

Post-Bankruptcy Transfers an Old Problem in Need of a New Solution

Hal M. Bateman

Follow this and additional works at: <http://scholarship.law.cornell.edu/clr>

 Part of the [Law Commons](#)

Recommended Citation

Hal M. Bateman, *Post-Bankruptcy Transfers an Old Problem in Need of a New Solution*, 53 Cornell L. Rev. 280 (1968)
Available at: <http://scholarship.law.cornell.edu/clr/vol53/iss2/2>

This Article is brought to you for free and open access by the Journals at Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell Law Review by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact jmp8@cornell.edu.

POST-BANKRUPTCY TRANSFERS: AN OLD PROBLEM IN NEED OF A NEW SOLUTION

Hal M. Bateman†

In order to achieve one of the basic policies of the Bankruptcy Act¹—the orderly, equitable distribution of the bankrupt's nonexempt assets—it is necessary to fix a single point in time for reference in determining both the property that comprises the bankruptcy estate and the rights of the various interested parties. Yet, because subsequent transactions in the property thus identified as part of the estate may occur before the trustee has actually reduced it to possession and may involve the rights of third parties who act in good faith without knowledge of the bankruptcy, it is equally necessary that adequate and fair provision be made in the Act concerning post-bankruptcy transfers.

These problems are now dealt with in sections 70a, 70d, and 21g of the Bankruptcy Act.² Under section 70a the trustee is vested by operation of law with the title of the bankrupt to specified types of property as of the date the petition in bankruptcy is filed. But the selection of the trustee and his taking possession of the property will not actually occur until some later time. Meanwhile, the bankrupt will often have possession or control of the property and may easily deal with it as if he still has title. Under sections 70d and 21g,³ limited protection from liability to the trustee is extended to third persons who act without knowledge of the bankruptcy and either give present value or discharge an existing obligation of the bankrupt. But the decisions interpreting these sections have made it clear that the scope of protection they afford is unduly restricted and should be revised.⁴

† Assistant Professor of Law, University of Missouri School of Law (Columbia). B.A. 1954, Rice University; LL.B. 1956, Southern Methodist University.

¹ Title 11, U.S.C. (1964). The short title, "Bankruptcy Act," was added by 64 Stat. 1113 (1950). Sections of the Bankruptcy Act will hereinafter be referred to in the text by their customary numbers in the Act, rather than by the less familiar numbers assigned to them in Title 11 of the United States Code.

² 11 U.S.C. §§ 110(a), 110(d), 44(g) (1964).

³ 11 U.S.C. §§ 110(d), 44(g) (1964).

⁴ See, e.g., *Bank of Marin v. England*, 385 U.S. 99 (1966), *rev'g* 352 F.2d 186 (9th Cir. 1965); *Feldman v. Capitol Piece Dye Works, Inc.*, 293 F.2d 889 (2d Cir.), *cert. denied*, 368 U.S. 948 (1961); *Kohn v. Myers*, 266 F.2d 353 (2d Cir. 1959), *aff'g In re Autocue Sales & Distrib. Corp.*, 162 F. Supp. 17 (S.D.N.Y. 1958); *Lake v. New York Life Ins. Co.*, 218

The recent case of *Bank of Marin v. England*⁵ dramatically illustrates the problem. Prior to bankruptcy the bankrupt had drawn five checks on its commercial account with the Bank of Marin and had delivered them to the payee, Eureka Fisheries, Inc. A few weeks later the bankrupt filed a voluntary petition in bankruptcy. Six days thereafter Eureka Fisheries presented the checks for payment, and the bank, without notice or knowledge of the pending bankruptcy, paid them in the ordinary course of business. Although a receiver had been appointed by the bankruptcy court when the petition was filed, he did not notify the bank until the day after it had paid the checks. On later being appointed trustee, he initiated turnover proceedings against the bank and Eureka Fisheries to recover the amount paid on the checks out of the bank account to which he had succeeded under section 70a prior to the payment. The referee held the bank and Eureka Fisheries jointly liable for the entire amount, which Eureka Fisheries paid, demanding contribution from the bank. The bank petitioned for review of the referee's order.

Both the district court and the Court of Appeals for the Ninth Circuit affirmed the decision of the referee.⁶ They concluded that the exclusive protection for post-bankruptcy transfers not involving real property⁷ is that afforded by section 70d, and that the period during which protection is available under that section ends with the adjudication of the bankrupt.⁸ Since section 18f, as amended in 1959,⁹ provides that adjudication in voluntary proceedings occurs automatically upon the filing of the petition, there is actually no period in such proceedings during which innocent third parties are protected. Also, in view of the prohibition in section 70d(5), the courts may not create protection beyond that granted in sections 70d and 21g. Thus, the bank had paid out funds belonging to the trustee without his authorization and was therefore liable to him for that amount.

Notwithstanding the strict logic of the Ninth Circuit's interpre-

F.2d 394 (4th Cir.), cert. denied, 349 U.S. 917 (1955); *Rosenthal v. Guaranty Bank & Trust Co.*, 139 F. Supp. 730 (W.D. La. 1956).

⁵ 385 U.S. 99 (1966), rev'g 352 F.2d 186 (9th Cir. 1965).

⁶ *Bank of Marin v. England*, 352 F.2d 186 (9th Cir. 1965).

⁷ Real property transfers are dealt with in § 21g and are therefore excluded from the scope of § 70d.

⁸ The opening phrase of § 70d limits the availability of protection to the period "[a]fter bankruptcy and either before adjudication or before a receiver takes possession of the property of the bankrupt, whichever first occurs." 52 Stat. 881 (1938), 11 U.S.C. § 110(d) (1964). Section 1(13) defines the date of bankruptcy as "the date when the petition was filed." 52 Stat. 841 (1938), 11 U.S.C. § 1(13) (1964).

⁹ 11 U.S.C. § 41(f) (1964).

tation of sections 70d and 18f, the Supreme Court granted certiorari¹⁰ and reversed.¹¹ The Court held that the trustee, like the bankrupt to whose title he had succeeded, was bound by the bank's contractual right to honor valid outstanding checks in the absence of a timely stop payment order or some other reasonable and effective notice of the trustee's rights. It concluded that, despite the apparent exclusiveness of the protection afforded by section 70d, "[t]here is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction," and that this consideration warranted the avoidance of an obviously inequitable result.¹² A vigorous dissent by Mr. Justice Harlan demonstrates that, although the result reached was clearly desirable in this case, the precise basis of the decision is elusive and difficult to reconcile with section 70d.¹³ As a result, the courts in future cases must either adhere strictly to the provisions of section 70d, notwithstanding obvious inequities, or extend protection beyond the limitations of section 70d in implicit abrogation of the statute; and they must act without any clear guide to resolution of the dilemma. The only satisfactory solution to the resulting uncertainty is revision of the statute to deal more adequately with the problem.

I

THE HISTORICAL DEVELOPMENT OF SECTION 70d

Section 70d was added to the Bankruptcy Act by the Chandler Act in 1938. Section 70a was being amended at that time to provide that the trustee's title in the bankrupt's property is determined as of the date the petition is filed. Because of that change in section 70a, section 70d was added to provide protection for certain transactions which might occur in the interval between filing the petition and the earlier of adjudication of the bankrupt or possession of the estate by a receiver or trustee.¹⁴ The area of protection defined by the new section

¹⁰ *Bank of Marin v. England*, 383 U.S. 906 (1966).

¹¹ *Bank of Marin v. England*, 385 U.S. 99 (1966).

¹² *Id.* at 103. In his dissenting opinion, Mr. Justice Fortas reasoned that the case was moot, since the trustee had been paid by Eureka Fisheries, whose claim against the bank for contribution was not before the court.

¹³ Although Mr. Justice Harlan effectively criticized the majority opinion's departure from § 70d on the basis of "equitable principles," he did not adequately answer the bank's arguments based on its rights under the deposit contract and the lack of due process in the absence of reasonable notice. See Notes, 31 MO. L. REV. 565 (1966), 42 NOTRE DAME LAWYER 818 (1967), 15 U. KAN. L. REV. 100 (1966), 52 VA. L. REV. 528 (1966). *But see* Note, 65 MICH. L. REV. 195 (1966).

¹⁴ 11 U.S.C. § 110(d) (1964). The Chandler Act amendments are found at 52 Stat. 840-940 (1938).

was intended to conform generally to the existing case law that had developed under the 1898 Act, but to provide greater consistency and clarity than the decisions had afforded.¹⁵ Hence, the situation that had developed prior to 1938 is directly relevant to the structure of section 70d.

As originally enacted in 1898, section 70a provided that, upon his appointment and qualification, the trustee

shall . . . be vested by operation of law with the title of the bankrupt, *as of the date he was adjudged a bankrupt* [to six broad categories of nonexempt property, including] . . . (5) property which *prior to the filing of the petition* he could by any means have transferred or which might have been levied upon and sold under judicial process against him¹⁶

Thus, subject to the ambiguity posed by the reference to the date of the petition in the fifth clause, the 1898 version of section 70a determined the trustee's title as of the date of adjudication, which occurred only upon the actual entry of a decree by a bankruptcy court.¹⁷

This aspect of the 1898 Act was in direct contrast to the Bankruptcy Act of 1867, which provided that the bankruptcy assignee, elected by the creditors at their first meeting, received an assignment from the judge or register¹⁸ of the bankrupt's nonexempt property, the effect of which related back to the time the petition was filed.¹⁹ Although the 1867 Act contained no provision expressly protecting innocent third persons during the interval between the petition and the assignment, it did provide that upon adjudication of the bankrupt the judge or register was to issue a warrant to the marshal

authorizing him forthwith, as messenger, to publish notices in . . . newspapers [specified in the warrant or selected by the marshal, and to give written notice to scheduled creditors and] . . . to any person concerned as the warrant specifies [to the effect that the warrant had issued and the first meeting of creditors had been called, and] . . . [t]hat the payment of any debts and delivery of any property belonging to such debtor to him or for his use, and the transfer of any property by him, are forbidden by law.²⁰

¹⁵ See McLaughlin, *Aspects of the Chandler Bill To Amend the Bankruptcy Act*, 4 U. CHI. L. REV. 369, 381-84 (1937). See also 4 W. COLLIER, BANKRUPTCY ¶¶ 70.03[5], 70.66[1] (14th ed. 1964).

¹⁶ Act of July 1, 1898, ch. 541, § 70a, 30 Stat. 565-66 (emphasis added).

¹⁷ *Id.* § 18g, at 551.

¹⁸ Under the nomenclature used in the 1867 Act the register served a function similar to that of the referee under the present Bankruptcy Act.

¹⁹ Act of March 2, 1867, ch. 176, §§ 13, 14, 42, 14 Stat. 522, 537.

²⁰ *Id.* §§ 11, 42, at 521-22, 537.

In addition, the assignee was required to publish notice of his appointment weekly for three weeks and to record the assignment in the appropriate public records within six months.²¹ Thus, the 1867 Act, like the present act, dated the trustee's title from the filing of the petition, but, unlike the present Act, it also provided some means for giving notice of the pendency of the bankruptcy proceeding to third parties.²²

Soon after the 1898 Act was adopted the Supreme Court decided *Mueller v. Nugent*,²³ which involved a question of the bankruptcy court's summary jurisdiction rather than the rights of an innocent third person in a post-bankruptcy transaction. But in its opinion the Court made the sweeping declaration that:

It is as true of the present law as it was of that of 1867, that the filing of the petition is a *caveat* to all the world, and in effect an attachment and injunction, [*International*] *Bank v. Sherman*, 101 U.S. 403; and on adjudication, title to the bankrupt's property became vested in the trustee, §§ 70, 21*e*, with actual or constructive possession, and placed in the custody of the bankruptcy court.²⁴

As the Court later observed in *York Manufacturing Co. v. Cassell*,²⁵ this language concerning the effect of filing the petition was merely dictum, stated in the limited context of the facts in *Mueller v. Nugent*, and could not be applied literally in other situations without qualification. Nevertheless, the caveat dictum quickly became famous and was cited in innumerable subsequent decisions.²⁶

²¹ *Id.* §§ 14, 42, at 522-24, 537.

²² The relevant provisions of the two earlier bankruptcy acts should also be noted. The Act of Aug. 19, 1841, ch. 9, § 3, 5 Stat. 440, provided that the bankruptcy assignee's title dated only from the time of the decree adjudicating the bankrupt but that the title passed as of that date "by mere operation of law, ipso facto . . ." The 1841 Act required an actual decree of adjudication, *id.* § 1, at 440, but contained no provision dealing with subsequent transfers by the bankrupt or the rights of transferees for value without notice. The Act of April 4, 1800, ch. 19, §§ 5-7, 2 Stat. 23, provided only for involuntary proceedings and directed the bankruptcy commissioners, upon adjudication of the bankrupt, to take possession of the bankrupt's property "forthwith" and assign it to the assignees elected at the first meeting of creditors or appointed by the commissioners. This assignment was declared valid as against the bankrupt and all claiming under him through transactions "at the time, or after [the bankrupt] shall have committed the act of bankruptcy, upon which the commission issued." *Id.* § 10, at 24. But the act expressly protected bona fide transferees for value without notice or knowledge of any act of bankruptcy, who purchased before the bankruptcy commission issued. *Id.*

²³ 184 U.S. 1 (1901).

²⁴ *Id.* at 14. *But cf.* *May v. Henderson*, 268 U.S. 111, 117 (1925).

²⁵ 201 U.S. 344, 353 (1906); *accord*, *In re Zotti*, 186 F. 84, 85-86 (2d Cir.), *cert. denied*, 223 U.S. 718 (1911).

²⁶ In 1937 Professor McLaughlin stated that the dictum had then been cited more than 30 times by the Supreme Court and more than 300 times by the lower federal courts.

The original source of the caveat language was *International Bank v. Sherman*,²⁷ decided under the 1867 Act. That case, unlike *Mueller v. Nugent*, had squarely involved the rights of post-petition transferees under the 1867 Act provision that title passed to the trustee as of the filing of the petition. The Supreme Court concluded that these provisions were clear and mandatory and that subsequent transfers were necessarily invalid against the trustee.²⁸ But the transferees in *Sherman*, unlike those in *Bank of Marin v. England*, had been fully aware of the pendency of the bankruptcy proceeding and of the bankrupt's insolvency at the time of the transfer.²⁹

Following the decision in *Mueller v. Nugent*, both aspects of the problem presented by the ambiguity in section 70a of the 1898 Act arose: (1) whether the trustee had title to the estate during the interval between filing and adjudication; and (2) if so, whether innocent transferees from the bankrupt during that interval would be protected against liability to the trustee. For several years there was uncertainty on the matter.³⁰ In *Acme Harvester Co. v. Beekman Lumber Co.*,³¹ the Supreme Court concluded, on the basis of the caveat dictum and the general importance of the date of filing in the 1898 Act, that, after the filing of the petition, the bankrupt's property is *in custodia legis* pending adjudication of the bankrupt and therefore is not subject to levy of attachment or garnishment by a creditor.³² Sixteen months later the Court finally resolved the matter in *Everett v. Judson*,³³ in which it concluded:

We think that the purpose of the law was to fix the line of cleavage with reference to the condition of the bankrupt estate as the time at which the petition was filed and that the property which vests in the trustee at the time of adjudication is that which the bankrupt owned at the time of the filing of the petition.³⁴

Accordingly, the Court held that the trustee's rights in the bankrupt's

McLaughlin, *supra* note 15, at 382 n.58. The caveat dictum has not since lost its popularity.

²⁷ 101 U.S. 403 (1879).

²⁸ *Id.* at 406.

²⁹ *Id.* at 407.

³⁰ See *Johnson v. Collier*, 222 U.S. 538 (1912); *In re Zotti*, 186 F. 84 (2d Cir.), *cert. denied*, 223 U.S. 718 (1911).

³¹ 222 U.S. 300 (1911).

³² *Id.* at 306-08; see *Zavelo v. Reeves*, 227 U.S. 625 (1913).

³³ 228 U.S. 474 (1913). See also *Andrews v. Partridge*, 228 U.S. 479 (1913), decided the same day.

³⁴ 228 U.S. at 479.

life insurance policies were determined as of the date the petition had been filed, notwithstanding the subsequent death of the bankrupt prior to adjudication.³⁵

Had the courts applied this principle consistently to all post-petition transactions, the result would have been an extremely harsh application of the doctrine of *lis pendens*, based merely on the filing of a bankruptcy petition. Fortunately, this was avoided. Since the courts had created the relation-back doctrine to resolve an inherent ambiguity in section 70a, they were equally free to develop exceptions to the rule when necessary to avoid inequitable results. But because the relation-back rule concerned only the period between the filing and the adjudication, the exceptions developed by the courts also focused on that period. Yet this limitation on the context of the exceptions resulted ultimately from nothing more than the structure of the ambiguity in section 70a.

Since the courts developed the exceptions to the relation-back rule largely on an *ad hoc* basis, they failed to provide any consistent or clear set of principles for determining the availability of protection in post-petition transactions.³⁶ Certain situations did emerge, however, in which protection was granted or denied with some predictability. Post-petition preferences,³⁷ fraudulent transfers,³⁸ and liens obtained by legal or equitable proceedings³⁹ were usually invalidated. Also, if the post-petition transferee knew of the pending bankruptcy at the time of the transfer⁴⁰ or did not give present value,⁴¹ he took subject

³⁵ Under the proviso following § 70a(5) the trustee can, in effect, reach the cash surrender value or its equivalent in policies on the life of the bankrupt. Under the terms of an ordinary life policy, such value would exist on the date the petition is filed but would cease to exist upon the death of the insured bankrupt prior to adjudication. Hence, if the trustee's title vests as of the date of adjudication, he takes nothing; but if it vests as of the date of filing, he can recover the cash surrender value existing at that time. *Cf. Fairbanks Steam Shovel Co. v. Wills*, 240 U.S. 642 (1916), *citing Everett v. Judson*, 228 U.S. 474 (1913), and *Acme Harvester Co. v. Beekman Lumber Co.*, 222 U.S. 300 (1911).

³⁶ See *In re Scranton Knitting Mills, Inc.*, 21 F. Supp. 227 (M.D. Pa. 1937); 4 W. COLLIER, BANKRUPTCY ¶ 70.66 (14th ed. 1964); McLaughlin, *Amendment of the Bankruptcy Act*, 40 HARV. L. REV. 583, 612-16 (1927).

³⁷ *Grand Rapids Dry Goods Co. v. Ostendorf*, 6 F.2d 506 (6th Cir. 1925); *Reed v. Barnett Nat'l Bank*, 250 F. 983 (5th Cir. 1918); *In re R & W Skirt Co.*, 222 F. 256 (2d Cir. 1915); *cf. In re Perpall*, 271 F. 466 (2d Cir. 1921).

³⁸ *May v. Henderson*, 268 U.S. 111 (1925); *In re Denson*, 195 F. 854 (N.D. Ala. 1912); *cf. Grand Rapids Dry Goods Co. v. Ostendorf*, 6 F.2d 506 (6th Cir. 1925).

³⁹ *Acme Harvester Co. v. Beekman Lumber Co.*, 222 U.S. 300 (1911).

⁴⁰ *May v. Henderson*, 268 U.S. 111 (1925); *In re Denson*, 195 F. 854 (N.D. Ala. 1912).

⁴¹ *Cf. May v. Henderson*, 268 U.S. 111 (1925); *Fairbanks Steam Shovel Co. v. Wills*, 240 U.S. 642 (1916); *In re R & W Skirt Co.*, 222 F. 256 (2d Cir. 1915).

to the trustee's rights. On the other hand, the courts usually protected good-faith transferees who gave present value after the petition had been filed.⁴² Also, to enable a person against whom an involuntary petition had been filed to continue his business until adjudication or possession by a receiver, transactions with the bankrupt after the filing and in the ordinary course of business were usually upheld.⁴³

Trustees frequently raised the question whether a bank was liable for the balance on deposit in the bankrupt's account as of the date of filing even though the bank had subsequently honored checks drawn by the bankrupt and presented in the ordinary course of business. The courts consistently held that, where the bank had acted in good faith without actual notice of the bankruptcy and pursuant to the terms of the deposit contract, it was not liable to the trustee.⁴⁴

Since most of the cases granting exceptions to the relation-back rule involved only the period prior to adjudication, some courts were led to assert in dicta that after adjudication no transfer by the bankrupt could be valid against the trustee.⁴⁵ Apparently, however, it was never so held; and in two cases the Supreme Court actually granted protection to transfers that had occurred after adjudication, although the significance of the fact that adjudication had occurred does not appear to have been urged or considered in either case.⁴⁶

⁴² *In re Perpall*, 271 F. 466 (2d Cir. 1921); *In re Latex Drilling Co.*, 11 F.2d 373 (W.D. La. 1926).

⁴³ *Hersh v. United States*, 68 F.2d 799 (9th Cir. 1934); *In re Retail Stores Delivery Corp.*, 11 F. Supp. 658 (S.D.N.Y. 1935); *In re Latex Drilling Co.*, 11 F.2d 373 (W.D. La. 1926). See also *In re Mertens*, 144 F. 818 (2d Cir. 1906).

⁴⁴ *Citizens' Union Nat'l Bank v. Johnson*, 286 F. 527 (6th Cir. 1923); *In re Zotti*, 186 F. 84 (2d Cir.), cert. denied, 223 U.S. 718 (1911); *In re Retail Stores Delivery Corp.*, 11 F. Supp. 658 (S.D.N.Y. 1935); cf. *In re Fuller*, 294 F. 71 (2d Cir. 1923). In an analogous case the bankrupt died more than 3 months after the petition was filed. The life insurance company, without notice of the pending bankruptcy, paid the proceeds due under the policy to the named beneficiary. The insurance company was held not liable to the trustee for the cash surrender value of the policy at the date the petition was filed. *Frederick v. Fidelity Mut. Life Ins. Co.*, 256 U.S. 395 (1921).

⁴⁵ See, e.g., *J.S. & J.F. String, Inc. v. Birkhahn*, 30 F.2d 492, 495 (3d Cir. 1929); *Southern Ry. v. Cole*, 49 Ga. App. 635, 176 S.E. 512 (1934).

⁴⁶ In *Frederick v. Fidelity Mut. Life Ins. Co.*, 256 U.S. 395 (1921), an insurer had paid the proceeds of the bankrupt's life insurance policy to the named beneficiary on May 7, 1913, following the insured's death on April 4, 1913. The insurer had no notice of the bankruptcy, although the adjudication had occurred on January 8, 1913, pursuant to a petition filed on December 19, 1912. The Court held that the insurer had discharged its duties under the policy in good faith and was not liable to the trustee. In *Jones v. Springer*, 226 U.S. 148 (1912), the bankruptcy petition was filed on March 12, 1906, and the adjudication followed on April 23. A creditor had attached property of the bankrupt in a state court proceeding on February 27. The state court ordered sale on May 1, and its receiver sold the property to an innocent purchaser for value on June 26. The Court

II

THE 1938 AMENDMENTS—SECTIONS 70a, 70d, AND 21g

Among the extensive amendments of the Bankruptcy Act in 1938⁴⁷ were the revision of section 70a and the addition of the present sections 70d and 21g. Acting in the light of the existing patterns in the law and with a desire to remedy only its obvious inadequacies, Congress was largely influenced by the form of the existing situation.

First, Congress clarified the ambiguity in section 70a concerning the time as of which the trustee's title vests and the assets of the estate are identified. In accord with the relation-back rule, the opening clause of section 70a was revised to provide that the trustee, upon his appointment and qualification, is "vested by operation of law with the title of the bankrupt as of the *date of the filing of the petition . . .*"⁴⁸ This was intended to remedy what the Senate and House Judiciary Committees both regarded as "a very serious defect"⁴⁹ in the 1898 Act. The House Judiciary Committee considered the problem to be particularly acute "in the administration of cases in which the adjudication is contested."⁵⁰

Due to the drastic consequence this change would have, under the caveat principle, for innocent third persons involved in post-bankruptcy transactions, sections 21g and 70d were added to the Act to provide an affirmative grant of protection in certain cases. Transactions in real property were dealt with in section 21g and transactions in all other property were covered by section 70d.⁵¹ In granting pro-

held that the sale was valid as against the trustee, since the state court and the parties had been unaware of the pending bankruptcy and the property had been in the custody of the state court when bankruptcy began. It does not appear in either of these cases that the fact of the bankrupt's adjudication prior to the transfer was regarded as foreclosing the possibility of protection for the transfer.

⁴⁷ 52 Stat. 840 (1938). These amendments are known as the Chandler Act and are codified in scattered sections of 11 U.S.C.

⁴⁸ 52 Stat. 879 (1938), 11 U.S.C. § 110a (1964) (emphasis added).

⁴⁹ S. REP. No. 1916 (Judiciary Comm.), 75th Cong., 3d Sess. 18 (1938); H.R. REP. No. 1409 (Judiciary Comm.), 75th Cong., 1st Sess. 34 (1937). Both reports accompanied the Chandler Bill, H.R. 8046, 75th Cong., 1st Sess. (1937).

⁵⁰ H.R. REP. No. 1409, *supra* note 49, at 34.

⁵¹ Section 70d reads:

After bankruptcy and either before adjudication or before a receiver takes possession of the property of the bankrupt, whichever first occurs—

(1) A transfer of any of the property of the bankrupt, other than real estate, made to a person acting in good faith shall be valid against the trustee if made for a present fair equivalent value or, if not made for a present fair equivalent value, then to the extent of the present consideration actually paid therefor, for which amount the transferee shall have a lien upon the property so transferred;

(2) A person indebted to the bankrupt or holding property of the bankrupt

tection in specified situations, Congress was guided by, and intended substantially to follow, the judicially-created exceptions to the relation-back rule.⁵²

Two basic types of post-bankruptcy transfers are dealt with separately in clauses (1) and (2) of section 70d. Clause (1) provides protection for the good-faith transferee of the bankrupt's property to the extent that he gives "present fair equivalent value" for the property received. The key requirement of "present fair equivalent value" implicitly excludes from protection the preference, the fraudulent transfer, and the judicial lien.⁵³

Under clause (2), debtors of the bankrupt and persons holding his property are protected if in good faith they pay the debt or deliver the property to the bankrupt or on his order after the petition has been filed and title has vested in the trustee. This protects a bank that pays a check against the bankrupt's account, an insurance company that pays under the bankrupt's policy, a bailee of the bankrupt's prop-

may, if acting in good faith, pay such indebtedness or deliver such property, or any part thereof, to the bankrupt or upon his order, with the same effect as if the bankruptcy were not pending;

(3) A person having actual knowledge of such pending bankruptcy shall be deemed not to act in good faith unless he has reasonable cause to believe that the petition in bankruptcy is not well founded;

(4) The provisions of paragraphs (1) and (2) of this subdivision shall not apply where a receiver or trustee appointed by a United States or State court is in possession of all or the greater portion of the nonexempt property of the bankrupt;

(5) A person asserting the validity of a transfer under this subdivision shall have the burden of proof. Except as otherwise provided in this subdivision and in subdivision g of section 21 of this Act, no transfer by or in behalf of the bankrupt after the date of bankruptcy shall be valid against the trustee: *Provided, however*, that nothing in this Act shall impair the negotiability of currency or negotiable instruments.

Bankruptcy Act § 70d, 52 Stat. 881-82 (1938), 11 U.S.C. § 110d (1964).

⁵² See S. REP. No. 1916, *supra* note 49; H.R. REP. No. 1409, *supra* note 49; HOUSE JUDICIARY COMMITTEE, ANALYSIS OF H.R. 12889, 74th Cong., 2d Sess. 229-31 (1936) [hereinafter cited as ANALYSIS OF H.R. 12889]. Section 70d, like much of the Chandler Act, was primarily the result of the extensive work of the National Bankruptcy Conference, the history of which is described in H.R. REP. No. 1409, *supra* note 49, at 1-3. Professor James A. McLaughlin was the principal proponent and draftsman of § 70d itself. In 1927 he had suggested a provision based on § 45 of the English Bankruptcy Act of 1914. McLaughlin, *Amendment of the Bankruptcy Act*, 40 HARV. L. REV. 583, 615-16 (1927). As a member of the Conference he was closely involved in the development of § 70d as finally enacted in 1938. The Chandler Bill was introduced in the 74th Congress as H.R. 12889 two years before its enactment in 1938. ANALYSIS OF H.R. 12889 contains detailed comments by members of the National Bankruptcy Conference on each section of the Chandler Bill and furnishes valuable insight into the legislative intent at many points. With these comments at hand, the committee reports dealt briefly with many new provisions such as § 70d. See McLaughlin, *supra* note 15.

⁵³ Cf. cases cited notes 37-39 *supra*.

erty who delivers it as directed, and a trade account debtor of the bankrupt who pays his account to the bankrupt.⁵⁴

Although "good faith" is not fully defined, clause (3) provides that "actual knowledge of [the] pending bankruptcy" precludes one from being in good faith for the purposes of section 70d "unless he has reasonable cause to believe that the petition in bankruptcy is not well founded." The latter qualification, which evidently could relate only to involuntary proceedings, was intended primarily to protect debtors engaged in business from harassment by ill-founded petitions, and to enable them to continue doing business pending a judicial determination on the petition.⁵⁵

Clause (5) places the burden of proof on the party claiming protection under section 70d and provides that "nothing in this Act shall impair the negotiability of currency or negotiable instruments." Although the exact meaning of the latter provision is obscure, its purpose was apparently to avoid any interference with negotiable instruments law.⁵⁶

The opening phrase of section 70d sharply limits the availability of protection in the situations defined in clauses (1) and (2) to the period "[a]fter bankruptcy and either before adjudication or before a receiver takes possession of the property of the bankrupt, whichever first occurs." Also, clause (4) denies protection under clauses (1) and (2) "where a receiver or trustee appointed by a United States or State court is in possession of all or the greater portion of the nonexempt property of the bankrupt."

The intended relationship between the two references to possession by a receiver is unclear, but four facts support the conclusion that, read together, these provisions terminate the protected interval whenever any receiver is in possession of the greater portion of the bankrupt's nonexempt property. First, since the provisions serve only to define the end of the protected interval, only the event that will necessarily occur first is material. Second, before a receiver can possess all of the bankrupt's property, he must necessarily possess the greater portion of it. Third, since possession by a receiver of *all* of the property would prevent a post-bankruptcy transfer, only possession of the

⁵⁴ Cf. cases cited note 44 *supra*.

⁵⁵ See J. MACLACHLAN, BANKRUPTCY § 293 (1956); cf. cases cited note 43 *supra*.

⁵⁶ See *Rosenthal v. Guaranty Bank & Trust Co.*, 139 F. Supp. 730 (W.D. La. 1956); 4 W. COLLIER, BANKRUPTCY ¶ 70.68, at 1502 n.3 (14th ed. 1964); Note, *Bankruptcy and Negotiable Instruments*, 64 HARV. L. REV. 958 (1951); cf. Seligson, *Creditors' Rights*, 32 N.Y.U.L. REV. 708, 729-31 (1957); Note, 70 HARV. L. REV. 548 (1957).

greater portion of the property is relevant to section 70d. Finally, in the absence of any definition in the act of the term "receiver,"⁵⁷ it should be construed to include both bankruptcy and nonbankruptcy receivers both in the opening phrase of section 70d and in clause (4).⁵⁸

The combined effect of the opening clause of section 70d and clause (4) is to end the interval during which protection for transactions within clauses (1) and (2) is possible upon the earlier of two events: (1) the adjudication of the bankrupt, or (2) possession of the greater portion of his nonexempt property by a receiver or trustee. Neither of these events bears any logical relationship to the position or rights of innocent third persons involved in the post-bankruptcy transactions described in clauses (1) and (2). The legislative history and background of section 70d do not reveal that any serious, critical consideration was given to the propriety of terminating protection prior to receipt by the third party of actual notice of the bankruptcy or actual possession of the particular property in question by a receiver or trustee. It does not appear that the soundness of either terminal event was separately weighed on its merits or that Congress had any considered intent to prohibit all possibility of protection for a transfer after either event.⁵⁹ Rather, in concentrating on the affirmative creation of a clear, predictable area of protection along the lines indicated by the prior cases, Congress inadvertently perpetuated in section 70d the limitations on the protected interval suggested by those cases. Since the relation-back rule itself pertained only to the period between filing the petition and adjudication, the exceptions created by the courts were similarly restricted to the pre-adjudication period,⁶⁰ and some of the cases had suggested the limitation based on possession by a receiver during that period.⁶¹

These restrictions on protection are reinforced by the provision in clause (5) that, except as otherwise provided in sections 70d and

⁵⁷ Cf. Bankruptcy Act § 1(31), 52 Stat. 842 (1938), 11 U.S.C. § 1(31), which does not define "receiver," but merely provides that the term "shall include all of the receivers of an estate."

⁵⁸ No distinction between the two was recognized in *Lake v. New York Life Ins. Co.*, 218 F.2d 394 (4th Cir.), cert. denied, 349 U.S. 917 (1955), which held that clause (4) applied to the *bankruptcy* receiver. A different interpretation, recognizing a distinction, has been suggested. 4 W. COLLIER, BANKRUPTCY ¶ 70.68, at 1504 n.9 (14th ed. 1964).

⁵⁹ Cf. S. REP. No. 1916, *supra* note 49; H.R. REP. No. 1409, *supra* note 49; ANALYSIS OF H.R. 12889, *supra* note 52; McLaughlin, *supra* note 15, at 381-84, 401-02.

⁶⁰ The only two exceptions found were *Frederick v. Fidelity Mut. Life Ins. Co.*, 256 U.S. 395 (1921), and *Jones v. Springer*, 226 U.S. 148 (1912). In neither case was the post-adjudication feature stressed. The cases are discussed in note 46 *supra*.

⁶¹ See cases cited note 43 *supra*.

21g, "no transfer by or in behalf of the bankrupt after the date of bankruptcy shall be valid against the trustee." Congress's primary concern was to guarantee that protection would be forthcoming in the situations defined in sections 70d and 21g, and thus to eliminate prior uncertainties about whether a court would grant protection in each particular case. Toward this end, Congress sought to take the matter out of the domain of judicial discretion and place it under the exclusive control of the statute. This provision, however, does not appear to have been motivated by any desire to prohibit protection *after* the period covered by section 70d.⁶² Yet, this has been the chief use of the prohibition in the cases that have arisen under section 70d.⁶³

Section 21g, dealing with post-petition transfers of the bankrupt's real estate, was also added in 1938.⁶⁴ Although the section was new, its substance and approach were derived from the former section 21e and certain problems that had arisen thereunder. The former section 21e had provided that a certified copy of the order approving the trustee's bond constituted conclusive evidence that title had vested in him and that, if recorded, the order imparted the same notice of the trustee's title as would be imparted by a recorded deed from the bankrupt to the trustee.⁶⁵

The decisions under the former sections 70a and 21e had consistently held that the vesting of title in the trustee was not in derogation of local recording acts. Thus, unless the notice provision of section 21e had been utilized, an innocent purchaser of realty from the bankrupt could prevail under the local recording acts against the trustee.⁶⁶ But since section 21e based notice only on the recorded order approving the trustee's bond, which could be entered by the court only after adjudication of the bankrupt and qualification of the trustee, the estate

⁶² Cf. ANALYSIS OF H.R. 12889, *supra* note 52, at 229-31; McLaughlin, *supra* note 15, at 383-84.

⁶³ See cases cited note 4 *supra*.

⁶⁴ 11 U.S.C. § 44g (1964).

⁶⁵ Section 21e then read:

A certified copy of the order approving the bond of a trustee shall constitute conclusive evidence of the vesting in him of the title to the property of the bankrupt, and if recorded shall impart the same notice that a deed from the bankrupt to the trustee if recorded would have imparted had not bankruptcy proceedings intervened.

Act of July 1, 1898, ch. 541, § 21e, 30 Stat. 552.

⁶⁶ Beach v. Faust, 2 Cal. 2d 290, 40 P.2d 822 (1935); Vombrack v. Wavra, 331 Ill. 508, 163 N.E. 340 (1928); Derryberry v. Matterson, 193 La. 624, 192 So. 78 (1939). See also the discussion in Vierson v. Boettcher, 387 P.2d 133, 139 (Okla. 1963) (dissenting opinion). The doctrine of *lis pendens* could create an exception in some cases when the realty was situated within the territorial jurisdiction of the bankruptcy court.

was left unprotected against dissipation of the bankrupt's realty prior to that point in the proceeding.⁶⁷

Intending to deal with this problem,⁶⁸ Congress provided in the new section 21g that the *petition*, without the schedules, the *decree of adjudication*, or the order approving the trustee's bond, might be recorded by the trustee, the referee, or any interested party, and that any such recording would constitute notice to third parties of the trustee's title. In addition, express provision was made to protect innocent purchasers for value in the absence of such recording. Curiously, however, a concluding proviso in section 21g was added to limit application of the section to counties other than that in which the bankruptcy is pending, apparently leaving local realty to the operation of the local recording statutes and rules of *lis pendens*.⁶⁹

Unlike the approach taken in section 70d, nothing in section 21g terminates the protection granted innocent purchasers of realty prior to the actual recording of the required notice. No suggestion seems to have been made in the drafting and enactment of section 21g that protection should be denied with respect to post-adjudication transfers, as was being done in section 70d.⁷⁰ But this aspect of section 21g—

⁶⁷ See *Vierson v. Boettcher*, 387 P.2d 133, 139 (Okla. 1963) (dissenting opinion); ANALYSIS OF H.R. 12889, *supra* note 52, at 130-31.

⁶⁸ *Vierson v. Boettcher*, 387 P.2d 133, 139 (Okla. 1963) (dissenting opinion); ANALYSIS OF H.R. 12889, *supra* note 52, at 130-31.

⁶⁹ Section 21g reads:

A certified copy of the petition with the schedules omitted, of the decree of the adjudication or of the order approving the trustee's bond may be recorded at any time in the office where conveyances of real property are recorded, in every county where the bankrupt owns or has an interest in real property. Such certified copy may be recorded by the bankrupt, trustee, receiver, custodian, referee, or any creditor, and the cost of such recording shall be paid out of the estate of the bankrupt as part of the expenses of administration. Unless a certified copy of the petition, decree, or order has been recorded in such office, in any county wherein the bankrupt owns or has an interest in real property in any State whose laws authorize such recording, the commencement of a proceeding under this Act shall not be constructive notice to or affect the title of any subsequent bona-fide purchaser or lienor of real property in such county for a present fair equivalent value and without actual notice of the pendency of such proceeding: *Provided, however*, That where such purchaser or lienor has given less than such value, he shall nevertheless have a lien upon such property, but only to the extent of the consideration actually given by him. The exercise by any court of the United States or of any State of jurisdiction to authorize or effect a judicial sale of real property of the bankrupt within any county in any State whose laws authorize the recording aforesaid shall not be impaired by the pendency of such proceeding unless such copy be recorded in such county, as aforesaid, prior to the consummation of such judicial sale: *Provided, however*, That this subdivision shall not apply to the county in which is kept the record of the original proceedings under this Act.

Bankruptcy Act § 21g, 52 Stat. 853 (1938), 11 U.S.C. § 44(g) (1964).

⁷⁰ Cf. S. REP. NO. 1916, *supra* note 49; H.R. REP. NO. 1409, *supra* note 49; ANALYSIS OF H.R. 12889, *supra* note 52, at 130-31.

allowing protection after adjudication—like the contrary provision in section 70d, seems to have resulted primarily from the uncritical acceptance of the form of the previous situation.

III

THE 1959 AMENDMENT—SECTION 18F

Until 1959 the adjudication of the debtor as a bankrupt pursuant to either a voluntary or an involuntary petition could only occur upon the affirmative entry of an order to that effect by a United States district judge or a referee.⁷¹ Thus, it was somewhat plausible to treat such an order as a judicial act of sufficient dignity and notoriety to impart constructive notice of its occurrence and consequences, although to do so constituted a rather sweeping application of the concept of *lis pendens*. It is reasonably probable that the adjudication in a contested involuntary proceeding will attain at least local notoriety. But for many years prior to 1959 the entry of the adjudication order in voluntary proceedings was essentially a matter of routine, occurring promptly after the filing of the petition and receiving virtually no public attention.⁷² Nevertheless, since an actual court order was necessary to effect the adjudication in every case, some interval of time was assured between the filing of the petition and the entry of the order.

In 1959, however, Congress amended section 18f to provide that "[t]he filing of a voluntary petition under chapters I to VII of this Act . . . shall operate as an adjudication with the same force and effect as a decree of adjudication."⁷³ Thus, in voluntary cases the "adjudication" became a fiction based on the mere *ex parte* filing of the petition, without further notoriety or judicial act. The legislative history of this amendment clearly establishes that its sole purpose was to simplify and expedite the handling of bankruptcy cases and to achieve greater administrative efficiency.⁷⁴ This purpose was commendable, and in this respect the amendment has proven highly effective and workable.

⁷¹ Act of June 22, 1938, ch. 575, § 18g, 52 Stat. 852. Section 18g was renumbered § 18f by the 1949 amendment, and the former § 18f was repealed. 73 Stat. 109 (1959). The adjudication order was normally signed by the judge. See J. MACLACHLAN, *supra* note 55, § 49.

⁷² See S. REP. NO. 320, 86th Cong., 1st Sess. (1959).

⁷³ Bankruptcy Act § 18f, 73 Stat. 109 (1959), 11 U.S.C. § 41(f) (1964).

⁷⁴ See S. REP. NO. 320, *supra* note 72; H.R. REP. NO. 241, 86th Cong., 1st Sess. (1959). This amendment was coupled with an amendment to § 22 to provide for automatic reference of cases to a referee "[u]nless the judge or judges direct otherwise" Bankruptcy Act § 22a, 73 Stat. 109 (1959), 11 U.S.C. § 45(a) (1964).

Congress evidently failed, however, to take into account all the consequences of the linguistic formula it used to achieve this end. At no point in the drafting, consideration, and enactment of this amendment does it appear to have been recognized that in voluntary proceedings the amendment would have the effect of eliminating all protection under section 70d for innocent third parties involved in post-bankruptcy transactions, although this result appears logically inevitable.⁷⁵

IV

JUDICIAL INTERPRETATION OF SECTION 70d

Although section 70d was enacted primarily to provide affirmative protection for innocent third parties involved in post-bankruptcy transactions, the leading decisions under it have principally concerned the rigid limitations on the protection created. Until the Supreme Court's decision in *Bank of Marin v. England*,⁷⁶ most of the cases had interpreted the section's prohibition against judicial interference with the defined area of protection⁷⁷ as forbidding the granting of protection in other situations, equitable considerations notwithstanding.⁷⁸ *Bank of Marin v. England* stands as the major exception to this trend. Although the case fails to provide a satisfactory solution to the problem, it demonstrates the inherent narrowness and unreasonableness of the limitations in section 70d on the protected interval.

The opinion in *Lake v. New York Life Insurance Co.*⁷⁹ was the first major interpretation of section 70d. The bankrupt had been insured by five life insurance companies. On August 6, 1951, an involuntary petition in bankruptcy was filed against him and a receiver was appointed. At the time the aggregate cash surrender value of the policies was \$45,702.44. By August 21 the receiver had taken possession of all or the greater portion of the bankrupt's known assets, but he did not then know of the existence of the life insurance policies. Between August 21 and August 29, the five insurance companies, un-

⁷⁵ S. REP. No. 320, *supra* note 72; H.R. REP. No. 241, *supra* note 74; *cf.* *Bank of Marin v. England*, 385 U.S. 99, 109 n.16 (1966) (Harlan, J., dissenting).

⁷⁶ 385 U.S. 99 (1966).

⁷⁷ The prohibition is contained in clause (5) of § 70d, quoted in note 51 *supra*.

⁷⁸ *Feldman v. Capital Piece Dye Works, Inc.*, 293 F.2d 889 (2d Cir.), *cert. denied*, 368 U.S. 948 (1961); *Kohn v. Myers*, 266 F.2d 353 (2d Cir. 1959), *aff'g In re Autocue Sales & Distrib. Corp.*, 162 F. Supp. 17 (S.D.N.Y. 1958); *Lake v. New York Life Ins. Co.*, 218 F.2d 394 (4th Cir.), *cert. denied*, 349 U.S. 917 (1955). *But see* *Rosenthal v. Guaranty Bank & Trust Co.*, 139 F. Supp. 730 (W.D. La. 1956). The Ninth Circuit and Mr. Justice Harlan, in his dissent in *Bank of Marin*, also adhered to the strict interpretation of § 70d.

⁷⁹ 218 F.2d 394 (4th Cir.), *cert. denied*, 349 U.S. 917 (1955).

aware of the pending bankruptcy, made loans to the bankrupt aggregating \$45,334.28, and secured repayment by taking contemporaneous assignments of the policies from the bankrupt.

Adjudication of the bankrupt occurred on September 24, and the trustee first discovered the existence of the policies on October 29. By that time, however, the bankrupt had used most of the borrowed money to pay various creditors. The portion remaining was recovered by the trustee. Pursuant to section 70a(5) the trustee gave the bankrupt the option to remit the balance of the cash surrender value of the policies as of August 6. On the bankrupt's failure to do so, the trustee brought suit against the insurance companies for the cash surrender value of the policies as of August 6, less the portion of the loans already recovered by the trustee. The insurance companies defended on the ground that they held valid security assignments of the policies, taken by them in good faith without knowledge of the pending bankruptcy to secure contemporaneous loans to the bankrupt.⁸⁰ They argued that their liability should therefore be limited to the cash surrender value of the policies less the balance due on the loans. The trustee replied that at the time of the loans the bankruptcy receiver had been in possession of the greater portion of the bankrupt's property, and that the security assignments were therefore beyond the scope of the protection afforded by section 70d.

The Fourth Circuit, reversing the district court's decision, sustained the trustee's argument on this issue.⁸¹ In an opinion by Judge Soper, often cited for its interpretation of section 70d, the court reviewed the history of the treatment of post-bankruptcy transfers culminating in the enactment of section 70d, and concluded:

It is obvious that the intent of this enactment is to invalidate transactions not granted specific protection under the Act and thus put to an end the confusion theretofore existing in the decisions. There is almost always some injustice or hardship which attends transactions occurring after the filing of a petition in bankruptcy between the bankrupt, acting wrongfully, and an innocent third person, because the loss must fall either upon the third person or upon the creditors of the bankrupt. Whether the line which has been drawn is the best possible solution of the problem is not for the courts to say. The line has in fact been drawn by

⁸⁰ In addition to the principal defense urged and discussed here, the defendants urged defenses of election of remedies in recovery of part of the fund, and of estoppel by benefit to the estate through satisfaction of creditors' claims with the fund. These defenses were also rejected by the court.

⁸¹ *Lake v. New York Life Ins. Co.*, 218 F.2d 394 (4th Cir.), *cert. denied*, 349 U.S. 917 (1955), *rev'g* 122 F. Supp. 348 (D. Md. 1954).

competent authority and it is no longer necessary for the courts to make the attempt, which has not been conspicuously successful in the past, to decide cases on the facts as they arise and to draw a fine distinction between transactions which should be protected and those which should not.⁸²

Accordingly, the court held that under section 70d(4) protection for transactions described in sections 70d(1) and (2) had ceased to be available when the receiver took possession of most of the bankrupt's assets on August 21, and that section 70d(5) prohibited the extension of any protection thereafter. The later security assignments of the policies to the insurance companies were, therefore, held to be ineffective against the trustee's title to the policies under section 70a(5).

A similar contention was made by the trustee in *Rosenthal v. Guaranty Bank and Trust Co.*⁸³ The bankrupt had filed a petition in the Southern District of New York for reorganization under Chapter X,⁸⁴ which the court approved on October 3, 1951. The trustee was appointed on October 5, and on October 11 he notified the defendant bank in Lafayette, Louisiana, where the bankrupt had its principal checking account, that the reorganization proceeding was pending. Between October 4 and October 10, however, the bank, in honoring checks previously issued by the bankrupt, had paid the \$6,699.91 balance that was on deposit in the account at the close of business on October 3. On June 7, 1954, the court adjudicated the debtor a bankrupt and directed that straight bankruptcy be proceeded with.

The trustee brought suit against the bank to recover the \$6,699.91 on the theory that the order approving the reorganization petition on October 3 amounted to an "adjudication" within the meaning of section 70d, and that the bank's payment of the checks between October 4 and October 10 was therefore beyond the scope of the protection afforded. The trustee relied on the prohibition expressed in section 70d(5) as precluding the grant of any further protection.⁸⁵

The court was "inclined to agree"⁸⁶ with the trustee's strict interpretation of the prohibition in section 70d(5), but pointed out that

⁸² *Id.* at 399.

⁸³ 139 F. Supp. 730 (W.D. La. 1956).

⁸⁴ Bankruptcy Act §§ 101-276, 11 U.S.C. §§ 501-676 (1964).

⁸⁵ The trustee also contended that the bank had knowledge of the pending reorganization proceeding from its awareness of newspaper accounts and rumors which indicated major difficulty but were not specific concerning the pending proceeding. The court concluded that this did not give the bank "actual knowledge" within the meaning of § 70d(3) and that the bank had no such knowledge until the notification on October 11, 1951.

⁸⁶ 139 F. Supp. at 734.

the section also contained an exception from this prohibition for transactions involving the "negotiability of currency or negotiable instruments."⁸⁷ Observing the acute dilemma faced by a bank when its depositor's status is uncertain—having to choose between liability to the depositor for dishonoring valid checks (if bankruptcy has not occurred) and liability to the trustee for honoring checks (if bankruptcy has occurred)—the court concluded that the negotiability exception was intended to prevent the Bankruptcy Act from interfering with the normal handling of negotiable instruments in the absence of actual knowledge that bankruptcy is pending.⁸⁸ Therefore, the bank was held to be protected.

The strict interpretation of section 70d was accepted in *Kohn v. Myers*,⁸⁹ with full recognition of its possible harshness. A competitor of the bankrupt and the competitor's attorney purchased \$16,987.57 of the bankrupt's accounts receivable for \$16,817.49 while an involuntary petition against the bankrupt was pending, but prior to adjudication. The competitor and its attorney knew that the bankruptcy was pending and that the first two pleadings by the petitioner were defective. They did not know, however, that a second amendment to the petition, curing the defects in the prior pleadings, had been filed by the time of their purchase. After adjudication the trustee brought a summary proceeding against the competitor and its attorney for return of the accounts receivable or their proceeds. Among the disputed issues was whether the competitor and its attorney had acted in "good faith" within the meaning of section 70d(3).

Both the district court and the Second Circuit held that the competitor and its attorney had not acted in "good faith" because, knowing of the first two pleadings, they were charged with knowledge of the third, which supplied the curative amendment. Hence, they did not have "reasonable cause to believe that the petition [was] . . . not well founded"⁹⁰ at the time of the purchase.

⁸⁷ 52 Stat. 882 (1938), 11 U.S.C. § 110(d)(5) (1964). See note 51 *supra*.

⁸⁸ This interpretation of the "negotiability proviso" has been criticized by several authors on the ground that presentment of a check for payment is not a "negotiation" of it in the strict sense of negotiable instruments law and, therefore, not within the "negotiability proviso." See 4 W. COLLIER, BANKRUPTCY ¶ 70.68, at 1502 n.3 (14th ed. 1964); Seligson, *Creditors' Rights*, 32 N.Y.U.L. REV. 708, 729-31 (1957); Note, 70 HARV. L. REV. 548 (1957); cf. Note, *Bankruptcy and Negotiable Instruments*, 64 HARV. L. REV. 958 (1951).

⁸⁹ 266 F.2d 353 (2d Cir. 1959), *aff'g In re Autocue Sales & Distrib. Corp.*, 162 F. Supp. 17 (S.D.N.Y. 1958).

⁹⁰ Bankruptcy Act § 70d(3), 52 Stat. 881 (1938), 11 U.S.C. § 110(d)(3) (1964).

In the district court opinion, Judge Dimock ably described the rigidity and harshness of section 70d:

It is not to be wondered that petitioners go to extremes in an attempt to find some amelioration of the extraordinarily arbitrary provisions of the statute. There seems to be no escape from the fact that, even though the transferees gave more than adequate consideration for the accounts receivable transferred to them and the bankrupt used this consideration for the payment of taxes and wage claims, the transferees must now reassign the accounts receivable or their proceeds without the benefit of the return of the consideration to which they would be entitled upon conventional rescission of the transaction. Petitioners put the case of a department store against which a petition in bankruptcy has been filed with resulting publicity in the newspapers. Business continues as usual and a customer who has read of the proceedings but has no views as to their validity buys an overcoat and pays \$100 for it. The store is later declared bankrupt and the trustee brings a summary proceeding for the return of the overcoat. Under the Referee's construction of the statute the trustee is entitled to the return of the overcoat but need not return the \$100 that was paid for it. Such a statute would seem to be calculated to put a stop to any business as soon as a petition in bankruptcy was filed against it. Nevertheless, I see no escape from that construction of the Bankruptcy Act.⁹¹

Concurring in this interpretation of section 70d, the Second Circuit stated:

The policy of the statute is to place a rigid and absolute ban on all transfers and even as to the exceptions specifically mentioned in [section 70d(1)] . . . the transferee has the burden of proof. The period between the filing of the petition and adjudication is a sensitive and important period. Any contrary policy would render it very difficult, if not impossible, for the trustee to liquidate or dispose of the bankrupt's property most advantageously.⁹²

The Second Circuit adhered to this view of section 70d in *Feldman v. Capitol Piece Dye Works, Inc.*⁹³ The bank honored the bankrupt's payroll checks against its account after an involuntary petition had been filed, but prior to adjudication. Although the bank acted without knowledge of the bankruptcy, it was held liable to the trustee

⁹¹ 162 F. Supp. at 22-23.

⁹² 266 F.2d at 357.

⁹³ 293 F.2d 889 (2d Cir.), cert. denied, 368 U.S. 948 (1961). See also *Schilling v. McAllister Bros.*, 310 F.2d 123 (2d Cir. 1962); *Kass v. Doyle*, 275 F.2d 258 (2d Cir. 1960). In both cases the central issue was the interpretation of "present fair equivalent value" within § 70d(1).

for the amount paid on the checks. The court held that section 70d(2)⁹⁴ did not protect the bank in this case, because the bankrupt's treasurer, who had signed the checks and had been previously authorized to do so, had resigned his office with the bankrupt prior to the signing. The court found that the bank, although unaware of the Treasurer's resignation, had not relied on his apparent authority to sign the checks, and concluded that the checks were therefore not orders of the bankrupt within the meaning of section 70d(2).

The shortcomings of section 70d and the unreasonable harshness of the *lis pendens* theory on which it relies were most clearly demonstrated in *Bank of Marin v. England*.⁹⁵ Checks that the bankrupt had issued to a creditor shortly before filing a voluntary petition in bankruptcy were presented to the bank and paid in the ordinary course of business six days after the filing. When the bank paid the checks, it had no knowledge of the pending bankruptcy. The protection otherwise available under section 70d(2) was apparently precluded only because the petition had been voluntary and therefore, under section 18f, resulted in an "adjudication" immediately upon filing.

Appealing from adverse decisions of the referee and the district court, the bank presented four principal arguments against this result to both the Ninth Circuit and the Supreme Court.⁹⁶ First, the bank contended that its payment of the checks was protected by the "negotiability proviso" in section 70d(5), as interpreted in *Rosenthal v. Guaranty Bank and Trust Co.*,⁹⁷ even though the payment was made after the technical "adjudication" of the bankrupt under section 18f. Second, it argued that under section 70a the trustee succeeded only to the bankrupt's rights in the checking account, which under the terms of the deposit contract were qualified by the obligation to give the bank adequate notice to stop payment before the bank could be held liable for paying valid outstanding checks. Third, it asserted that, without more adequate and reasonable notice of its depositor's bankruptcy than the mere filing of a voluntary petition, it would be denied due process of law if held liable to the trustee for payment of the checks. Finally, it appealed to the court to grant it protection on equitable principles regardless of the apparent effect of section 70d.

⁹⁴ 11 U.S.C. § 110d(2) (1964). If the checks had been validly issued, this section clearly would have protected the bank.

⁹⁵ 385 U.S. 99 (1966), *rev'g* 352 F.2d 186 (9th Cir. 1965).

⁹⁶ The significance of the issues raised was underscored by the appearance of the California Bankers Association as *amicus curiae* in support of the bank's position. See 352 F.2d at 187; 385 U.S. at 100.

⁹⁷ 139 F. Supp. 730 (W.D. La. 1956), discussed at pp. 297-98 & notes 83-88 *supra*.

The Ninth Circuit rejected the argument based on the "negotiability proviso" on two grounds. First, it held that the proviso, like the protection in sections 70d(1) and (2), is limited by the opening phrase of section 70d to the interval between the petition and adjudication, and therefore is not available in a voluntary case. Second, it held that the proviso does not apply to presentment of a check for payment, because such presentment is not a "negotiation" of the check in the strict sense of the term.⁹⁸ Although this issue was evidently presented to the Supreme Court, it was dealt with only in the dissent of Justice Harlan, who rejected the bank's argument.⁹⁹

The legislative intent behind the "negotiability proviso" is obscure, but the language "nothing in this Act shall impair . . . negotiability" appears to be opposed on its face to the Ninth Circuit's limitation of the proviso to the interval between petition and adjudication. Further, despite the strict definition of "negotiation" in the law of negotiable instruments, the broader provision in section 70d(5) that "nothing . . . shall impair . . . negotiability" can easily be viewed as including the indirect consequences to the normal handling of checks prior to presentment that might result from the risks faced by drawee banks under the Ninth Circuit's interpretation. Nevertheless, since the Supreme Court did not deal with the applicability of the "negotiability proviso" in this case, its precise meaning remains obscure.

The bank's second argument, predicated on its right and duty under the deposit contract to make payment on validly issued checks until ordered to stop payment or given actual notice of the depositor's bankruptcy, was rejected rather casually by the Ninth Circuit on the dubious theory that the depositor's bankruptcy had automatically revoked the bank's authority to make payment from the account, even with respect to the outstanding checks, and that this restriction on the bank's authority constituted an implied exception to the deposit contract.¹⁰⁰ But the bank's position on this issue was sustained by the Supreme Court and constituted one of the principal grounds of its decision:

[W]e do not agree with the Court of Appeals that the bankrupt's checking accounts are instantly frozen in the absence of knowledge or notice on the part of the drawee of the bankruptcy. The trustee succeeds only to such rights as the bankrupt possessed; and the trustee is subject to all claims and defenses

⁹⁸ See the criticism of *Rosenthal* on this point cited note 88 *supra*.

⁹⁹ See 385 U.S. at 104 n.2 (dissenting opinion).

¹⁰⁰ 352 F.2d at 191.

which might have been asserted against the bankrupt but for the filing of the petition. . . . The relationship of bank and depositor is that of debtor and creditor, founded upon contract. The bank has the right and duty under that contract to honor checks of its depositor properly drawn and presented . . . absent a revocation that gives the bank notice prior to the time the checks are accepted or paid by the bank.¹⁰¹

At this point the Court appears to have held that the trustee, like the bankrupt depositor, must give the bank specific directions to stop payment on outstanding checks before the bank will be liable for paying them, regardless of any general knowledge the bank may have of the pendency of the bankruptcy. But this appearance is clouded considerably by the Court's further statements, which seem to relate equally to this issue and to the bank's third argument (concerning the adequacy of notice to it to satisfy due process requirements).

The kind of notice required is one "reasonably calculated, under all the circumstances, to apprise the interested parties of the pendency of the action." *Mullane v. Central Hanover Bank & Trust Co.*, [339 U.S. 306, 314 (1950)] We cannot say that the act of filing a voluntary petition in bankruptcy *per se* is reasonably calculated to put the bank on notice. Absent revocation by the drawer or his trustee or absent knowledge or notice of the bankruptcy by the bank, the contract between the bank and the drawer remains unaffected by the bankruptcy and the right and duty of the bank to pay duly presented checks remain as before. In such circumstances the trustee acquires no rights in the checking account greater than the bankrupt himself.¹⁰²

It is clear from this part of the opinion that the Court has soundly rejected the constructive notice, or *lis pendens*, theory of bankruptcy adjudication when based merely on the filing of a voluntary petition. But the Court has linked this holding with its holding sustaining the bank's rights under the deposit contract. This was done in such a manner that it is impossible to predict whether either ground standing alone would be conclusive. The bank urged both grounds separately and in conjunction, and both were evidently sustained. But the Court did not expressly deal with the "due process" argument, nor did it hold, as noted by Mr. Justice Harlan, that section 70d is constitutionally defective for failing to require adequate notice to third parties.¹⁰³

¹⁰¹ 385 U.S. at 101.

¹⁰² *Id.* at 102.

¹⁰³ *Id.* at 110 (dissenting opinion). That the Court's language concerning the adequacy of notice relates to the due process argument is suggested by, among other things, the

The most reasonable interpretation of this combination of holdings appears to be that the bank is entitled to rely on the deposit contract and to honor checks against the account until it receives *either* a stop payment order *or* any actual notice of the bankruptcy. But the Court did not hold that actual notice or knowledge of the bankruptcy alone would terminate the bank's rights and duties under the deposit contract. It held only that, where the bank had neither a stop payment order nor actual notice or knowledge of the bankruptcy, it was entitled to rely on the deposit contract, notwithstanding the "adjudication" of the bankrupt.

Also, although the Court emphasized the necessity of notice in this case, it did not hold that in *every* situation arising under section 70d third parties will be protected against the trustee unless they have actual notice or knowledge of the bankruptcy. At best, the Court held only that the pre-bankruptcy contract rights of a third person cannot be altered by the bankruptcy until the third party has actual notice or knowledge of it.

Adding substantially to these uncertainties is the disposition made of the bank's fourth argument, that the bankruptcy court is generally governed by equitable principles which it should invoke in a case such as this regardless of the apparent limitations of section 70d. The difficulty of the bank's position in the absence of such relief was well described by the Ninth Circuit:

Under the trustee's theory of the case the bank must, in order to avoid liability, keep itself informed of the possibility of bankruptcy proceedings involving a depositor. According to the bank, this will require it to keep advised momentarily of bankruptcy filings. This burden is enhanced by the fact that filing in any district court in the United States will have the same effect. The steps demanded for protection are cited as impractical and otherwise burdensome.

Court's reliance on *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306 (1950), *Schroeder v. City of New York*, 371 U.S. 208 (1962), and *Walter v. City of Hutchinson*, 352 U.S. 112 (1956), none of which were bankruptcy or bank deposit cases, but all of which dealt with the adequacy of notice under the requirements of due process. The Ninth Circuit rejected the bank's "due process" argument on the theory that prior to the turnover proceeding "the rights of the bank were not affected by any order entered by the referee" (352 F.2d at 192), notwithstanding the fact that the bank's liability was based solely on the "adjudication" of the bankrupt upon filing the voluntary petition. It is difficult to reconcile this holding with the Ninth Circuit's rejection of the bank's second argument, holding that the filing of the bankruptcy petition automatically terminated the bank's right to honor valid checks as an exception to the deposit contract. The filing of the petition should be regarded as affecting or as not affecting the bank's rights and liabilities for all purposes.

The bank's dilemma is real since it is under a duty to depositors to honor checks which are validly drawn; at the same time there is always the possibility that the depositor, without the knowledge of the bank, has become the subject of bankruptcy proceedings. The hardship to the bank of keeping itself apprised of developments in the bankruptcy court is contrasted with the relatively light burden that a notice requirement would place upon the trustee. The trustee or receiver, upon filing, is informed of the bankrupt's accounts and deposits; and notification by him to the bank would be relatively simple.¹⁰⁴

Nevertheless, adhering to the strict interpretation of section 70d adopted in the earlier cases, the court rejected the bank's appeal for the application of "equitable principles" to extend protection to it beyond that in section 70d.

The Supreme Court rejected the strict interpretation of section 70d and the trustee's argument based on the prohibition expressed in section 70d(5).

Yet we do not read these statutory words with the ease of a computer. There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction. . . . We have said enough to indicate why it would be inequitable to hold liable a drawee who pays checks of the bankrupt duly drawn but presented after bankruptcy, where no actual revocation of its authority has been made and it has no notice or knowledge of the bankruptcy. The force of §§ 70d(5) and 18f can be maintained by imposing liability on the payee of the checks where he has received a voidable preference or other voidable transfer. The payee is a creditor of the bankrupt, and to make it reimburse the trustee is only to deprive it of preferential treatment and to restore it to the category of a general creditor. To permit the trustee under these circumstances to obtain recovery only against the party that benefited from the transaction is to do equity.¹⁰⁵

The dissent by Mr. Justice Harlan deals principally with the problems posed by the Court's reliance on "equitable principles" contrary to the provisions of section 70d. Although he recognizes that the result reached by the Court does "alleviate an indisputable inequity to the bank," he would nevertheless affirm the decision for the trustee on the basis of the proscription in section 70d(5). He concludes:

I had thought it well settled that equity may supplement, but may never supersede, the Act. . . . The Act's language is neither imprecise nor infelicitous; I can therefore see no room for the interposition of equity.¹⁰⁶

¹⁰⁴ 352 F.2d at 190.

¹⁰⁵ 385 U.S. at 103.

¹⁰⁶ *Id.* at 110 (dissenting opinion).

The dilemma faced by the Court and the solution reached demonstrate the inadequacy of section 70d in its present form and suggest the manner in which it should be amended. But in the absence of an amendment, the Court's opinion leaves the future interpretation and application of section 70d and the principles governing post-bankruptcy transfers in serious uncertainty.

The Court's final holding, based on "equitable principles" notwithstanding the apparent exclusiveness of section 70d, presents two basic difficulties. First, if a court may now grant protection beyond the limitation of section 70d on the basis of "equitable principles," it would appear to be equally able to deny protection on the same basis, despite the provisions of section 70d. If so, the matter of post-bankruptcy transfers may have returned to the pre-1938 pattern of applying judicial discretion to each case, with the attendant unpredictability, risk, and uncertainty that existed then. Second, the Court's opinion fails to clarify the relationship between the third holding, based on "equitable principles," and the first two holdings, based respectively on the bank's rights under the deposit contract and on the lack of adequate notice. Each of these grounds alone might have been sufficient to support the decision. But the Court did not hold that each, or any one of them, was alone decisive without the aid of the others. Nor did it reject such possibility. It held only that the three grounds together supported its conclusion.

V

THE NEED FOR AMENDMENT—AND A PROPOSAL

These developments demonstrate that an amendment of section 70d is necessary for three basic reasons. First, it is as true today as it was when sections 70d and 21g were adopted in 1938 that the matter of post-bankruptcy transfers should be governed exclusively by adequate statutory provision rather than by the uncertain application of "equitable principles." Second, although section 70d was well drafted in many respects, the narrow limitations it imposes on the protected interval produce unreasonably harsh results. Third, in an effort to avoid such harshness, the Supreme Court's opinion in *Bank of Marin v. England* has left the future significance of section 70d in serious question without providing in its place any clear guide for future decisions.

Section 70d has four functional parts: (a) the denial in clause (5) of protection except as specified in sections 70d and 21g; (b) the basic grant of protection to the two types of post-bankruptcy transfers de-

scribed in clauses (1) and (2); (c) the "negotiability proviso" in clause (5); and (d) the dual limitations on the protected interval expressed in the opening phrase of section 70d and in clause (4).

The first of these components is clearly necessary in any attempt to govern the subject of post-bankruptcy transfers exclusively by statute. Clauses (1) and (2), defining the two basic types of protected post-bankruptcy transfers, have proven to be sound and well drafted.¹⁰⁷ By employing the key terms "good faith" and "present fair equivalent value," they limit their protection to those persons whose post-bankruptcy transactions with the bankrupt do not diminish the bankruptcy estate and who in most cases act without knowledge of the bankruptcy. Such persons should be protected against the trustee's claim, and those not deserving protection are excluded by necessary implication.

The critical term "good faith" is not adequately defined in section 70d. Clause (3) indicates that in most cases the term means only the absence of actual knowledge of the bankruptcy. But the possibility that it means something more than this is not foreclosed. Also, the qualification on the usual meaning of "good faith"—that a person knowing of the bankruptcy may still be in "good faith" if "he has reasonable cause to believe that the petition in bankruptcy is not well founded"¹⁰⁸—seems inappropriate in section 70d. The intended purpose of this provision—to protect businesses from harassment by unfounded involuntary petitions—could be accomplished more effectively in a separate provision designed specifically to meet that problem, which is extraneous to the matter of post-bankruptcy transfers. It also seems unlikely that anyone with actual knowledge of the bankruptcy and the trustee's rights will intentionally continue to deal with the bankrupt, or will extend credit to him, merely on the strength of his ability to prove in future litigation with the trustee that he had reasonable cause to believe the petition was not well founded. The problems affecting post-bankruptcy transfers would be reduced by defining the term "good faith" for all purposes as the absence of actual knowledge of the pendency of the bankruptcy.

The scope and intended purpose of the "negotiability proviso" remain obscure. The broad interpretation of this provision in *Rosenthal v. Guaranty Bank and Trust Co.*¹⁰⁹ has been criticized on the ground that presentment of a check for payment is not a "negotiation"

¹⁰⁷ See, e.g., *Schilling v. McAllister Bros.*, 310 F.2d 123 (2d Cir. 1962); *Kass v. Doyle*, 275 F.2d 258 (2d Cir. 1960).

¹⁰⁸ Bankruptcy Act § 70d(3), 52 Stat. 881 (1938), 11 U.S.C. § 110d(3) (1964).

¹⁰⁹ 139 F. Supp. 730 (W.D. La. 1956).

in the strict sense.¹¹⁰ Nevertheless, the language "nothing . . . shall impair the negotiability of . . . negotiable instruments" does not require such strict interpretation. In any event, the intended meaning of this provision should be clarified.

The principal defect in section 70d, which has produced most of the litigation under that section, and which dictates the urgency of amendment, is that the availability of protection to third persons under clauses (1) and (2) is severely limited by the opening phrase of section 70d and by clause (4) to the interval between the filing of the petition and the earlier of adjudication or possession of the bankrupt's property by a receiver. If either of these two terminal events has occurred, section 70d purports to prohibit protection to the third person, even though he participates in good faith in a transaction squarely within clause (1) or (2) in all other respects. The earlier cases accepted the statutory command with its unreasonably harsh consequences.¹¹¹ *Rosenthal* avoided its effect through reliance on the "negotiability proviso."¹¹² The Supreme Court in *Bank of Marin v. England* found it unacceptable and refused to obey it.¹¹³

The legislative history of section 70d indicates that the provisions limiting the protected interval were not based on any carefully considered policy to deny protection in the transactions described in clauses (1) and (2) after either of the two terminal events. Instead, the limitations resulted only from a general effort to conform the new section to the pattern of the existing case law. The case law in question concerned the relation-back rule and its exceptions, all of which, because of the structure of the internal ambiguity in section 70a, related to the interval between filing the petition and adjudication. For this reason the case law was interpreted as limiting protection for post-petition transfers to the pre-adjudication period, although in two cases post-adjudication transfers had been protected.¹¹⁴ None of the cases, however, held that protection could not be granted to an innocent third person after adjudication, nor did any of them seriously consider the question.

¹¹⁰ See note 88 *supra*.

¹¹¹ *Feldman v. Capitol Piece Dye Works, Inc.*, 293 F.2d 889 (2d Cir.), *cert. denied*, 368 U.S. 948 (1961); *Kohn v. Myers*, 266 F.2d 353 (2d Cir. 1959), *aff'g In re Autocue Sales & Distrib. Corp.*, 162 F. Supp. 17 (S.D.N.Y. 1958); *Lake v. New York Life Ins. Co.*, 218 F.2d 394 (4th Cir.), *cert. denied*, 349 U.S. 917 (1955).

¹¹² *Rosenthal v. Guaranty Bank & Trust Co.*, 139 F. Supp. 730 (W.D. La. 1956).

¹¹³ *Bank of Marin v. England*, 385 U.S. 99 (1966).

¹¹⁴ The two cases were *Frederick v. Fidelity Mut. Life Ins. Co.*, 256 U.S. 395 (1921), and *Jones v. Springer*, 226 U.S. 148 (1912). *But cf.* *J.S. & J.F. String, Inc. v. Birkhahn*, 30 F.2d 492 (3d Cir. 1929); *Southern Ry. v. Cole*, 49 Ga. App. 635, 176 S.E. 512 (1934).

When Congress amended section 70a in 1938 to eliminate the internal ambiguity, it put an end to the need for the relation-back rule and to the significance of the interval between the petition and adjudication. The ill-considered inclusion at that time of the provision in section 70d ending the protected interval on the adjudication of the bankrupt—ostensibly to conform to the pattern of prior case law—was actually the perpetuation of an anachronism that had never been directly passed on in the prior cases.

The provisions in section 70d that end the protected interval when a receiver has taken possession of the bankrupt's property were also derived from indications in the earlier cases, rather than from an independent consideration of the merits of the limitation itself. Innocent purchasers for value in the ordinary course of the bankrupt's business had been protected against the relation-back rule, if they had purchased while an involuntary petition was pending and prior to a receiver's taking possession of the business.¹¹⁵ But these cases *granted* protection where no receiver was in possession; they did not *deny* protection where a receiver had taken possession. There appear to have been no cases of the latter sort. Thus, this feature of section 70d also perpetuated a rule suggested, but not actually decided, by the earlier cases.

The principle reflected in the use of these two events in section 70d for terminating the protected interval is that either event is of sufficient public notoriety to constitute constructive notice of the bankruptcy to any third person who may become involved in a post-bankruptcy transaction. Essentially, this is a form of the principle of *lis pendens*, by which everyone dealing with property involved in pending litigation is deemed constructively on notice of the litigation and its outcome.¹¹⁶ The doctrine of *lis pendens*, however, is usually applicable only to suits involving title to specifically identified real property and is restricted by a requirement that a notice of the suit be filed in the appropriate public land records.¹¹⁷

Even subject to these limitations *lis pendens* is usually regarded as a harsh principle, the use of which should be limited to those situations in which it has become customary and should be coupled with

¹¹⁵ *Hersh v. United States*, 68 F.2d 799 (9th Cir. 1934); *In re Retail Stores Delivery Corp.*, 11 F. Supp. 658 (S.D.N.Y. 1935); *In re Latex Drilling Co.*, 11 F.2d 373 (W.D. La. 1926). See also *In re Mertens*, 144 F. 818 (2d Cir. 1906).

¹¹⁶ ANALYSIS OF H.R. 12889, *supra* note 52, at 229-31; McLaughlin, *supra* note 36, at 612-14.

¹¹⁷ See, e.g., *Hailey v. Ano*, 136 N.Y. 569, 575-76, 32 N.E. 1068, 1068-70 (1893) (requirements not met and doctrine held inapplicable); McLaughlin, *supra* note 36, at 613.

a requirement to give effective public notice of the suit beyond the mere records of the court.¹¹⁸ Section 70d, however, is concerned only with personal property, including intangible property, which is often involved in rapidly moving commercial transactions. The section contains no provision for giving effective public notice of the litigation beyond the records of the court. Since a bankruptcy petition can be filed effectively in any district in the United States,¹¹⁹ and since commercial transactions today are frequently handled at high speed across great distances, it is obvious that the principle of *lis pendens* has been pushed beyond all reasonable bounds in section 70d.

Adding to the difficulties created by use of the *lis pendens* principle in section 70d is the 1959 amendment of section 18f to provide that "[t]he filing of a voluntary petition . . . shall operate as an adjudication with the same force and effect as a decree of adjudication."¹²⁰ Given literal effect, this provision inevitably eliminates any interval between the filing of the petition and adjudication, and thereby eliminates, in voluntary proceedings, all protection for the transactions described in clauses (1) and (2). There is no indication in the legislative history of the 1959 amendment that Congress intended to achieve this result. Rather, the amendment was evidently intended solely for administrative simplification and efficiency. Since it has worked well toward that end, the problem it creates for protection of post-bankruptcy transfers should be cured by amendment of section 70d rather than by any change in section 18f. There appears to be no valid reason for distinguishing between the rights of innocent third persons in voluntary cases and their rights in involuntary cases.¹²¹ The type of petition that initiated the proceeding is immaterial from the standpoint of an innocent third person.

For a third person to come within clause (1) or clause (2) of section 70d, he must give value or its equivalent, and in most cases he

¹¹⁸ McLaughlin, *supra* note 36, at 612-14.

¹¹⁹ Bankruptcy Act §§ 2a(1), 32b-c, 11 U.S.C. §§ 11a(1), 55(b)-(c) (1964), provide, in effect, that cases filed in the wrong district are misfiled as to venue only and may be transferred to the appropriate district. Thus, a petition filed in the wrong district is nevertheless within the court's jurisdiction subject to a change of venue, and the filing establishes both the date of bankruptcy, and, if the petition is voluntary, the adjudication, even though the case may subsequently be transferred across the continent.

¹²⁰ 73 Stat. 109 (1959), 11 U.S.C. § 41(f) (1964).

¹²¹ Mr. Justice Harlan suggests that § 70d may have been intended only for involuntary proceedings. 385 U.S. at 108-09 (dissenting opinion). The legislative history of 70d, however, does not require such inference. Nor does the distinction between voluntary and involuntary proceedings appear to have any logical relevance to the rights of innocent third persons.

must act without any actual knowledge of the bankruptcy. Therefore, both events that terminate the availability of protection—the bankrupt's adjudication and a receiver's possession of some of his property—are necessarily unrelated to the third person's practical situation and conduct, and their use to deny him protection is essentially arbitrary. The effect of this feature of section 70d is to benefit the creditors of the estate—most of whom voluntarily extended credit to the bankrupt prior to bankruptcy after calculating the risk—at the expense of the innocent third person who has no opportunity to protect himself. This result is difficult to justify.¹²²

Based on these considerations and on the implications of the holding in *Bank of Marin v. England* that, "before a person is deprived of property" by the pendency of litigation, he must be given notice "reasonably calculated, under all the circumstances, to apprise [him] of the pendency of the action,"¹²³ it is submitted that section 70d should be amended (1) to delete both of the present limitations on the interval during which protection is possible, and (2) to extend the protected interval until the earlier of (a) actual notification to third persons of the pendency of the bankruptcy, or (b) actual possession of the property in question by a receiver or trustee. These changes would eliminate the questionable use of the doctrine of *lis pendens* in this context and would help to bring this facet of the Bankruptcy Act into closer harmony with the realities of contemporary commercial life. The proposed amendment would also remove the uncertainties left by the Supreme Court's resort to "equitable principles" in *Bank of Marin v. England* by restoring the matter of post-bankruptcy transfers to the exclusive control of the statute.

This proposal does not actually suggest any startling innovation in bankruptcy administration. In the present Act innocent third persons involved in post-bankruptcy transfers of real estate situated beyond the county in which the bankruptcy is pending are protected under section 21g unless a document giving notice of the bankruptcy has been filed in the appropriate public land records. The availability of this protection does not end with adjudication of the bankrupt or with possession of his other property by a receiver. It ends only when

¹²² J. MACLACHLAN, *supra* note 55, § 293, at 346, suggests that the limitation is designed to inhibit further "meddling" with the estate and is proper because the bankrupt is no longer entitled to special consideration. But the person whose interests are actually at stake is the innocent third person who in "good faith" gives present value and can scarcely be said to be "meddling" with the estate.

¹²³ 385 U.S. at 102, *quoting* *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306, 314 (1950).

the necessary document is properly filed. The absence of litigation under section 21g since its adoption in 1938, in contrast to the experience under section 70d, is evidence of the soundness and workability of the section 21g approach.

Further precedent for the suggested amendment of section 70d is found in the 1867 Act, which required both publication of notices in newspapers selected by the court or the marshal and actual written notification of scheduled creditors and other interested persons. These notices advised of the pendency of the bankruptcy and gave specific warning against post-bankruptcy transfers. The present proposal is similar to these provisions.

In amending section 70d to provide for affirmative notification of third persons who might become involved in post-bankruptcy transactions, it is necessary to distinguish between two groups of persons. Persons indebted to the bankrupt or holding property of the bankrupt when the petition is filed can be individually identified without difficulty and should be fully disclosed in the schedules filed by the bankrupt. These persons can and should be individually notified of the pendency of the bankruptcy. As under section 21g, it should be permissible for this to be done by the bankrupt, a receiver, the trustee, the referee, or any creditor at any time after the petition is filed, and it should be sufficient if effected by delivery of a copy of the petition or by such other means as the court may direct. This would place no more burden on the court and its officers than notification of scheduled creditors does now.

The second group consists of persons who may become innocent transferees for value within clause (1) of section 70d. These persons cannot be identified in advance and therefore cannot be individually notified. Their situation would be materially improved, however, and the likelihood of their becoming involved in transactions within clause (1) reduced, by a requirement that notice of the bankruptcy be published, as directed by the court, in appropriate newspapers both where the bankrupt's property is located and where the bankruptcy is pending, and that the public be notified of the bankruptcy in such other manner as the court directs. Although any form of general public notice is necessarily imperfect, this suggestion would give the pendency of the bankruptcy substantially greater notoriety than it now receives and as much as the circumstances appear to permit. This provision should also permit the public notice to be given by any interested party at any time after the petition is filed.

The proposed change would not expose an estate to post-

bankruptcy transfers indefinitely. At any time a receiver or trustee, a creditor, or the court could act promptly to give effective notification to third persons. Also a receiver or trustee could promptly take possession of all the bankrupt's property. Either event would prevent further post-bankruptcy transactions within clauses (1) and (2) of section 70d. But until one of these events has taken place, innocent third persons would be protected in transactions within clauses (1) and (2). This would remedy the most serious shortcomings of the present section 70d and would assure that third persons would receive notice of the bankruptcy "reasonably calculated, under all the circumstances, to apprise them of the pendency of the action"¹²⁴ before being adversely affected by it. This being assured, the matter of post-bankruptcy transfers could be restored to the exclusive regulation of the statute.¹²⁵

¹²⁴ *Id.*

¹²⁵ As a corollary to the proposed amendment to § 70d, § 21g should be amended to delete the exception to the notice recording requirement that now exists with respect to land in the county where the bankruptcy is pending. The general notice recording requirement as to all other land has worked well. There seems to be little justification for not making this reasonable provision uniformly applicable to all realty. The exception is based essentially on the *lis pendens* doctrine. Although that doctrine is more customary in the real property context, its operation is harsh unless coupled with a notice recording requirement. Though less urgent than amendment of § 70d, this suggestion is equally appropriate to making the law governing post-bankruptcy transfers more reasonable and uniform.