PREFERENCES IN BANKRUPTCY

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THE American Bar Association in 1946 approved a proposal to amend Section 60, the preferential transfer section of the Bankruptcy Act. I was a member of the special committee which prepared this amendment, and acted by informal designation as its draftsman. As a member of the National Bankruptcy Conference I was also part of a joint committee representing the Bar Association and the Conference which prepared the draft that was approved, with some reservations as to language on the part of the Conference, by both the Association and the Conference. It is my purpose here to discuss some of the reasons for the amendment, to outline the procedure by which the present draft was formulated, and to make certain observations regarding its provisions.

Conflicting social philosophies with their infinite variations are apt to affect any law making. Consciously or unconsciously, social and political attitudes influence even those concerned with such an apparently technical matter as the definition of preferential transfer in bankruptcy. If one believes that bankruptcy legislation can be used to accomplish broad social purposes, his recommendations are not likely to coincide with those of one who thinks that bankruptcy has a much narrower function.

To me, federal bankruptcy is simply a convenient device to administer an insolvent estate as a whole for the benefit of all creditors, with no bias against any creditor or class of creditors, and with only such priorities as accord with our traditions. A subsidiary objective is to give certain debtors an opportunity for a new start by discharging them from some of their obligations. The administration is federal rather than state, in recognition of the fact that under modern business conditions a debtor is likely to have assets in different parts of the country. Since Congress has been given bankruptcy power by the Constitution, a unified administration can be had most easily under federal law. Federal bankruptcy also avoids certain constitutional obstacles to a discharge by state process. Nothing in the Constitution nor in the history of bankruptcy legislation, at least until

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† The present members of the special Committee of the Corporation Banking and Mercantile Section are Milton P. Kupfer, chairman, Homer J. Livingston, J. Francis Ireton, James A. McLaughlin, and the writer.
1938, ever hinted that bankruptcy was to be used to reform state rules of property and contracts. In a recent article Referee Oglebay contends that the purpose of bankruptcy is the protection of unsecured creditors. Judge Clark in the *Tonto Realty* case speaks disparagingly of the creditor who obtains an advantage by superior acumen or better economic position. Such remarks seem to belong with those about preferring human rights to property rights, which overlook the fact that security of property is one of the great human rights. Bankruptcy scarcely seems to me a proper agency for redistributing wealth by governmental fiat. Socialistic aspirations are certainly not to be denied expression, but until public opinion has approved them it is unsporting for their exponents to try to attain them by indirection against the unwary. It is no more the business of a bankruptcy court to favor unsecured creditors over secured creditors than it would be to favor merchandise creditors over financial creditors, or creditors who had sold cabbages to the bankrupt over creditors who had sold him artichokes.

Bankruptcy, in the opinion of many, is a phase of equity. Even if this is too broad a statement, a bankruptcy court by the words of the statute has equitable as well as legal jurisdiction. No one denies the applicability to bankruptcy of such maxims as that equality is equity. To assume that a bankruptcy statute should be framed to reduce all creditors to a common level, irrespective of their contracts with the bankrupt, is a novel view of the doctrine of equitable equality. The same sort of spurious logic might conclude that because the Declaration of Independence speaks of all men as created free and equal, there should be no bar examinations. What equality in equity demands is a fair application of rules to all persons. Individuals within a class must be treated equally, but a reasonable classification is not excluded.

That insolvent debtors can act unjustly by preferring some creditors is obvious. Bankruptcy is not the only field of law where preferences by insolvents are regarded as inequitable. While the common law did not place an insolvent's preferences in the category of fraudulent conveyances, many students think such an extension of the law of fraudulent conveyances would be abundantly justified. No one quarrels with the doctrine that preferences by an insolvent may be considered as inequitable and made voidable in bankruptcy. Since *Twyne's case*, if not longer, a secret transfer of assets which are allowed to remain in the beneficial manage-

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3 *Olden v. Tonto Realty Corp.*, 143 F. 2d 916, 920 (C.C.A. 2d, 1944).
ment and control of the debtor has been viewed with suspicion and has been regarded as some evidence of fraud. The law was well established, however, that such evidential factors could be met completely when it was shown that the transfer was for the purpose of creating in good faith security for the creditor. As a characteristic example, a chattel mortgage is not a fraudulent conveyance. This latter rule did not satisfy a good many people. They thought the secret security transfer had such serious potentialities of fraud that it should be deemed fraudulent. To prevent such a result they proposed to substitute notoriety for secrecy. In simpler words, they would protect a chattel mortgage only if it were publicly registered. The same considerations to an even greater degree justified the adaptation of recording statutes for real estate transfers.

That there is some danger of injury to creditors and purchasers by ostensible ownership of land or chattels which have already been secretly transferred may be admitted. It is true that possession has never been conclusive evidence of ownership. All sorts of bailees, agents, lessees, and licensees are in actual or apparent possession of assets they use, without any power to deprive an owner of his paramount interest. Their possession gives their creditors no chance of acquiring any property interest superior to that of the true owner. Furthermore, in modern life credit is rarely extended on the basis of ostensible ownership. No substantial number of credit transactions occur without the debtor’s furnishing a financial statement and banking and other business references. The creditor obtains additional information from credit agencies and personal inquiries. Purchasers, except in the regular course of business, do not buy without inquiring about the title from the seller and others. Those who talk of the deception of the innocent by ostensible ownership assume a degree of naïveté in others they would scarcely ascribe to themselves. It would require considerable search in America to locate a person so innocent of the actualities of modern life that he would believe his neighbor owned all the things on his premises. While chattel records have some utility for credit agencies, their chief significance is to prevent an insolvent from yielding to the temptation to protect his family and perhaps himself at the expense of his creditors. Wives, relations, and friends of men in business often make advances, not strictly as partners, but which are meant as a stake in the business. Such advances are normally unsecured when made. If there were no recording statutes or no penalty for delayed recording, an insolvent might execute an antedated chattel mortgage to these creditors, with the expectation that they would take all his assets and permit him

to continue to enjoy their benefits, directly or indirectly. Where he had received no early advances, he might invent them, and in many cases the proof of the facts would be difficult. While there is not much statistical evidence that fraud has been perpetrated as here outlined, this is a matter upon which the expert opinion of those experienced with insolvency administration may well be accepted. There is little doubt that such opinion favors recording as a preventive of fraud.

If agreements to pledge were allowed to create interests valid against creditors, such agreements could also be a device for those fraudulently inclined. To agree that some security devices, if secret, could be the ready tools of the unscrupulous is by no means to agree that no security should be valid without recording. The nature and use of some forms of security make it almost impossible for them to be used fraudulently without easy detection. Even such a simple security as the conditional sale cannot be conveniently employed by the fraudulent. Perhaps the best argument for recordation statutes in respect of conditional sales is that functionally the conditional sale is about the same thing as the chattel mortgage. If one carries the burden of recording, the other should be subjected to a similar burden, so that the choice of one rather than the other can be made solely on the basis of business utility.

Accounts receivable are not property which have a visible ownership. Ostensible ownership has no bearing on the problem of recording of accounts receivable. The normal size of transactions in accounts receivable financing, and the available bank records of such financing, make it practically impossible for assignment of receivables to be employed fraudulently in any way in which recording of the assignments would have much relevance. We are not concerned with the man who deliberately concocts a swindling device. He will not be restrained by recording statutes but must be left to other civil remedies and the criminal law.

Statutory factors' liens and trust receipts are not intended to affect the title of purchasers in the regular course of business. While public notoriety of factors' liens may have some slight importance to creditors, the public record of the tripartite trust receipt has practically no significance. After years of study of trust receipts and a wide acquaintance with those who use them, I have never heard of a case of their use to deceive creditors, and have never met a person who thought there was any real danger that they would or could be so used. Such security as the conditional sale, the statutory factors' lien, and the trust receipt does not represent anything taken from unsecured creditors. On the contrary, the holders of such forms of

7 In most organizations where security problems are debated an active and persistent minority believes in broadening recording requirements even to cover assignments of accounts.
security have added in most cases much more to the assets of the debtor than their security interests at the time of insolvency. The hostility of trustees in bankruptcy and other friends of the unsecured creditor to the holders of the typical modern forms of security, on the basis of supposed harm or unfairness by the secured creditor, has practically no justification in statistical or other evidential fact.8

Congress has no constitutional authority over the law of property. Except under the commerce power, the federal government has little jurisdiction over the law of contracts. While uniformity in certain aspects of the law of property and contracts is desirable and has been recognized by voluntary action of the several states, the diversity of conditions throughout the nation justifies allowing the states a considerable area in which they are free to experiment with modification of property and contract law. State freedom is worth maintaining even at the cost of a certain delay in the progress towards a commendable uniformity. It has always been the policy of bankruptcy legislation to respect property interests recognized by state law except in such matters as the avoiding of preferences. Thus state exemption statutes are given complete effect in bankruptcy, although a number of such statutes would by no means be approved by the consensus of opinion among lawyers. The different states have a variety of recording statutes and individual states usually have several such statutes, often inconsistent in terms and effects. Some states require the recording of conditional sale contracts; others do not. In some states unrecorded real estate transfers are valid against all but bona fide purchasers. In other states a record is necessary also to protect transferees against creditors. Similar recording statutes are subject to different interpretations in different jurisdictions. Sometimes a late recording will defeat any creditor who subsequently levies on the property in question. In others a late recording is a nullity against creditors. The states have a great variety of rules in respect of the effect of actual notice as a substitute for recording.

The complexity and uncertainty of the application of recording statutes has long vexed many persons interested in bankruptcy. The believers in recording as an end in itself want to use bankruptcy to coerce the states to adopt better and stricter recording requirements. These people and others think that the bankruptcy law ought to be framed to give a uniformity of application in bankruptcy even to divergent state laws. Some even propose a federal recording system.

8 Some lawyer can write an informative article if he will make a study and report of the actual use made of the trust receipt recording machinery. My understanding is that in New York only a small portion of the total volume of trust receipt business is recorded, and that examinations of such records as exist are infrequent.
I have already indicated a scepticism as to the necessity of a greater extension of recording requirements. The use of recording machinery costs something. This cost is a burden on the national economy. It adds to the expense of the lender which is passed on to the borrower who, if it is at all possible, pushes it further on to the ultimate consumer. Those who want to extend recording should assume the burden of showing it is worth what it costs. We have too many laws which impose a charge upon the 99 per cent of honest business to protect a tiny fraction of careless dupes from hypothetical harm from 1 per cent of dishonest business. In at least some of these cases losses could better be distributed by self-insurance through reserves against losses or by having the risk underwritten by professional insurers. In addition the recording systems increase the number of governmental employees. While the cost of this service is borne by the users rather than by the general taxpayer, the cost is really on the public. Moreover, the economic utility of the public servant is generally much less than the potential utility of the same person in productive employment.

Bankruptcy rules about preferences and fraudulent conveyances, especially the former, are intimately connected with state recording statutes. A preference is a transfer in payment or part payment of an antecedent debt or as security for it. If the transfer represents merely a fair exchange in value, it is no preference whether or not one or both parties are insolvent and whether it is made five years or one hour before bankruptcy. The bankruptcy law could set aside preferences made any reasonable period before bankruptcy. In fact, it does not concern itself with preferential transfers made more than four months before the petition. A primary task of the trustee in bankruptcy is to determine when transfers by the bankrupt were made. This would be relatively simple if there were no recording statutes. The trustee would merely find out the date of the transfer. The recording statutes, however, make unrecorded transfers ineffective against some persons. The trustee must therefore determine whether as against him, the transfer must be dated when made, or if it can be considered as made at some later date, presumably the date of recording. If he can reach the latter conclusion, a transfer for an antecedent debt made more than four months before the petition may come within such period, or a transfer for present new value may become one for an antecedent debt.

A preference has a double significance in bankruptcy. It is an act of

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9 The trustee in bankruptcy under the Act, aside from what he can do under state laws, may set aside fraudulent transfers made up to a year before bankruptcy. 52 Stat. 875 (1938), 11 U.S.C.A. § 107d (Supp., 1946).
bankruptcy upon which a petition may be founded, and it may be avoided by the trustee in order to add to the assets of the estate. In the Act of 1898 in its original form, the preferential transfer was dated, for the purpose of determining the time within which a petition could be filed, from the date of recording if recording was required or permitted. Nothing was said about recording in Section 60. If the transfer was good against the bankrupt without recording, it was valid against the trustee unless it was actually invalid against creditors represented by the trustee. Although for some purposes the petition was regarded as an attachment, the trustee was not allowed to avoid preferences for lack of recording, even if recording was required against lien creditors and recording had not occurred at the date of bankruptcy. Thus in *York Manufacturing Co. v. Cassell*, when the state law invalidated unfiled chattel mortgages against creditors who fastened a lien on the chattel before filing, the mortgagee under an unfiled mortgage was protected against the trustee. Congress responded in 1910 by an amendment to Section 47 declaring that the trustee "as to all property in the custody of the bankruptcy court, shall be deemed vested with the rights, remedies and powers of a creditor holding a lien by legal or equitable proceedings thereon; and also, as to all property not in the custody of the bankruptcy court, shall be deemed vested with all the rights, remedies and powers of an execution creditor holding an execution duly returned unsatisfied." From that time the trustee could defeat any unrecorded transfer where the transfer had to be recorded to be good against lien creditors. It had no effect if recording was required only against bona fide purchasers.

Congress in 1910 also changed Section 60b by providing that if recording was required, the transfer was voidable within four months of the recording, assuming that the person receiving it had reason to believe that the transfer would effect a preference. Nothing was said about perfecting transfers in other ways than by recording.

The 1910 amendments were involved in *Bailey v. Baker Ice Machine Company*, a conditional sale case where filing had occurred within two months of bankruptcy. The court held that there was no transfer by the bankrupt. The rule of this case has never been questioned by the Supreme Court except in a footnote to the *Klauder* case. The definition of "transfer" has since been broadened, especially by the phrase "fixing a lien." The prevailing opinion today seems to be that the effect of a late filing of

10 201 U.S. 344 (1906).
12 239 U.S. 268 (1915).
a conditional sale is the same as in the case of a chattel mortgage. Functionally considered, the chattel mortgage and the conditional sale are almost identical and should be subject to the same law with respect to preferences.

Carey v. Donohue[^15] was a real estate case from Ohio, where an unrecorded real estate mortgage was held valid even against lien creditors although not against bona fide purchasers. The mortgage was actually recorded before bankruptcy, but even if it had not been it would have been good against the trustee. In its opinion the court took the important position that the trustee's rights before bankruptcy were to be strictly measured by the rights of the creditors he represented. In the usual case such creditors had no liens.

Martin v. Commercial National Bank[^16] in 1918 gave the Supreme Court an opportunity to clarify its interpretation of Section 60. The chattel mortgage involved had been executed long before bankruptcy, but was filed only the day before, when the mortgagee was fully aware of the debtor's insolvency. The Court said that since prior to bankruptcy no creditors represented by the trustee had a lien, the unfiled mortgage was good against such creditors. At bankruptcy, the mortgage, being filed, was good against the trustee as a lien creditor. It did not need to be dated from the date of filing, because since the transfer was made more than four months before bankruptcy and since the transfer was not a voidable preference, it did not become such because of the late recording, because the perfection related back to the date of the transfer.

Six years earlier in Sexton v. Kessler & Company[^17] the Supreme Court had held that an agreement to pledge more than four months before bankruptcy, which was consummated by delivery within four months of bankruptcy, was not a voidable preference.

Section 60a[^18] was amended in 1926 to include the word “permitted” with “required” in reference to recording, but no change was made in Section 60b defining the trustee's power to avoid preferential transfers. As the Act stood in 1938, if a transfer was good against non-lien creditors before bankruptcy, and it was perfected in any way before bankruptcy, the perfection related back to the time the transfer was made. There was considerable dissatisfaction with this situation[^19]. Many persons thought the Supreme Court's strict construction had defeated Congressional in-

[^16]: 245 U.S. 513 (1918).
[^17]: 225 U.S. 90 (1912).
[^19]: See McLaughlin, Amendment of the Bankruptcy Act, 40 Harv. L. Rev. 341, 583 (1927); McLaughlin, Aspects of the Chandler Bill to Amend the Bankruptcy Act, 4 Univ. Chi. L. Rev. 369, 393 (1937).
Others felt also that holders of secret liens were destroying the beneficial purposes of both the recording statutes and the preference sections of the Bankruptcy Act. On the other hand, the existing rules had some justification, since it was frequently impossible to consummate a security transfer at the time an advance was made. Within reasonable limitations, the doctrine of relation back served a legitimate business purpose.

The draftsmen of the Chandler Act were determined to make a clean sweep of the relation back doctrine and to avoid existing complications in measuring the interests of the trustee by the rights of actual creditors. A simple but drastic solution was to say that so far as the trustee was concerned no transfer was valid unless it was perfected four months before bankruptcy so that it was good against a bona fide purchaser. In other words, for the purpose of dating transfers they were dated only at the time they were valid against a hypothetical bona fide purchaser. While the trustee at the date of bankruptcy had the position of a lien creditor, for four months before bankruptcy in the matter of avoiding transfers he had the position of a bona fide purchaser. The draftsmen provided in fact that the transfer must also be perfected against creditors.

This change was not only illogical, since the trustee was administering an estate for the benefit of creditors, not purchasers, but it showed serious unconcern for important and desirable developments in the modern law of security.

Modern business is characterized by large production and distribution upon comparatively small margins of profit. A good deal of the product of this business is sold on credit. This necessitates working capital, which is obtained from banks and other financing institutions. The security problem is to enable the debtor to secure his borrowing with the assets he must sell to liquidate his loan. His creditors are willing to trust him to account for the proceeds of loans. What they want is a security good against other creditors. They have no concern for making their security interest superior to the interest of purchasers in due course of business. Trust receipts, factors' liens, chattel mortgages on stocks of goods, conditional sales for resale, pledges after chattels are returned for temporary and limited purposes, do not and are not intended to prevent sales to bona fide purchasers.20

With its hypothetical bona fide purchaser test in Section 60 the Chandler Act said in substance that, irrespective of state law and its requirements, a secured creditor would not be protected in bankruptcy for the wholly irrelevant reason that his interest was not intended to prevent the

debtor's continuing to carry on his business. It was a capital illustration of burning a barn to kill a mouse.

Section 67b did qualify to some extent Section 60. Statutory liens, created or recognized by statute for landlords, merchants, and other classes of persons, are excepted from the provisions of Section 60. What liens are statutory liens and what are consensual liens, subject to statutory regulation, is not clearly determined. It is my opinion that the modern factors' lien is a statutory lien. It certainly is not the old common law possessory factors' general lien. I also think that the trust receipt under the Uniform Trust Receipts Act is a statutory lien. In states not having the Uniform Trust Receipts Act, and where the trust receipt transactions are recognized as a *sui generis* type of security, it is possible that there is no transfer within the terms of Section 60. If this is true in such states Section 60 is not applicable to trust receipts. I am also inclined to believe that when a pledge is once consummated by possession so that it is then valid against a bona fide purchaser, that determines the date of the pledge under Section 60. If the pledged chattel is later returned to the pledgor, so that the pledgor has the power to transfer title to a bona fide purchaser, it seems to me, as a matter of technical interpretation, the pledge is still valid against the trustee and would be valid even after bankruptcy, assuming that in the jurisdiction an attaching creditor could not acquire an interest superior to the pledgee.22


22 In a discussion of Section 67b at the 1947 convention of the Commercial Finance Industry, some of those believing that Section 67b did not save factors' liens and trust receipts from the operation of Section 60a argued that the former section referred only to liens created or recognized by state laws irrespective of any agreement regarding the security interest itself. Thus a person who does work or furnishes materials in circumstances covered by a mechanics' lien law obtains the lien automatically, irrespective of any agreement relating to it, admitting that he may be able to waive it. Where a state gives an equitable lien on the property of an embezzler to the victim of an embezzlement, there is no element of a consensual transaction. In the case of chattel mortgages and the like, and in the view of some, also in the case of trust receipts and factors' liens, the lien is primarily consensual. Where the lien is one at common law, but not regulated by statute, this is not what the Bankruptcy Act means by statutory or other liens created or recognized by state law. It is also pointed out that Section 67b refers to liens for "classes" of persons, and this does not appear to mean a lien which might be enjoyed by anyone who participates in a certain kind of transaction.

While the point is uncertain, it seems to me that factors' liens and trust receipts are liens for a class of persons, while in a sense there is no class of beneficiaries of chattel mortgages and conditional sales. The states' creative contribution is also larger as to the former. It can scarcely be the purpose of Section 67b to destroy liens which are not secret and which conform to state standards. I doubt if the courts will extend logical formalism in interpretation of Section 60a to make it control Section 67b. In the final analysis, if there is any inconsistency between the two the latter will prevail. On the returned pledge question, the Act deemed it made at the time when it was so far perfected. When a pledge is complete by delivery, it is perfected against a bona fide purchaser. The Act does not say it must be kept perfected.
Whether or not I am correct in my interpretation of Section 67b with respect to trust receipts and factors’ liens, it seems likely that certain other security interests, such as chattel mortgages on stocks of goods, which may be valid under state laws against creditors, are not good against the trustee under Section 60.

The story of accounts receivable and the Chandler Act has been told so often and so ably that it is not necessary to repeat it here. Suffice it to say that as a result of the *Klauder* decision,*23 a security interest which need not be recorded by state law, and which has added to the assets of the debtor, perhaps with the knowledge and enthusiastic acquiescence of other creditors, can be destroyed by the trustee in bankruptcy simply because a hypothetical bona fide purchaser, not merely by his purchase, but by something additional following his purchase, could have defeated the assignment of the accounts.

The present situation under the Chandler Act places an unconscionable burden upon lawyers who advise business men. In some cases they must decide against allowing customary and desirable practices to continue. In other cases the best they can do is to say that perhaps by carrying a case to the Supreme Court they might obtain sanction for a security interest long recognized in state practice and confirmed by state statutes.

My own opposition to the present form of Section 6oa of the Chandler Act has been accompanied by suggestions intended to be constructive and attempting to retain the main purposes of the amendment while preserving legitimate security interests. My first proposal, which was supported by the Bankruptcy Committee of the Association of the Bar of New York, was to eliminate the hypothetical bona fide purchaser test and substitute a hypothetical lien creditor test. This seemed to accord with the theory of bankruptcy, defeat the relation back rule, and take care of the principal security situations heretofore discussed. The amendment could be effected with a minimum change in wording.

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The consternation which followed the *Klauder* case induced the Corporation Banking and Mercantile Section of the American Bar Association to appoint a special committee to consider the amendment of Section 60a. In the correspondence which followed the announcement of its plans, several suggestions seemed worthy of notice. The fact was that since in some jurisdictions a garnishing creditor might defeat an assignee of accounts receivable, the hypothetical lien creditor test was unsatisfactory. It was suggested that after stating in general a hypothetical lien creditor test, a separate provision be inserted to the general effect that no transfer in fact for present consideration should be regarded as a preference unless the applicable law required some type of perfection which had not been effected.

There was also objection to the reference to a creditor with a lien by legal or equitable proceedings. It was pointed out that under some state laws, particular types of creditors had a special priority. For example, successful claimants for damages in motor vehicle cases might have a priority over lien creditors. It was felt that the theoretical possibility of the existence of such a creditor should not be a measure of the trustee's right to set aside a preference. The amendment accordingly referred to a simple contract creditor without special priority.

State laws frequently provide that a recording within a stated period of a transfer shall be effective as of the date of the transfer. Others have no special provision, although a reasonable time rule is common. It was felt fair to fix a thirty-day period where the applicable law fixed no period or some longer period. If the state fixed a shorter period, that was controlling. Some sentiment was expressed in favor of a ten-day period, but this seemed unduly short, since financing transactions may involve parties separated by the width of the continent.

The Committee, both officially through its chairman and informally by its several members, conducted a voluminous correspondence with persons interested in Section 60. The Committee had several meetings at which experts outside the Committee were invited to state their views. One meeting was held jointly with a committee of the National Bankruptcy Conference, and a final meeting was held with the whole Conference. The Committee tried to satisfy so far as possible every interest it considered legitimate. It also agreed to several suggestions with which it had less sympathy, where it could do so without affecting its main purpose. The Committee argued it was advisable to compromise as to details for the sake of removing opposition in advance and to insure that those favoring a change in existing law would present a united front to Congress. The
refinements thus introduced in the draft bill altered the original simplicity of earlier proposals. While the changes are perhaps technically justifiable, they have also made the proposed Act somewhat more difficult reading. My own wish was to use such words as rights and interests only in the sense approved by the American Law Institute in its Restatements, and I agreed only with reluctance to retain the usage now rather inconsistently employed in various sections of the Bankruptcy Act.

The amendment as now introduced in Congress by the Reed Bill contains the following features:

The preference section is now made applicable to the whole Act with the exception of Chapter IX, relating to arrangements by local taxing districts, that is, the municipal bankruptcy chapter. The principal change thus effected is to make the section applicable to Section 75 dealing with agricultural compositions and extensions.238

The hypothetical lien creditor test is adopted in place of the hypothetical bona fide purchaser test for determining the date of preferential transfers. The Bar Association Committee included, at the request of the National Bankruptcy Conference, a retention of the bona fide purchaser test in respect of real estate transfers for or on account of antecedent debts. The purpose of this qualification is to override the decision in Carey v. Donohue.24 I regard this as an unnecessary intrusion upon state law, but it seems to me of little commercial or other importance. Our hypothetical creditor is one "obtaining under applicable law by legal or equitable proceedings on a simple contract a lien on such property without a special priority (whether or not such a creditor exists)." We date the transfer for the purpose of the preference law at a time when it became so far perfected that our hypothetical creditor could not defeat it. If a transfer is good four months before bankruptcy against an ordinary contract creditor, assuming he did everything open to him under applicable law, it is good against the trustee. There have been many arguments about the proper language by which to express this simple notion. Anyone who thinks he can improve the rather involved phraseology is welcome to suggest a more felicitous wording.

If the transfer in question is never perfected, the amendment states it will be considered to have been made immediately before bankruptcy. It seemed to me that this provision was unnecessary and that it was enough, where transfers were not perfected at all, to make them good against a levying creditor, to allow the trustee to rely upon his position at the date of the petition, as provided in Section 70. My argument was that the

238 Section 75 has since expired by its own time limitations. 24 240 U.S. 430 (1916).
similar sentence in the present law was relevant only because of the bona
fide purchaser position of the trustee before but not after bankruptcy.
Perhaps the real estate proviso with its bona fide purchaser test justifies
the retention of the "immediately before bankruptcy" clause. The clause
may also have additional technical significance. My chief reason for not
objecting more strenuously to the clause is, however, that I think it will
be of little practical significance.

The sense of the original Bar Association paragraph about transfers not
for an antecedent debt was that no transfer for a present consideration
should be deemed a preference unless there were recording requirements
under applicable law which were not complied with. Because of the techni-
cal ambiguity of the expression "present consideration" I proposed the
words "new value." In our session with the National Bankruptcy Con-
ference we carelessly permitted the insertion of the words "present and
fair consideration." Upon further study this was seen to be highly objec-
tional. Excessive consideration could already be recovered by the trust-
ete under Section 67. To make the test of a preference what some court
might regard as an undue margin of security is obviously unjust. The para-
graph was later revised to substitute the words "new and contemporaneous
consideration to the extent of such consideration and interest thereon and
the other obligations of the transferor connected therewith." The new
language is not particularly artistic but at least spells out what we were
trying to say.

The draft bill also inserted a provision not in the original Bar As-
sociation draft to the effect that a transfer to secure a future loan, if the
loan is made, shall have the effect of a transfer on account of a new and
contemporaneous consideration. This may be all right so far as the law
of preference is concerned, but may result in complications under the law
of some states where a subsequent creditor may obtain a priority over the
one with the future loan contract for security. The preference section has
no fair application to the competing claims of secured creditors, and this
language may need further clarification.

With all the study the Committee has made there are at least two prob-
lems presented to it about which it has not yet made any concrete pro-
posals. The first relates to chattel mortgage construction loans, for ex-
ample for aircraft construction. Under the laws of many states an effec-
tive mortgage cannot be made upon a chattel not in existence. When the
loan is made the security at best is an agreement to give a mortgage. Even
when a mortgage with an after-acquired property clause is recognized as
a present mortgage, the interest thus created may not be good against an
attaching creditor even if the mortgage is duly filed. The mortgage is not sufficiently perfected to satisfy our hypothetical judgment creditor test. If a new mortgage is given after the chattel is in existence, it may be regarded as security for an antecedent debt. The Committee thus far has declined to try to cover this situation under Section 60, and has left the matter for determination under state law.

A second matter involves emergency loans where the loan must be made immediately but where some delay cannot be avoided in providing security. For example, a loan is made on Friday in New York to a Chicago debtor upon his agreement to pledge securities in a safety deposit box in Chicago. Access to the box cannot be had until Monday. The pledge until the delivery of the securities is not so far perfected as to be good in most states against a levying creditor. When it is perfected it is security for an antecedent debt. Even under the Bar Association’s draft, if bankruptcy ensues within four months of the delivery, the transfer is a voidable preference. A similar situation might be presented where a loan was made to a corporation upon an agreement for a real estate mortgage but where the mortgage could not be executed until some time after the loan. These are situations where the relation back rule operated more equitably than the present or proposed statute. Our provisions regarding perfection requirements do not fully cover the point, because the applicable law may really require perfection at once to create a security interest valid against our hypothetical judgment creditor. Perhaps we should add a sentence providing that where a present transfer is contemplated and is consummated by delivery or execution of necessary instruments at the earliest practicable time, it shall not be regarded as a transfer for an antecedent debt. I see little likelihood that such a provision would result in any harm to unsecured creditors. The facilities of emergency loans might save an occasional business from disaster.

The Bar Association Committee’s recommendations have been widely supported by organizations of lawyers and businessmen. The present uncertainty regarding all sorts of inventory financing, which it is estimated amounts to about $2,000,000,000 annually, presents an emergency which should receive the earnest attention of Congress. The problem today is much more acute than during the war years, when questions of security were largely academic.25

25 While I have no authority to speak for other members of our Committee, my own position is that no further amendments should be made to our draft until it has been considered by a Congressional committee or subcommittee. Expressions of opinion in its favor have been overwhelming. Even a brief business recession would cause the present Bankruptcy Act’s preference section to work grave injustice. Nevertheless, it has not been possible even
Following is the draft of the American Bar Association’s Committee as approved in principle by the National Bankruptcy Conference, and as introduced in the House of Representatives, March 6, 1947, by Mr. Reed of Illinois:

SECTION 60a

60a (1) A preference is a transfer, as defined in this Act, 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 original petition initiating a proceeding under this Act [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; provided, however, that this section shall have no application to proceedings under Chapter IX of this Act.

(2) For the purposes of subdivisions (a) and (b) of this section, and subject to the provisions of paragraph (3), a transfer shall be deemed to have been made or suffered at the time when it became so far perfected that no [bona fide purchaser from the debtor and] creditor holding a lien without a special priority, obtained on such property under applicable law by legal or equitable proceedings on a simple contract (whether or not such creditor exists), could [thereafter have acquired any rights] acquire, after such perfection, 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 original petition initiating a proceeding under this Act [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] the filing of such original petition; provided, however, that where real property is transferred for or on account of an antecedent debt,
the 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 could acquire, after such perfection, any rights in the property so transferred superior to the rights of the transferee therein.

(3) A transfer, wholly or in part, for or on account of a new and contemporaneous consideration shall, to the extent of such consideration, be deemed to be made or suffered at the time of the transfer, unless the applicable law requires the transfer to be perfected by recording, delivery or otherwise, in order that no creditor described in paragraph (2) could acquire, after such perfection, any rights in the property so transferred superior to the rights of the transferee therein. A transfer to secure a future loan shall, if such loan is actually made, have the same effect as a transfer for or on account of a new and contemporaneous consideration. If any requirement specified in this paragraph (3) exists, the time of the transfer shall be determined by the following rules:

I. Where (A) under applicable law the transfer is required to be perfected within a specified time, not more than thirty days after the transfer, and the transfer is perfected within such time; or where (B) under applicable law no time is specified or the time specified is more than thirty days, and the transfer is perfected within thirty days after the transfer, the perfection shall be deemed to be made or suffered at the time of the transfer.

II. Where the transfer is not perfected in accordance with the provisions of subparagraph I, the transfer shall be deemed to be made or suffered at the time of the perfection.

Since the introduction of the amendment to Section 6oa additional amendments, criticisms, and suggestions have been offered from many sources. Some of these deserve comment.

FEDERAL RECORDING

An amendment, Section 70j, to provide a federal recording requirement, has been drafted by W. Randolph Montgomery of New York, counsel for the Retail Men's Credit Association. Professor McLaughlin has also made certain suggestions for a similar amendment to Section 70. These learned men are my friends and I recognize the respect their opinion is entitled to receive from all persons interested in creditors' rights. While I do not believe that federal recording is either necessary or desirable, the matter is one upon which well-informed persons disagree, and deserves the mature consideration of the Bar. Even if I favored federal recording, I should regard it as less of an emergency than the amendment to Section 6o, and
thus far I am confident that Professor McLaughlin is of the same opinion. The amendment to Section 6o is supported by a variety of groups that are sharply divided about federal recording. Each measure should be presented independently to Congress. If there is any merit in federal recording it will be just as apparent after the amendment of Section 6o as now.

Mr. Montgomery's draft for Section 70j defines "account" or "account receivable" to mean open book account, mutual account, or account receivable arising in the regular course of business. He excludes indebtedness represented by negotiable instrument or judgment, or secured by title or lien on tangible property. The filing officer is the clerk of the United States District Court of the district or division. The filing is similar to that now required under the Uniform Trust Receipts Act, that is, it is not a record of the separate assigned accounts but of the fact of an assignment or intended assignment, between the named parties.

Assignments of accounts are to be invalid against a trustee in bankruptcy unless filed. Provision is made for cancellation of filing. Fees are one dollar each for filing, including indexing, issuing a receipt, and furnishing a certificate. If there is a state recording requirement for assignments, and there is compliance therewith, it is not necessary to employ the federal filing facilities.

EXTENT OF FEDERAL POWER OVER SECURED CREDITORS

My somewhat casual expression of doubt as to constitutionality of Section 6o as interpreted by the Circuit Court of Appeals for the Third Circuit in the Klauder case before the Supreme Court's decision has brought me an amount of correspondence perhaps disproportionate to the current importance of constitutional discussion relating to bankruptcy. A safe observation is that the Supreme Court probably will not declare unconstitutional any bankruptcy provisions which Congress is likely to enact. Nevertheless the problem of how far Congress could go in nullifying the interests of secured creditors is worthy of attention. I have already said that Mr. Oglebay, one of the learned editors of Collier on Bankruptcy, regards one purpose of the Act as the protection of unsecured creditors. While this seems a fair summary of his opinion, a more precise statement is that he says the purpose is equitable distribution among unsecured creditors. Whatever Mr. Oglebay's opinion may be, some persons do believe that Congress has practically unlimited power to avoid

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27 Hanna, Some Unsolved Problems under Section 6oa of the Bankruptcy Act, 43 Col. L. Rev. 58, 61 (1943).
28 In re Quaker City Sheet Metal Co., 129 F. 2d 894 (C.C.A. 3d, 1942).
29 Collier, Bankruptcy (Moore and Oglebay's ed., 1947).
security interests, and among them are those who would be pleased if Congress went as far as it could. They would probably admit that as a matter of retrospective application the bankruptcy power is limited by the Fifth Amendment. They believe that Congress has the power to say that all security interests credited after such a legislative statement could be avoided by the trustee in bankruptcy and that all creditors, secured and unsecured, should share equally, subject to recognized priorities, in the assets of a bankrupt's estate, enlarged by the shifting down of security interests. The Supreme Court from Sturges v. Crowninshield\textsuperscript{30} to Wright v. Vinton Branch of the Mountain Trust Bank of Roanoke\textsuperscript{31} has interpreted broadly the bankruptcy power. It is true that, as Justice Brandeis observed in Louisville Joint Stock Land Bank v. Radford,\textsuperscript{32} where the first Frazier-Lemke Act was held unconstitutional in respect of mortgages existing at the date of the passage of the Act, that Congress might have greater power prospectively than retrospectively. All this does not mean that the bankruptcy power is unlimited in the administration of insolvent estates. Admitting that the Tenth Amendment is only declaratory of what could be implied from the separation of powers in the federal system,\textsuperscript{33} the bankruptcy power was scarcely intended to give Congress authority over the states' reserved power over property and contracts. At the least, secured creditors would be entitled to a clear warning from Congress that, prospectively, secured creditors' interests would be worthless against the trustee. Even then, so long as the power of the states to govern the creation of property interests continues, I doubt whether any wholesale avoidance of security interests, which could not be tied in rather closely with the equitable principles related to preferences and fraudulent conveyances, could be regarded as anything else than arbitrary spoliation of one class of creditors, the secured, for the benefit of another class, the unsecured. I hope some specialist on constitutional problems will find this issue sufficiently challenging to write an authoritative exposition of the subject for the benefit of bankruptcy and security lawyers.

CRITICISM OF THE PROPOSED AMENDMENT

The Bar Association's Special Committee on Section 6oa is receiving currently a volume of correspondence which indicates a continuing interest in its proposals. The Committee has received assurances which justify the hope that early hearings by a sub-committee of the Senate

\textsuperscript{30} 4 Wheat. (U.S.) 122 (1819).


\textsuperscript{32} 295 U.S. 555 (1935).

\textsuperscript{33} United States v. Darby, 312 U.S. 100 (1940).
Committee on the Judiciary will give all interested parties a chance to present their views for the record and for the guidance of Congress.

Professor Keeffe of Cornell, in collaboration with Messrs. Kelly and Lewis of the Cornell Law Quarterly, has recently published a sprightly article entitled *Sick Sixty.*34 Professor Keeffe, like Mr. Oglebay, thinks the Bar Association draft is difficult reading but he sidesteps the opportunity to write a simplified version. Any legislative draftsman after offering his work to a critical world is apt to be shown that unwittingly his draft threatens harm to the virtuous or leaves loopholes for the wicked. So far this criticism has not been made against the Bar Association Committee. What we have done is to attempt to add to our original simple proposal, some but not all, of the qualifications and additions which we think will better define our purposes. That the final result is nothing to read aloud for the entertainment of a party, I freely admit. But it has not been convincingly asserted that bankruptcy lawyers, accustomed to technical language, find the meaning obscure. Indeed, several suggestions, which the Committee has considered and rejected, not so much because of opposition to them, as the fact that their inclusion would present new points of controversy, would have made the amendment more, rather than less, complex.

Professor Keeffe and his collaborators found two specific defects in the amendment and suggest two additions. The first addition is to insert in subsection (2) the statement “For the purposes of this section, such a creditor shall be deemed to have an interest superior to that of any equitable lienor.” In the same subsection, they offer an additional proviso: “For the purposes of this section, applicable law shall be construed to mean the statutes of a state and the common law of a state providing such common law accords with the general law.”

While our Committee has not met since *Sick Sixty* was published, I have discussed the article with Milton P. Kupfer and have also had the benefit of comments by Irvin I. Livingston of Chicago, and Walter D. Yankauer of New York. I doubt if either of the proposed additions would be acceptable to the Committee and even if as an academic matter the members of the Committee favored them, it would be fatal to the prospects of the amendment to burden it with such controversial provisions.

The word “lien,” aside from the common law possessory lien,35 has no exact meaning in our law. It is merely our general term for any tie which a claimant has on specific property. An equitable lien, if the term means

34 33 Corn. L. Q. 99 (1947).
anything, is merely a charge that originated in equity. Equitable liens and secret liens are not synonymous terms. A pledge is a legal interest and may be fully perfected although secret in the sense of absence of actual knowledge by other creditors, or any form of public notoriety. On the other hand some equitable interests in real estate may be recorded. No one could seriously contemplate putting in such an equitable lien proviso without a comprehensive study of such liens and some corresponding changes in Section 1 and Section 67b. This is another illustration of the persistent effort to use the bankruptcy law to control the judgment of the various states as to the priority of property interests. If a state believes that certain equitable interests, especially in respect of land, should prevail over judgment creditors, that, it seems to me, is the business of the state.

I have a certain sympathy with the desire of the authors of *Sick Sixty* to reverse *Erie v. Tompkins* so far as commercial law is concerned. Indeed, for the purposes of administration of insolvent estates in bankruptcy, Section 60 already goes rather far in that direction. Bankruptcy after all is only a small phase of commercial law and compared to what can be accomplished for desirable uniformity by cooperative state action and federal rules relating to interstate commerce, bankruptcy has no great significance. The difficulty in bankruptcy administration of recognizing property interests under divergent state laws is exaggerated. There is little or no injustice in such recognition for the interests have been created with reference to the state law. To require every security holder to determine prior to any transaction whether the state law conformed to the general law would cause more complication than proceeding under non-uniform state laws. Finally, the second proviso, like the first, opens up for debate the whole issue of *Swift v. Tyson* and *Erie v. Tompkins* and of federal interference with state law. The Bar Association amendment to Section 60 is an attempt to deal with a specific injustice in the Bankruptcy Act created by the judicial interpretation of an improper test of the interests of creditors under the Chandler Act. The business community is entitled to a settlement of this matter without waiting for a comprehensive survey of the whole field of the relative powers of federal and state governments.

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36 Perhaps Section 67b would now require amendment in view of Professor Keeffe’s statutory qualification in his proviso, 33 Corn. L.Q. 99 (1947).
38 16 Pet. (U.S.) 1 (1842).
39 304 U.S. 64 (1938).