes place simultaneously with the passing of consideration. If a few minutes or a few days elapse before record, does the transfer become preferential? Probably not. If the transferee records with reasonable promptness, courts will probably say that it is a continuing transaction.[22] It is only when the two events—transfer and record—are separated by an appreciable lapse of time that the transaction will be set aside, for it is this evil which Congress has attempted to reach. Admittedly any other construction would work hardship on creditors. There will, of course, be close cases which will have to be placed arbitrarily on one side of the line or the other; but this is no reason to reject an interpretation of the statute which gives rise to such cases. As Justice Holmes has said, when "distinguished extremes have between them a penumbra in which one gradually shades into the other, a tyro thinks to puzzle you by asking where you are going to draw the line, and an advocate of more experience will show the arbitrariness of the line proposed by putting cases very near to it on one side or the other. But the theory of the law is that such lines exist, because the theory of the law as to any possible conduct is that it is either lawful or unlawful. As that difference has no gradation about it, when applied to shades of conduct that are very near each other it has an arbitrary look."[23]

Elizabeth Durfee *

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[22] In re Perpall, (C. C. A. 2d, 1921) 271 F. 466.

[23] HOLMES, COLLECTED LEGAL PAPERS 233 (1920), reprinted from "Law in Science and Science in Law," 12 HARV. L. REV. 443 at 457 (1899).

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