

Proposed Bankruptcy Acts-Chapter IV Part 6 Reshaping the Trustee's Sword

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NOTES

THE PROPOSED BANKRUPTCY ACTS—CHAPTER IV, PART 6: RESHAPING THE TRUSTEE'S SWORD

A 1971 Brookings Institution report describes the existing bankruptcy process as an "assembly of administrative and fiscal error and confusion [which] has become an accepted way of professional life."¹ Congress, having recognized the need to study the bankruptcy process, created the Commission on Bankruptcy Laws, which proposed the completely new Bankruptcy Act of 1973.² Some of the changes suggested by the Commission, however, have not been well received by the bankruptcy bar. In 1974, the National Conference of Bankruptcy Judges responded to the Commission's Bill with their own proposed act.³ At first glance, the two proposals appear to be virtually identical. However, a number of substantial differences exist.⁴ One of the most important differences concerns the nature and extent of the powers given the trustee to avoid certain transfers made by the bankrupt.⁵ The purpose of this Note is to compare the trustee's avoidance powers under the present Bankruptcy Act with his proposed powers under the Judges' and the Commission's Bills.

A fundamental goal of the bankruptcy system is the equal distribution of the bankrupt's assets to his unsecured creditors.⁶

¹ D. STANLEY & M. GIRTH ET AL., *BANKRUPTCY: PROBLEM, PROCESS, REFORM* 4 (1971).

² Pub. L. No. 91-354, 84 Stat. 468 (1970); *COMM'N ON THE BANKRUPTCY LAWS OF THE UNITED STATES, REPORT, PART II (Proposed Bankruptcy Act)*, H.R. Doc. No. 137, 93d Cong., 1st Sess. (1973) [hereinafter cited as *Commission's Bill*]. The proposed legislation was introduced in Congress as H.R. 10792 and S. 2565, 93d Cong., 1st Sess. (1973).

³ The National Conference of Bankruptcy Judges had their proposed act introduced in Congress as H.R. 16643 and S. 4046, 93d Cong., 2d Sess. (1974) [hereinafter cited as the *Judges' Bill*]. The bankruptcy judges were formerly called referees in bankruptcy. The new bankruptcy rules elevated them to judgeship status. *BANKRUPTCY RULE 901(7)*. References jointly to the Commission's Bill and the Judges' Bill are hereinafter cited as the "proposals."

⁴ See generally Lee, *A Critical Comparison of the Commission Bill and the Judges' Bill for the Amendment of the Bankruptcy Act*, 49 *AM. BANK. L.J.* 1 (1975).

⁵ Probably the largest difference between the proposals is the Commission's new administrative procedures which eliminate Judges. See Walker, *An Introduction to the Proposed Bankruptcy Act of 1973: From Revision to Revolution*, 41 *TENN. L. REV.* 635, 643-46 (1974).

⁶ E.g., *Sampson v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941); *COMM'N ON THE BANKRUPTCY LAWS OF THE UNITED STATES, REPORT PART I*, H.R. Doc. No. 137, 93d Cong., 1st Sess. 213 (1973) [hereinafter cited as *Commission's Report*]; 3 *W. COLLIER, BANKRUPTCY* ¶ 60.01 (14th ed. 1975) [hereinafter cited as *COLLIER*]; Seligson, *Preferences Under the Bankruptcy Act*, 15 *VAND. L. REV.* 115 (1961). Since secured creditors and certain types of general creditors receive more than the percentage given to other creditors upon

The power of the trustee to set aside a bankrupt's transfers of his property and recapture assets for the distributable estate is therefore essential. Unless the trustee has avoiding powers, a bankrupt could frustrate this purpose by transferring all of his assets to his friends, relatives, or favored creditors before bankruptcy.⁷ The principal avoiding powers of the trustee under existing law are contained in section 60 (preferences),⁸ section 67d (fraudulent conveyances),⁹ section 70c (trustee as a lien creditor),¹⁰ and section 70e (trustee as a successor to the creditor's state law claims).¹¹ The proposals grant the trustee the power to negate the bankrupt's transfers in Chapter IV, part 6—Collection and Liquidation of the Estate—and in Chapter IV, part 3—Administration. The focus of the present analysis will be upon these provisions.

I

PREFERENTIAL TRANSFERS

At common law a debtor had the power to convey all of his assets to one of his creditors, thus preventing his other creditors from collecting their debts.¹² Such preference of one creditor to the detriment of others shortly before bankruptcy obviously would frustrate the attempt to achieve a fair and equitable distribution among all creditors. Therefore, the earliest provisions of bankruptcy law were designed to deal with such preferences.¹³ Closely related aims of a preference proscription are to lessen the likelihood that creditors will be scrambling to obtain advantages over one another and to preclude their making unwise loans upon promises of a subsequent preferential payment.¹⁴ The present

distribution of the bankrupt's estate, the significance of this equal distribution goal could be challenged. See Morris, *Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens*, 54 MINN. L. REV. 737, 738 (1970). Perhaps the proper way to phrase this goal is that all creditors are to be treated fairly, which means that all creditors of a certain type are to receive equal treatment although differential treatment may exist between the types of creditors. D. STANLEY & M. GIRTH, *supra* note 1, at 9-10.

⁷ Commission's Report 18.

⁸ 11 U.S.C. § 96 (1970).

⁹ 11 U.S.C. § 107(d) (1970).

¹⁰ 11 U.S.C. § 110(c) (1970).

¹¹ 11 U.S.C. § 110(e) (1970).

¹² 3 COLLIER ¶ 60.02

¹³ *Id.* ¶ 60.04-06.

¹⁴ COMMISSION'S REPORT 202; D. STANLEY & M. GIRTH, *supra* note 1, at 9; Seligson, *supra* note 6, at 115-16; Note, *Voidable Preferences: An Analysis of the Proposed Revisions of Section 60b of the Bankruptcy Act*, 1974 WIS. L. REV. 481, 483.

Bankruptcy Act and the two proposed acts deal with the problem of preferences in distinct ways.

A. *The Basic Elements of a Voidable Preference under Section 60*

Section 60a defines a preference as (1) a transfer of the bankrupt's property (2) to or for the benefit of a creditor (3) on account of an antecedent debt (4) made when the bankrupt was insolvent (5) within four months of the date of the filing of a petition in bankruptcy (6) which enabled the preferred creditor to obtain a greater percentage of his debt than another creditor of the same class.¹⁵ Even if all of the elements defining a preference exist, the trustee still cannot recover the property preferentially transferred by the bankrupt to one of his creditors unless a further test is met: to be a *voidable* preference, the preferred creditor must have had reasonable cause to believe that the debtor was insolvent.¹⁶ In addition to defining a voidable preference, section 60 contains complex timing provisions, which, in effect, shift the actual date of a transaction to a later point in time.¹⁷ This shifting critically affects whether a transaction is deemed to be within the four-month zone as well as the time at which some of the elements of a preference are determined.

The proposals have taken a different approach to defining a voidable preference. They categorize creditors according to their relation to the bankrupt. Preferences are thus treated as involving either insider creditors or non-insider creditors.

B. *Elements of a Non-Insider Preference under the Proposed Acts*

Under the proposals a non-insider voidable preference exists if (1) a transfer of the bankrupt's property (2) when the bankrupt was insolvent (3) to pay or to secure his antecedent debt (4) occurs within three months of the date of bankruptcy.¹⁸ The proposals, through an exception to the preference measure, add a fifth element: the transfer must enable the preferred creditor to obtain a greater percentage of his claim than other creditors of the same

¹⁵ Bankruptcy Act § 60a, 11 U.S.C. § 96(a) (1970). A preference may be voluntary or involuntary. In a voluntary preference, the bankrupt of his own free will transfers some of his property to a creditor. In an involuntary preference, the preferred creditor seizes, usually through judicial process, some property of the bankrupt.

¹⁶ 11 U.S.C. § 96(b) (1970). See, e.g., Note, *supra* note 14, at 483-84.

¹⁷ See notes 59-63 and accompanying text *infra*.

¹⁸ Commission's Bill § 4-607(a)(1); Judges' Bill § 4-607(a)(1) (four-month preference zone).

class, or must result in an unpaid creditor of a class higher than the preferred creditor's class.¹⁹

1. *A Transfer of the Bankrupt's Property*

The proposals retain the section 60 criterion that there must have been a transfer of the bankrupt's property. Obviously, a creditor could not be preferred unless he receives from the bankrupt part of the bankrupt's property. However, neither the current act nor the proposals define what constitutes a bankrupt's property. Thus, the case law under the Bankruptcy Act that does broadly define what constitutes a bankrupt's property will have continued validity.²⁰ In light of modern commercial transactions that have given rise to many new and different property interests, the use of a flexible common-law approach, rather than a rigid statutory definition, seems appropriate.

Bankruptcy does not distribute all of the assets of a bankrupt to his creditors. He is permitted to keep certain "exempt" property.²¹ *Rutledge v. Johansen*²² established that section 60 does not apply to a bankrupt's transfer of his exempt property. The *Rutledge* court reasoned that no creditor was harmed by such transfer since an exempt asset is not a part of the distributable estate of the bankrupt.²³ The proposals create a new approach to transfers of exempt assets: preferences made with exempt assets are recoverable either for the benefit of the distributable estate if the bankrupt voluntarily transferred them, or for the benefit of the bankrupt if

¹⁹ Commission's Bill § 4-607(b)(3); Judges' Bill § 4-607(b)(2).

²⁰ The existing case law on what constitutes a debtor's property is summarized in 3 COLLIER ¶ 60.07(2), which describes it as anything of value which could pay a debt. In § 4-601, the proposals define the property of a debtor's estate. This section does not aid the determination of a debtor's § 4-607 property because it defines property of the estate as property recovered under § 4-607. Commission's Bill § 4-601(a)(3); Judges' Bill § 4-601(a)(3). See generally Walker, *supra* note 5, at 646-49. The Commission's Bill may broaden the meaning of "transfer" to reach tax liens. See generally Plumb, *The Tax Recommendations of the Commission on the Bankruptcy Laws—Priority and Dischargeability of Tax Claims*, 59 CORNELL L. REV. 991, 1006 n.94 (1974).

²¹ Bankruptcy Act § 6, 11 U.S.C. § 24 (1970). The present act allows a bankrupt to keep whatever property his state of domicile declares to be exempt from judicial process. Walker, *supra* note 5, at 648-49. Because of the great variation among the exemption laws of the 50 states, a bankrupt in one state often cannot keep property which a bankrupt in another state could retain. See, e.g., Countryman, *For a New Exemption Policy in Bankruptcy*, 14 RUTGERS L. REV. 678 (1960); Note, *Bankruptcy Exemptions: A Full Circle Back to the Act of 1800?*, 53 CORNELL L. REV. 663 (1968). The proposals establish a uniform federal exemption law. See Liebowitz, *Exemptions Under the Proposed Bankruptcy Act*, CASE & COMMENT, Mar.-Apr. 1975, at 3; Walker, *supra* note 5, at 648-49.

²² 270 F.2d 881 (10th Cir. 1959).

²³ *Rutledge v. Johansen*, 270 F.2d 881, 882 (10th Cir. 1959); 3 COLLIER ¶ 60.25.

he involuntarily transferred them.²⁴ The rationale for this approach is unclear. The Commission dismisses the importance of the *Rutledge* concept that there is no diminution of the distributable estate without articulating its reasons for changing the existing law.²⁵ Of course, if the treatment of exempt assets in the proposals furthers the goals of a preference provision, it would be justified. Recovery of a transferred exempt asset, whether for the benefit of the bankrupt or for the benefit of the distributable estate, fails to advance the bankruptcy goal of achieving an equal distribution of the bankrupt's assets to his unsecured creditors because he could make the identical transfer to the preferred creditor after bankruptcy.²⁶ However, such a recovery promotes the two other pref-

²⁴ Section 4-607(a) applies to all of the bankrupt's property, whether exempt under the proposals or otherwise. Commission's Bill § 4-607, Note 9. After the recovery of a preferentially transferred exempt asset, § 4-503 of the proposals controls the subsequent disposition of that asset. Section 4-503(h) of the Commission's Bill (Judges' Bill § 4-503(j)) provides:

No property recovered under the provisions of this Act shall be allowed as exempt if the property recovered was concealed or voluntarily transferred by the debtor, unless so transferred to secure a debt and then only to the extent the value of the property exceeds the debt.

If the bankrupt voluntarily made the preferential transfer, he cannot keep the exempt asset or its value and it remains a part of his estate which the trustee distributes to his creditors. Commission's Bill § 4-503, Note 15; Commission's Report 204. If the bankrupt involuntarily made the preferential conveyance, he may keep the exempt asset. Commission's Bill § 4-503, Note 15. Neither proposal defines "voluntary." The Commission gives an example of an involuntary transfer as one in which the creditor acquired his preference by seizing the exempt asset through judicial process. *Id.* Even with this example as a benchmark, deciding whether a specific act by a bankrupt fits the voluntary or involuntary category could be difficult. For example, would the intentional failure of a bankrupt to defend a quasi-in-rem proceeding against his exempt asset result in a voluntary transfer? The proposals could aid the courts in resolving such issues by placing guidelines in their commentary.

²⁵ The Commission completely ignores the *Rutledge* rationale and instead suggests that a literal reading of § 60a(1) demonstrates that it applies. Commission's Bill § 4-607, Note 9; Commission's Report 204. Although ignoring the *Rutledge* concept of no diminution of the distributable estate in this context, the Commission uses it to create an inventory and accounts-receivable exception to its preference provisions. Section 4-607(d) exempts inventory and accounts receivable creditors who meet specified conditions from the preference proscription provided that they do not improve their position "at the expense of the estate." Commission's Report 209; see notes 101-07 and accompanying text *infra*. Thus the Commission builds into this exception a notion of not diminishing the distributable estate.

²⁶ The Commission, using egalitarian lenses, sets aside exempt transfers because the creditor who received the exempt asset has netted a larger percentage of the debt owed him than other creditors have realized. Commission's Report 204. However, the Commission sanctions the same unequal result by permitting the bankrupt to make the identical transfer after bankruptcy. Commission's Bill § 4-507, Note 2. More importantly, the proper focus of the preference goal of equal distribution is on each creditor receiving his fair share rather than on one creditor receiving more than the other creditors. See note 6 *supra*. A creditor receives property from the bankrupt's distributable estate. Any conveyance of the bankrupt's property which would have formed a part of his estate thus reduces the amount of property distributed to each creditor and impinges on this goal. On the other hand, each creditor

erence purposes by stopping the creditors' "race of diligence" to get exempt assets and by inhibiting their making unwise loans to the bankrupt upon his promise of subsequently transferring to them exempt assets. Thus, recovery of a preferentially transferred exempt asset furthers some of the purposes underlying a preference provision. However, these policy goals fail to indicate whether such a recovery should be for the benefit of the bankrupt or for his distributable estate.²⁷ A fundamental purpose underlying all of bankruptcy, giving the bankrupt a fresh start after bankruptcy,²⁸ suggests that the recovery should be for the benefit of the bankrupt. A recovery for the bankrupt ensures his possession of those minimal assets that the draftsmen deem necessary to begin anew. On the other hand, a recovery for the distributable estate not only might mean that the bankrupt lacks the necessary assets to begin anew, but might deprive him of any future consideration which the preferred creditor had promised to give him in return for the preference. Therefore, the proposals which wisely alter current law by authorizing recovery of preferential transfers of exempt assets should be changed to give the recovered assets to the bankrupt.

2. *When the Bankrupt was Insolvent*

Whether a bankrupt is solvent or insolvent at the time of a transaction has little relation to the three goals of a preference provision.²⁹ The lack of harm to his other creditors if he remains solvent after a conveyance justifies this criterion.³⁰ Although both proposals keep the existing balance-sheet approach to computing solvency, they change current law by excluding a bankrupt's exempt property from the equation.³¹ Because a creditor cannot normally reach a bankrupt's exempt property, this is a good

receives the same amount of property after a bankrupt transfers an exempt asset as before such transfer because the asset never would have formed a part of his estate. Since each creditor still receives his fair share after a transfer of an exempt asset, such transfers do not impinge on this aim.

²⁷ Since the mere ability to seize the exempt asset from the preferred creditor promotes the goals of the preference provision by destroying his incentive to obtain it, the subsequent disposition of the exempt asset is relatively unimportant with respect to these goals.

²⁸ Commission's Report 79.

²⁹ *Id.* at 204.

³⁰ *Id.*

³¹ Insolvency occurs under the Bankruptcy Act when a bankrupt's debts exceed the fair value of all of his property excluding that transferred in contravention of the fraudulent conveyance provisions. Bankruptcy Bill § 1(19), 11 U.S.C. § 1(19) (1970). See generally 1 COLLIER ¶ 1.19. The proposals define insolvency in § 1-102.

proposal; it gives a more realistic picture of the bankrupt's worth vis-à-vis his creditors.³²

The Commission's Bill also changes the evidentiary treatment of the insolvency issue. Under current law, which is unaffected by the Judges' Bill, the trustee has the burden of proof as to the bankrupt's insolvency.³³ The Commission wisely gives the trustee a rebuttable presumption of insolvency during the three months preceding bankruptcy.³⁴ Since the aims of a preference provision are not furthered by this element, the burden of proof should be on the creditor rather than on the trustee.

3. *Antecedent Debt*

The existence of an antecedent debt is an essential element of a preference because without it the transferee of the bankrupt's property could not have been a creditor of the bankrupt. The Bankruptcy Act fails to define "antecedent debt." Both proposals, however, provide statutory definitions of this term.

The Commission's Bill defines an antecedent debt as one incurred more than five days before a transfer that pays or secures the debt.³⁵ The five-day requirement thus creates a "grace period" of five days for all credit transactions.³⁶ Since the commercially important secured transactions enjoy at least a ten-day grace period under the Commission's Bill,³⁷ creation of this uniform interval seems unnecessary. The Commission's rationale for the grace period is to prevent the harsh results which can occur upon application of the *Hotchkiss* doctrine under which repayment of a loan on the day it was made can be set aside.³⁸ Professor Morris

³² Adding in the bankrupt's exempt assets could preclude a creditor or the debtor from initiating a bankruptcy proceeding even though the debt exceeds the total of all of the property of the debtor reachable by the creditor. *E.g.*, *Waddell v. Fleming*, 510 F.2d 4, 6-7 (10th Cir.), *cert. denied*, 95 S. Ct. 2629 (1975); *Lasswell v. Stein-Block Co.*, 93 F.2d 322 (5th Cir. 1937); *In re Baumann*, 96 F. 946 (W.D. Tenn. 1899); *see generally* Note, *The Balance Sheet Test of Insolvency*, 23 U. PITT. L. REV. 5 (1961).

³³ *See, e.g.*, *Bumb v. Paulin Motor Co.*, 454 F.2d 1149 (9th Cir. 1972). The Judges' Bill keeps this in § 4-607(a)(2).

³⁴ Commission's Bill § 4-607(f).

³⁵ *Id.* § 4-607(g)(1).

³⁶ A debt may be repaid within five days of its making without invoking the preference provision.

³⁷ Under the Commission's Bill, the perfection of a security interest made within ten days of a transaction relates back to the date of the transaction, thereby creating a ten-day grace period in which to perfect. Commission's Bill § 4-607(g)(7). *See* notes 65-67 and accompanying text *infra*.

³⁸ Commission's Bill § 4-607, Note 6. In *National City Bank v. Hotchkiss*, 231 U.S. 50

believes that a harsh result may occur in many common unsecured transactions that involve short delays between receipt of and payment for goods or services.³⁹ Examples of this type of transaction are credit card purchases, utility bills, wages, and rent, most of which would seem to be protected by the Commission's small-debt exception to the preference provision.⁴⁰ Even if the small-debt exception fails to prevent harsh results, the Commission arbitrarily draws the line at five days. Since the grace period fails to further any important policy in an equitable manner, the Commission should abandon it.

The Commission exempts four types of transactions from the preference provision by excepting them from the definition of an antecedent debt. The first exception is for debts incurred for "personal services."⁴¹ Confusion will be likely to result from the failure to define what constitutes a personal-service debt because many debts could arguably be so characterized. For example, attorneys' fees, brokers' fees, medical bills, and restaurant bills might be called personal-service debts although the Commission apparently intended that this exception apply only to employees.⁴² Since employees receive a distribution priority under the Commission's Bill,⁴³ allowing a preference exception for them would eliminate needless handling charges that would occur if the property or its value were recovered and then later returned to them in a distribution. But even so limited, this exception would allow a bankrupt to give his property to a selected group of his employees and ignore the rest of his workers. To prevent this possibility and to clarify the scope of the personal-service exception, the Commission should redraft it.

The payment of utility bills is the Commission's second exception.⁴⁴ Its rationale for favoring this type of creditor is that the payment of utility bills does not substantially violate any of the

(1913), the court held preferential a delay of five hours in repaying a loan used to obtain stock which was in the ordinary course of business immediately pledged in order to repay the loan.

³⁹ Morris, *supra* note 5, at 762.

⁴⁰ The Commission excepts most transfers of less than an aggregate amount of \$1,000 from the preference provision. Commission's Bill § 4-607(b)(1). Thus, at least as to many consumer transactions there should be no preference problems. The Commission fails to indicate the magnitude of this problem in the commercial area. Of course, as already noted, secured creditors enjoy a ten-day grace period. See note 37 *supra*.

⁴¹ Commission's Bill § 4-607(g)(1)(A).

⁴² *Id.* § 4-607, Note 6.

⁴³ *Id.* § 4-405(a)(3).

⁴⁴ *Id.* § 4-607(g)(1)(B).

purposes supporting a preference proscription and such payments are not voidable under current law because the utilities usually lack the requisite section 60b reasonable cause to believe that the bankrupt was insolvent.⁴⁵ The Commission's abolition of section 60b scienter as an element of a voidable preference is inconsistent with its use of the utilities' lack of scienter as a rationale for this exception.⁴⁶ The Commission fails to explain its conclusion that no substantial transgression of the aims of a preference provision would occur. Why should the payment of a utility bill not substantially impinge on the purposes of a preference proscription when an equivalent payment to a different creditor substantially infringes these purposes? A social policy rationale, however, supports this exception: utilities, that supply consumers with necessities of life, should not be tempted to cut off services to consumers.⁴⁷

The third exception proposed by the Commission is for debts arising from inventory delivered in the ordinary course of business and paid for within three months.⁴⁸ The Commission unfortunately uses the same dubious justifications for this favored treatment as it uses for favoring the utilities.⁴⁹ Considering the advantageous position given by the Commission to inventory sellers who take steps to protect themselves by obtaining and perfecting security interests,⁵⁰ it seems unjustifiable to safeguard those sellers who fail to protect themselves. Thus, the Commission should abandon the inventory exception.

Finally, the Commission excludes certain executory contracts

⁴⁵ *Id.* § 4-607, Note 6; Commission's Report 201.

⁴⁶ The Commission abolishes the creditor's scienter element because it has largely frustrated the effectiveness of the preference proscription. *See* notes 68-71 and accompanying text *infra*. Making the preference provision more effective by eliminating the scienter element must be intended to reach transfers which were not previously avoided because of an inability to prove scienter.

⁴⁷ During the winter of 1974, public utilities reportedly turned off power in thousands of homes across the United States for failure to pay rapidly inflating fuel bills. *N.Y. Times*, Jan. 6, 1975, at 1, col. 2. One year earlier, the cutting off of heat to an elderly couple's home for failure to pay a \$202 fuel bill resulted in the couple's freezing to death. *Id.* at 20, col. 6.

⁴⁸ Commission's Bill § 4-607(g)(1)(C).

⁴⁹ *Id.* § 4-607, Note 6 (lack of reasonable cause to believe that the debtor was insolvent); Commission's Report 201 (no substantial impairment of bankruptcy preference policy).

⁵⁰ The Commission gives an inventory creditor, who enabled a debtor to buy the inventory, ten days in which to perfect his security interest after the bankrupt acquired rights in the inventory. Commission's Bill § 4-607(g)(7). His after-acquired property clause is validated. *See* notes 105-07 and accompanying text *infra*. Thus, an inventory creditor who complies with the provisions of the Uniform Commercial Code to obtain and perfect a security interest on inventory is completely protected without this additional inventory exception.

from the category of antecedent debts.⁵¹ This qualification shields customers of a bankrupt who are making payments on an item before receiving full title to it. Protection of such persons seems to be a reasonable accommodation of consumer interests.

An antecedent debt under the Judges' Bill is one incurred more than thirty days before payment or before the perfection of a security interest.⁵² This one-month grace period magnifies the disadvantages of the Commission's five-day period. The Judges' Bill contains only one exception—for "personal services."⁵³ Unfortunately this provision suffers from the same difficulties as the Commission's personal-services exception.

4. *Obtaining a Greater Percentage than Another Creditor of the Same Class*

The proposals retain the existing law's requirement that the preferred creditor must have received a greater percentage of his claim than other creditors of his class.⁵⁴ This element measures the equality of distribution to all of the creditors. Since neither proposal defines the term "class," it appears that the presently-employed *Swarts* approach, defining it as the group of creditors who receive priorities in the distribution of the bankrupt's estate, would be continued.⁵⁵

5. *The Preference Time Zone*

Section 60 affects only those transfers that occur within four months of the date of the filing of a petition in bankruptcy. Although limiting preferential conveyances to a time zone does not of itself serve bankruptcy goals, it is justified by policies similar to

⁵¹ Commission's Bill § 4-607(g)(1)(D). Existing law may well take care of this problem. Cf. *In re Easy Living, Inc.*, 407 F.2d 142 (6th Cir. 1969) (lien of a creditor of a purchaser from the bankrupt upheld against the trustee's § 70a attack even though the bankrupt had the certificate of title).

⁵² Judges' Bill § 4-607(h)(I).

⁵³ *Id.*

⁵⁴ Commission's Bill § 4-607(b)(3); Judges' Bill § 4-607(b)(2).

⁵⁵ *Swarts v. Fourth Nat'l Bank*, 117 F. 1, 6-7 (8th Cir. 1902). See *Glessner v. Massey-Ferguson, Inc.*, 353 F.2d 986, 992 (9th Cir. 1965), *cert. denied*, 384 U.S. 970 (1966) (conditional vendors do not constitute a separate class from unsecured creditors); 3 COLLIER ¶ 60.34; Note, "Class"—*The Forgotten Element of Section 60a(1) of the Bankruptcy Act*, 11 ARIZ. L. REV. 360, 365-66 (1969). By changing who receives distribution priorities, the proposals change the composition of classes for preference purposes. For example, the Commission changes existing law on wage priorities, which does not consider employees' annuity plans as being within the priority (*e.g.*, *Joint Indus. Bd. v. United States*, 391 U.S. 224 (1968)), by allowing fringe benefits claims as a priority. Commission's Bill § 4-405(a)(4), Note 4.

those underlying a statute of limitations.⁵⁶ Because the choice of the length of the time zone is arbitrary,⁵⁷ it is difficult to evaluate. The Judges' Bill continues the four-month zone whereas the Commission's Bill specifies a three-month zone.⁵⁸

A bankrupt's transfer occurring outside of the preference time zone may be deemed to have been made within it unless the transfer was perfected "outside" of the zone.⁵⁹ A conveyance is deemed made on the date that it meets the perfection tests of section 60a(2).⁶⁰ A conveyance of property other than real property is perfected and thus deemed made when no subsequent judicial lien creditor of the bankrupt could acquire rights superior to those of the creditor-transferee.⁶¹ A conveyance of real property, on the other hand, is perfected and thus deemed made when no subsequent bona fide purchaser from the bankrupt could acquire rights superior to those of the creditor-transferee.⁶² Aside from bringing transfers within the time zone, section 60a(2) shifts the point in time for determining the presence or absence of the other elements of a voidable preference from the actual transfer date to the deemed transfer date.⁶³ Both proposals retain the section-60a(2) concept.⁶⁴

⁵⁶ See generally 6 S. WILLISTON, LAW OF CONTRACTS §§ 2001-44 (rev. ed. 1938).

⁵⁷ Commission's Bill § 4-607, Note 10.

⁵⁸ *Id.* § 4-607(a)(1); Judges' Bill § 4-607(a)(1). The Commission shortened the preference time period because it strengthened the trustee's avoiding power by eliminating the creditor's scienter element and giving the trustee a presumption of insolvency. Commission's Bill § 4-607, Note 10. Apparently, the Commission balanced the preference goals against a stability of transactions policy in making this decision.

⁵⁹ Bankruptcy Act § 60a(7), 11 U.S.C. § 96(a)(7) (1970). For example, if the bankrupt transfers a security interest to his creditor one year before bankruptcy, but his creditor delays perfecting it until two months before bankruptcy, § 60a(7) deems the bankrupt to have made the transfer two months before bankruptcy, thus subjecting the transfer to the avoidance power. If the creditor never perfected the security interest, § 60a(7) deems the date of bankruptcy as the date that the bankrupt transferred the interest to him. To escape the effect of this deemed transfer provision, a creditor must perfect his security interest at least four months before bankruptcy.

⁶⁰ 11 U.S.C. § 96(a)(2) (1970).

⁶¹ Bankruptcy Act § 60a(2), 11 U.S.C. § 96(a)(2) (1970).

⁶² *Id.* § 60a(7), 11 U.S.C. § 96(a)(7).

⁶³ The time at which a transaction is deemed to have been made measures the transfer of the bankrupt's property, the antecedent debt, and the insolvency elements. However, the date of the bankruptcy petition always measures whether or not a creditor obtained a greater percentage of his claim than other creditors of his class. 3 COLLIER ¶¶ 60.35-36.

⁶⁴ Commission's Bill § 4-607(g)(6)-(7); Judges' Bill § 4-607(i)(1)-(2). The proposals also harmonize the § 60a(2) division of property into real and non-real with the Uniform Commercial Code, which governs fixtures as well as personal property by subjecting fixtures to the lien-creditor test of perfection. See UNIFORM COMMERCIAL CODE § 9-313.

Section 60 contains complex provisions creating a grace period during which a creditor may perfect a security interest in the bankrupt's property after advancing credit to the bankrupt while avoiding the section 60a(2) effect.⁶⁵ The proposals simplify this by providing for a uniform ten-day grace period.⁶⁶ Presumably, the federal grace period preempts the grace period provided in the Uniform Commercial Code,⁶⁷ but this should be explicitly stated.

6. Reasonable Cause to Believe the Debtor Was Insolvent

For the trustee to avoid a preference under section 60, he must prove that the creditor had reasonable cause to believe that the debtor was insolvent. Both proposals abolish this requirement.⁶⁸ The Commission's reason for eliminating it is that it "has rendered ineffective the preference section of the present Act."⁶⁹ Although the burden of showing a creditor's scienter certainly creates difficulties, they have not been insurmountable.⁷⁰ An analysis of this criterion's impact on the goals of a preference

⁶⁵ Bankruptcy Act 60a(7), 11 U.S.C. § 96(a)(7) (1970). Section 60a(7)(I) creates two grace periods in which to perfect security interests. First, if state law provides a grace period of 21 days or less, such grace period is adopted for bankruptcy purposes. Second, if the state law provides no grace period, then a 21-day period in which to perfect security interests is adopted for bankruptcy purposes. A grace period is an interval of time after the creation of a security interest in which a creditor can perfect without invoking the deemed transfer provisions.

The § 60a(7) grace periods of bankruptcy do not mesh well with the Uniform Commercial Code. The Code creates a ten-day grace period in which to perfect a purchase money security interest if filing is required. UNIFORM COMMERCIAL CODE § 9-301(2). Literally read, § 60a(7) would adopt the Code's ten-day period and use it as the grace period for purchase money security interests. II G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 45.8, at 1328 (1965). Since the Code does not create a grace period for other types of security interests, § 60a(7) appears to give non-purchase money security interests a 21-day grace period in bankruptcy. II G. GILMORE, *supra*, at 1327. However, this is anomalous because the Code often favors purchase money interests over regular security interests. UNIFORM COMMERCIAL CODE § 9-107, Comment 1; II G. GILMORE, *supra*, at 1328. Relying on the Code policy favoring purchase money interests, some commentators have suggested that these interests should be given a 21-day grace period. I P. COOGAN, W. HOGAN, & D. VAGTS, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 9.03 (5)(c), at 995 (1963). Nevertheless, the Code policy favoring purchase money interests can also be harmonized with § 60a(7) by arguing that non-purchase money security interests should have a zero-day grace period in bankruptcy because the Code impliedly specifies a zero-day period for them when it creates a ten-day period for purchase money interests. II G. GILMORE, *supra*, at 1327-28.

⁶⁶ Commission's Bill § 4-607(g)(7); Judges' Bill § 4-607(i)(2).

⁶⁷ See note 65 *supra*.

⁶⁸ Commission's Bill § 4-607(a)(1); Judges' Bill § 4-607(a)(1); Commission's Report 201.

⁶⁹ Commission's Report 204.

⁷⁰ A large number of cases have found the scienter element. See generally 3 COLLIER ¶ 60.54 (collecting cases).

proscription, however, provides a better reason for its abandonment. When a creditor joins the race of the diligent or makes an unwise loan with the intention of subsequently obtaining a preferential transfer, he, of course, knows of the bankrupt's probable insolvency. Thus, the requisite scienter does not impede the achievement of the goals of preventing the creditors' race of diligence and of inhibiting unwise loans. However, requiring proof of the creditor's knowledge allows those creditors who lack such knowledge to obtain more than their fair share of the distributable estate. This requirement thus impedes the most important aim of a preference provision: the equal distribution of the bankrupt's assets to his unsecured creditors.⁷¹ It is not surprising, therefore, that both the Commission and the Judges have eliminated this element.⁷²

C. Insider Preferences

Section 60 makes no distinction based on a creditor's relation to the bankrupt. Both proposals, however, create a separate category of preferences for creditors who are "insiders."⁷³ Insiders are defined as persons with certain family relationships to the bankrupt, affiliates of the bankrupt, or if the bankrupt is a business, its directors, officers, partners, or managing agents.⁷⁴ Deciding who fits into most of these categories is relatively easy.⁷⁵ Although the

⁷¹ Professor Morris suggests that the Act requires proof of a creditor's scienter because the preferred creditor has done nothing dishonorable unless he possessed reason to know, the cost of setting aside these preferences exceeds the benefit gained from recapturing them, and waste would occur in that the asset taken away from the preferred creditor might later be returned to him in a distribution. Morris, *supra* note 6. A bankrupt's transfers frustrate the equal distribution goal whether or not the creditor acted dishonorably. The small loan exception meets the argument of the cost of recovery exceeding the benefit to the estate. See notes 92-93 and accompanying text *infra*. Although waste occurs if a preferred creditor happens to receive the recaptured asset in a distribution, the scienter element exempts transfers regardless of whether or not the preferred creditor would subsequently receive the asset in the distribution of the bankrupt's assets. Overall, little reason exists for retaining the requirement that a creditor have reason to know of the bankrupt's insolvency at the time of the transfer.

⁷² Commission's Bill § 4-607(a)(1); Judges' Bill § 4-607(a)(1).

⁷³ Commission's Bill § 4-607(a)(2); Judges' Bill § 4-607(a)(2).

⁷⁴ *Id.*

⁷⁵ The terms "partner," "officer," and "managing agent" seem clear enough for a court to apply in most situations. The proposals give a specific list of family members who comprise the insider family group. Commission's Bill § 1-102(32); Judges' Bill § 1-102(33). A corporate "affiliate" is defined, in most situations, in terms of the control of voting power in a corporation. Commission's Bill § 1-102(4); Judges' Bill § 1-102(2). Possible ambiguity could arise as to the last two portions of the definition of an affiliate, which are based upon the operation under lease of a substantial amount of property. Commission's Bill § 1-102(4)(B), (E); Judges' Bill § 1-102(2)(D), (E). In addition, a court could create ambiguity if it decided

proposals create a separate insider category of preferences, they also allow the trustee to challenge a bankrupt's conveyance to an insider creditor under the non-insider provision.⁷⁶

Under the Commission's Bill, the trustee can recover a transfer made by the bankrupt to an insider by proving that (1) it occurred within twelve months before the date of the bankruptcy petition, (2) it was for an antecedent debt owed to the insider, (3) it was made when the bankrupt was insolvent, and (4) the insider had reasonable cause to know of this insolvency.⁷⁷ Since the trustee can challenge a bankrupt's transfer to an insider under either the insider or the non-insider provision, the Commission in effect gives the trustee a three-month time period within which to challenge *all* transfers and an additional nine-month period within which to challenge *insider* transfers.⁷⁸ The attack against an insider differs from the attack against a non-insider in that, with respect to the former, the trustee receives a nine-month longer preference time zone, must prove an additional element of the creditor's scienter ("reason to know"), and loses the presumption of insolvency. The reason for the additional time allotment for challenging insider conveyances appears to be that a creditor's insider position would enable him either to know of the approach of bankruptcy well before it actually occurs or to persuade the insolvent bankrupt to wait three months after his conveyance to the insider before declaring bankruptcy.⁷⁹

By insisting that the trustee prove scienter, the Commission limits his avoiding power in the additional nine-month period. Since the purpose of this additional nine-month time zone is to correct abuses resulting from a creditor's close relation to the bankrupt rather than directly to further the three purposes underlying a preference proscription,⁸⁰ the Commission wisely insists

that the § 1-102 definitions conflict with the use of these terms in § 4-607. Judges' Bill § 1-102; Commission's Bill § 1-102 (general definitions apply unless inconsistent with usage).

⁷⁶ Commission's Report 201.

⁷⁷ Commission's Bill § 4-607(a)(2).

⁷⁸ Commission's Report 201.

⁷⁹ If the purpose for the additional nine-month period is generally to further the three goals of a preference provision, then the operation of the provision should not be restricted to insiders. Clearly, the provision aims at some problem which inheres in insider status. Most likely an insider creditor differs from a non-insider creditor in that the insider either possesses more knowledge or exercises more influence over the bankrupt than the non-insider. Cf. Note, *supra* note 14, at 495.

⁸⁰ Since the scienter requirement has no "rational connection with the objective of [the preference] provision," it seems contradictory to resurrect this element for insider transactions. Commission's Report 19-20; Note, *supra* note 13, at 495. However, the insider proscription aims not at the general goals underlying the preference provision but rather at

that the insider have had reasonable cause to believe that the bankrupt was insolvent. However, placing the burden of proof as to the creditor's knowledge on the trustee seems unwise; the insider is in a far better position to demonstrate what information he had and what information he lacked.

The Commission fails to explain why it shifted the burden of proving insolvency to the trustee. Possibly it believed that it had gone too far in undermining the security of insider transactions.⁸¹ However, the insider's probable access to the relevant financial information about the bankrupt at the time of the transfer favors placing the burden on him. The complicated task of weighing these conflicting policies makes it difficult to decide who should bear the burden of proof on insolvency. The unrelatedness of the insolvency of the bankrupt to the three aims of a preference proscription⁸² suggests striking the balance in favor of placing the burden of proof on the insider.

The Judges' insider-preference proscription is the same as its non-insider one except that it allows the trustee to recapture preferential conveyances to insiders made within one year of bankruptcy and it shifts the burden of proving solvency to the insider.⁸³ Unlike the Commission's provision, the Judges' Bill does not require that an insider have had reasonable cause to believe that the bankrupt was insolvent. Thus, an insider transfer can be more readily avoided than a non-insider transfer. This results in a four-month period for challenging conveyances to non-insider creditors and a separate one-year period for attacking conveyances to insider creditors. This attack on insiders appears to be excessive in light of the normal needs of the trustee.⁸⁴ Since the Commission's more moderate approach reaches the evils of insider transfers, the Judges' discriminatory treatment of all insider transfers is unwarranted.

D. *General Exceptions in the Proposals*

The proposals generally except from their preference provisions transfers followed by subsequent advances, transfers related to enabling loans, and small transfers.

the dangers arising from the nature of the insider relationship with the bankrupt. See note 79 *supra*. These dangers can occur only if the insider possesses scienter.

⁸¹ See Note, *supra* note 14, at 495.

⁸² See notes 29-32 and accompanying text *supra*.

⁸³ Judges' Bill § 4-607(a)(2).

⁸⁴ Cf. Note, *supra* note 14, at 493.

1. *Subsequent Advance Exception*

The proposals derive from sections 60c and 60a(8) the subsequent-advance exception, which allows a creditor who received a preference to set off against the amount that the trustee could otherwise recover from him any unsecured advances of credit that he made after the preferential transfer.⁸⁵ Allowance of this exemption does not appear to violate any of the aims of a preference proscription because the subsequently advanced unsecured credit restores the bankrupt's distributable estate.⁸⁶

2. *Enabling-Loan Exception*

The enabling-loan exception contained in the proposals has no counterpart in existing law. If credit is advanced to the bankrupt to enable him to obtain property and if the creditor perfects his security interest in that property within ten days of the bankrupt's acquiring rights in it, then the preference provision does not apply.⁸⁷ Allowing this exception, however, clearly violates some of

⁸⁵ Commission's Bill § 4-607(c)(2); Judges' Bill § 4-607(c)(2).

⁸⁶ Commission's Bill § 4-607, Note 15. This restorative effect can be seen in a simple example. Assume that creditor *A* receives within one year of bankruptcy a \$5,000 payment for an earlier unsecured loan #1. At this point § 4-607 would avoid the transfer and recapture \$5,000 for the distributable estate. Assume that creditor *A* then loans the bankrupt \$3,000 without taking any security. Under the subsequent advance exception the difference of \$5,000 minus \$3,000 or \$2,000 would be avoided. Thus, the distributable estate would have \$2,000 recovered as a preference and \$3,000 received from creditor *A*'s unsecured loan #2 for a total of \$5,000, precisely the amount of the original preference. In this way, a subsequent unsecured loan restores the bankrupt's estate and results in the bankrupt's other creditors suffering no diminution of their fair shares. Since the other creditors suffer no diminution, there does not appear to be any violation of the equal distribution goal. See note 26 *supra*.

Nevertheless, an atomistic view of the above example could indicate that the subsequent advance exception does infringe upon the goal of an equal distribution. Before the bankrupt preferred the creditor, the estate had \$5,000. The second loan gave the estate an additional \$3,000. Arguably, then, the estate should have \$8,000 for distribution instead of being "restored" to \$5,000. Such an atomistic view, however, assumes that the second loan would have been made even if the bankrupt had not repaid the first loan. This may be an unrealistic assumption.

This exemption encourages neither unwise loans nor a creditors' scramble because the creditor never improves his position vis-à-vis the estate by making a subsequent advance. In the above example, the creditor always has an unsecured claim against the estate for \$5,000. Before he made the second loan, the trustee could set aside the entire preference and relegate him to a \$5,000 claim against the estate. After he made the second loan, this exception would give him a \$2,000 claim arising from the trustee's recovery of the sum plus a \$3,000 claim arising from his second loan against the estate, for a total claim of \$5,000. Aside from not infringing upon these bankruptcy policies, this exemption promotes the commercial goal of extending new credit to debtors in financial trouble. Commission's Report 210.

⁸⁷ Commission's Bill § 4-607(c)(1); Judges' Bill § 4-607(c)(1).

the policy objectives of a preference proscription.⁸⁸ Apparently, the rationale for it is to put the secured creditor who enables a bankrupt to buy property on the same footing as a conditional seller.⁸⁹ Since article 9 of the Uniform Commercial Code already accomplishes this,⁹⁰ little reason exists for the exception. The Commission does point out that the Code has a tracing-of-funds clause which the enabling-loan exception lacks,⁹¹ but it fails to provide any rationale for abandonment—on the federal level—of the Code's tracing term.

3. *Small-Debt Exception*

In addition to the above exceptions, the Commission creates a new one for a preferred creditor who has received an aggregate of less than \$1,000 in value from the bankrupt and who is not an insider.⁹² The Judges' Bill, however, contains no similar provision. Administrative ease and the high costs of recovering such small amounts justify this minor subordination of preference policy, and its unavailability to insiders should prevent abuse of this exception.⁹³

E. *Inventory and Accounts-Receivable Financing*

Since 1959 a great controversy has arisen over the validity of after-acquired property clauses in commercial security agree-

⁸⁸ The enabling loan exception violates the preference aim of an equitable distribution because it allows a creditor to make an unsecured loan and then to obtain a security agreement and perfect a security interest when the bankrupt receives the asset. Since the loan was initially unsecured, it became a part of the distributable estate. The subsequent perfection removed this sum from the estate, thereby decreasing the distributable estate, which thereby infringes upon the distribution goal.

This exception also infringes upon the preference goal of preventing a creditors' scramble because it encourages the unsecured creditors to perfect on recently acquired assets and to claim that their loans were made to enable the bankrupt to purchase the recently acquired assets.

⁸⁹ In commenting on the enabling loan exception, the Commission refers to Uniform Commercial Code § 9-107(b) which gives a creditor who enabled a debtor to obtain an asset the same rights that a seller of the asset to the debtor would possess. Commission's Report 208; UNIFORM COMMERCIAL CODE § 9-107, Comment 1.

⁹⁰ UNIFORM COMMERCIAL CODE § 9-107(b).

⁹¹ Commission's Report 208.

⁹² Commission's Bill § 4-607(b)(1).

⁹³ Commission's Report 206. The Brookings Institution study found that in 11 to 15% of liquidation proceedings the costs of administration exceeded the assets of the estate. D. STANLEY & M. GIRTH, *supra* note 1, at 175. In the proceedings in which the creditors received a distribution dividend, about 25% of the entire assets were used for administrative claims. *Id.* at 176; Note, 32 ALBANY L. REV. 407 (1968). Given the high cost of administering the bankruptcy liquidation combined with the litigation expenses of attacking a small transfer, the net benefit to the distributable estate in challenging such a transfer is minimal.

ments.⁹⁴ These provisions give a creditor an additional security interest in property that a debtor acquires after the execution of a security agreement. Inventory and accounts-receivable financing arrangements typically contain such clauses and the Uniform Commercial Code expressly validates them.⁹⁵ However, even though the bankrupt executes the security agreement more than four months before bankruptcy, the trustee, by taking an "atomistic" view of the Code, is able to argue that the after-acquired security interest, created on inventory or accounts receivable obtained by the bankrupt within the preference zone, arises in the zone and is therefore a preference.⁹⁶ Secured creditors have developed a number of responses to the trustee's argument. They urge that the entity,⁹⁷ the "fat-pig,"⁹⁸ the substitution-of-collateral,⁹⁹

⁹⁴ There is a vast array of literature taking various views of the issues involved in after-acquired property clauses. *E.g.*, Finan, *The Secured Party and his Nemesis, the Trustee in Bankruptcy: After-Acquired Property, Unidentified Proceeds, and Selected Preference Problems*, 3 AKRON L. REV. 93 (1970); Healy, *The Floating Lien Controversy in the Courts: Judicial Response to the Preference Problem*, 10 B.C. IND. & COM. L. REV. 265 (1969).

⁹⁵ UNIFORM COMMERCIAL CODE § 9-204; Healy, *supra* note 94.

⁹⁶ Gordon, *The Security Interest in Inventory Under Article 9 of the Uniform Commercial Code and the Preference Problem*, 62 COLUM. L. REV. 49 (1962); Hogan, *Games Lawyers Play with the Bankruptcy Preference Challenge to Accounts and Inventory Financing*, 53 CORNELL L. REV. 553, 556-58 (1968); Kripke, *The Code and the Bankruptcy Act: Three Views on Preferences and After-Acquired Property*, 85 BANKING L.J. 377, 394 (1968). The Uniform Commercial Code's provisions which govern the attachment and perfection of a security interest provide the basis for the trustee's argument. "A security interest is perfected when it has attached and all of the applicable steps required for perfection have been taken." UNIFORM COMMERCIAL CODE § 9-303(1). If all of the applicable steps necessary for perfection are taken before the security interest attaches, perfection occurs "when it attaches." *Id.* A creditor performs all of the applicable steps by properly filing a financing statement related to his security agreement. *Id.* § 9-302. Thus, a creditor with an after-acquired property clause in his security agreement who files a financing statement will have a perfected security interest in his debtor's after-acquired property when his security interest attaches. A security interest attaches when the debtor has signed a security agreement, the creditor has given value to the debtor, and the debtor has rights in the collateral. *Id.* § 9-203(1).

The first two requirements for attachment can be met when the creditor files his financing statement. The third requirement causes difficulty. If the debtor does not acquire rights in the collateral until he receives the collateral, then perfection occurs when the debtor receives the asset. For example, if the debtor receives an asset in the preference zone, perfection of an after-acquired security interest occurs in that zone. The trustee uses the above reasoning to argue that as to each account receivable or item of inventory received by a debtor in the preference period, perfection of a security interest on it occurs in the preference zone, thus subjecting the interest to the preference provisions. *In re* Portland Newspaper Publishing Co., 4 CCH INSTALLMENT CREDIT GUIDE ¶ 98,483 (1966) (referee's opinion), *rev'd*, 271 F. Supp. 395 (D. Ore. 1967), *aff'd sub nom.* DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1969).

⁹⁷ The entity theory focuses on accounts receivable or inventory as an entity. A creditor perfects on this entity rather than on each component of the entity. The creditor then argues that he perfected on this entity when he obtained a security agreement and filed a financing statement on it. His perfection and therefore transfer occurred outside of the

the equitable-lien,¹⁰⁰ the abracadabra,¹⁰¹ and the antecedent-debt¹⁰² theories prevent a section 60 preference. Each of these theories has flaws when closely scrutinized in light of either the Code or the Bankruptcy Act and acceptance of some of these concepts allows massive evasion of the purposes underlying a preference proscription.¹⁰³

preference zone before the debtor acquired the specific account receivable or inventory item. Moving the date of transfer to the date of filing probably places the transfer outside of the four-month preference period and also negates the antecedent debt prerequisite for a voidable preference. *Grain Merchants, Inc. v. Union Bank & Sav. Co.*, 408 F.2d 209, 215-17 (7th Cir.), *cert. denied sub nom. France v. Union Bank & Sav. Co.*, 396 U.S. 827 (1969) (alternate holding); *Rosenberg v. Rudnick*, 262 F. Supp. 635, 639 (D. Mass. 1967); Healy, *supra* note 94, at 273; Henson, § 9-108 of the Uniform Commercial Code and § 60a of the Bankruptcy Act Reconciled, 21 BUS. LAW. 371, 375 (1966). The entity theory is also called the river theory or the res theory. *DuBay v. Williams*, 417 F.2d 1277, 1287 n.8 (9th Cir. 1969).

⁹⁸ The fat-pig theory is an analogy to a mortgaged pig being fattened with un-mortgaged grain. No one would find that a preference occurred with each gulp of the feeding pig. Hogan, *supra* note 96, at 558-59.

⁹⁹ If a creditor exchanges existing security for new security, no preference occurs because there is no antecedent debt involved in the transfer. II G. GILMORE, *supra* note 65, § 45.6, at 1315; Hogan, *supra* note 96, at 561-62. Under the substitution theory creditors argue that the Code abandoned the need for a strict matching of old security with new security. Abandonment of a strict matching requirement allows the perfected security interests arising during the preference time zone to be set off against the perfected security interests destroyed by the sale of prior inventory (or the collection of accounts receivable). *Grain Merchants, Inc. v. Union Bank & Sav. Co.*, 408 F.2d 209, 217-18 (7th Cir. 1969), *cert. denied*, 396 U.S. 827 (1969) (alternate holding); Healy, *supra* note 94, at 274.

¹⁰⁰ The equitable lien theory relies upon § 60a(6) of the Bankruptcy Act which invalidates certain types of equitable liens. The creditor argues that the after-acquired clause creates an equitable lien and that such lien meets the requirements of § 60a(6) because he took all necessary steps to perfect this equitable lien. *Finan, supra* note 94, at 129-35; *Gordon, supra* note 96, at 66-68.

¹⁰¹ The abracadabra theory hinges on § 60a(2) of the Bankruptcy Act which deems a transfer to be made when it is "so far perfected" that a subsequent lien creditor could not obtain superior rights. Section 9-301(I)(d) of the Code appears to give an inventory creditor or an accounts-receivable creditor rights superior to those of a judicial lien creditor from the date that the financing statement relating to the security agreement was filed. *See* note 96 *supra*. Thus, the creditor argues that the transfer is deemed to have occurred at the time of filing. If the filing occurred outside of the preference period there cannot be a voidable preference. In addition, moving the transfer date to the date of the original filing may negate the antecedent debt element. *See, e.g., Biggins v. Southwest Bank*, 490 F.2d 1304, 1309 (9th Cir. 1973); *In re King Porter*, 446 F.2d 722, 730-31 (5th Cir. 1971); *DuBay v. Williams*, 417 F.2d 1277, 1287-88 (9th Cir. 1969); *Rosenberg v. Rudnick*, 262 F. Supp. 635, 638 (D. Mass. 1967); Healy, *supra* note 94, at 273.

¹⁰² The antecedent debt theory relies upon § 9-108 of the Code, which rather directly negates the antecedent debt element by providing that after-acquired security interests arising in the ordinary course of the debtor's business are not for an antecedent debt. *In re White*, 283 F. Supp. 208, 210 (S.D. Ohio 1967); UNIFORM COMMERCIAL CODE § 9-108, Comment 1; Friedman, *The Bankruptcy Preference Challenge to After-Acquired Property Clauses under the Code*, 108 U. PA. L. REV. 194, 220 (1959); Reimer, *Bankruptcy—Preference—Conflict between Section 9-108 of the Uniform Commercial Code and Section 60(a) of the Bankruptcy Act*, 70 COM. L.J. 63 (1965).

¹⁰³ The difficulty with the entity theory is that §§ 9-204, 9-303, and 9-203 of the Code

The justification for this exception is the great commercial importance of these types of financing agreements.¹⁰⁴ The proposals attempt to end the confusion concerning after-acquired property clauses by excepting those that conform to certain standards. Both proposals permit such clauses to the extent that (1) the creditor had a security agreement that covered the subsequent collateral and (2) the transferee did not improve his position by an increase in the security's value at the expense of the estate.¹⁰⁵ It is important to note that the first requirement does *not* require that the creditor have completed all of the steps necessary under state law to have a perfected security interest when the bankrupt obtains the inventory or collateral.¹⁰⁶ Read literally, it permits a creditor to get a security agreement on a bankrupt's existing inventory and wait until shortly before bankruptcy to file it. Undoubtedly, the second prerequisite for this exemption, improvement of position at the expense of the estate, would be interpreted by a court to preclude this literal absurdity although such an interpretation does

do not take an entity approach to accounts receivable or inventory but rather apply to each component of them. Countryman, *Code Security Interests in Bankruptcy*, 75 COM. L.J. 269, 277 (1970). The fat-pig theory has the same difficulty as the entity theory. The substitution theory runs against the precise matching requirement of general bankruptcy law. Gordon, *supra* note 96, at 63. The equitable-lien theory contradicts the commentary to the Code which states that the after-acquired clause does not create an equitable lien. UNIFORM COMMERCIAL CODE § 9-204, Comment 1; Seligson, *The Code and the Bankruptcy Act: Three Views on Preferences and After-Acquired Property*, 85 BANKING L.J. 377, 404 (1968). See Finan, *supra* note 94, at 130. The abracadabra theory is vulnerable to a grammatical construction of § 60a(2). The pronoun "it" in § 60a(2) means that an actual transfer must have occurred before the provisions of § 60a(2) come into operation. The actual transfer does not occur until the debtor acquires rights in the collateral, which may occur in the preference time zone. Countryman, *supra*, at 277. The antecedent debt theory is vulnerable to attack on federal supremacy grounds in that § 9-108 of the Commercial Code interferes with the Bankruptcy Act. Gordon, *supra* note 96, at 58-61; Reimer, *supra* note 102, at 66; Seligson, *supra*, at 405. The entity theory, the fat-pig theory, and the abracadabra theory would allow a bankrupt intentionally to prefer the inventory or accounts-receivable creditor by converting his assets into inventory or accounts receivable. Finan, *supra* note 94, at 127; Hogan, *supra* note 96, at 559, 561.

¹⁰⁴ Hogan, *supra* note 96, at 569 n.65; Kripke, *supra* note 96, at 389-90.

¹⁰⁵ Commission's Bill § 4-607(d); Judges' Bill § 4-607(d). The proposals overrule the abracadabra theory in defining the time of transfer in § 4-607(g)(6)-(7). Commission's Bill § 4-607, Note 29.

¹⁰⁶ Perfection occurs when the last of the following four events are completed: (1) the taking of applicable steps (usually filing), (2) the debtor's signing of a security agreement, (3) the creditor's giving value to the debtor, and (4) the debtor's acquiring rights in the collateral. See note 96 *supra*. The fourth event has caused the problems in inventory and accounts receivable financing. See note 96 *supra*. The proposals condition their exemption on the prior existence of the security agreement. They do not require that the second or third events be completed before the debtor acquires rights in the collateral. Thus, perfection may occur after the proposed acts have exempted the transaction.

not readily flow from the proposed statute.¹⁰⁷ This section is sloppily drafted and should be rewritten to avoid this literal absurdity.¹⁰⁸

To determine whether a creditor has improved his position at the expense of the estate, the proposals adopt a "two-point-measuring-system" test. This examination compares a creditor's collateral at two points in time: three months before bankruptcy and the date of filing of the bankruptcy petition. Basically, improvement occurs if the percentage of a creditor's debt secured at bankruptcy exceeds the percentage secured at the anterior point. Since this test is not stated to be the exclusive yardstick for measuring improvement, a court could develop its own criterion.

Although the proposed statutory test for improvement is easy to administer,¹⁰⁹ it has several drawbacks as a result of the arbitrary choice of an anterior measuring point. First, it would allow a bankrupt to prefer a creditor whose security has lapsed during the preference zone but who had a large perfected security interest at

¹⁰⁷ Two possible arguments based on the second prerequisite for this exception could prevent the literal absurdity. First, the word "security" in § 4-607(d) could be interpreted to mean a perfected security interest. The belated filing that perfected the creditor's security interest which arose from his security agreement executed three months before bankruptcy would violate the two point measuring test of improvement because the creditor lacked a perfected security interest three months before bankruptcy. This approach seems proper and would probably be used. Unfortunately, the proposals do not clearly mandate such an interpretation. "Security" as used in § 4-607(d) could also be interpreted to include a mere security interest. The proposals define a security interest as an "interest in property created by contract to secure performance of an obligation." Commission's Bill § 1-102(43). Surely a security interest could be considered to be "security" since it secures performance. See UNIFORM COMMERCIAL CODE § 9-105(1)(c) ("collateral" is property subject to a security interest).

Second, a court could create a nonstatutory test of improvement of position at the expense of the estate. The basis of the new test would be the notion that since such a belated filing was a preference under § 60, it must be a forbidden improvement of position at the expense of the estate. However, such an approach would enable the trustee to resurrect his atomistic arguments concerning inventory and accounts receivable creditors under the guise of improvement of position. No ready solution exists to this problem under the language of § 4-607(d).

¹⁰⁸ Either the first limitation on the exemption should be recast to require that the creditor have taken all steps necessary under state law to have perfected a security interest or the word "security" should be replaced with a term requiring a perfected security interest.

¹⁰⁹ Mathematically the test can be represented by:

Let X = debt owed the creditor.

Let Y = value of all of this creditor's security for this debt at three months before bankruptcy or, if new value was extended during the three month period, then the value of all of his security at the date of extension of new value.

Let Z = value of all of this creditor's security for this debt at bankruptcy.

If $X > Y$ and if $(X - Y) > (X - Z)$ then there is forbidden improvement at the expense of the estate.

the anterior point. Second, it discriminates against the creditors of a business that has a cyclical flow of inventory or accounts receivable. For example, if the bankrupt sells his product in three-month intervals and if the anterior point falls on the day before his sale, his accounts-receivable creditor cannot keep the additional security which arose on the next day. Professor Hogan has demonstrated that replacement of the two-point system with an ordinary-course-of-business yardstick for measuring improvement of position eliminates these inequities.¹¹⁰ Under Professor Hogan's test, if the creditor's security arose in the ordinary course of the bankrupt's business it would not constitute improvement.¹¹¹ Although such an approach creates additional factual issues in a bankruptcy proceeding, the Commission provides no compelling reason why the equities favoring such an approach should be sacrificed to administrative efficiency.¹¹²

The Commission and the Judges have reexamined the aims that a preference proscription attempts to achieve and have proposed changes to better meet these aims. To deal with the special problems of a bankrupt's transfers to insider creditors they have created a special insider proscription. They have considered and balanced competing commercial policies with preference policies through a series of exceptions to the operation of their preference provisions. Although some of their measures need redrafting to prevent confusion or undesirable results and others probably should be abandoned, they have wisely reformed many areas of the trustee's power to avoid preferential transfers.

II

FRAUDULENT CONVEYANCES

The proposals retain in a simplified version the section 67d powers of the trustee to recover property transferred by the bankrupt to another party in order to defraud his creditors.¹¹³ This power enables the trustee to recover the bankrupt's property from any transferee, whether or not such person is a creditor.

¹¹⁰ Hogan, *supra* note 96, at 569-71.

¹¹¹ Hogan, *supra* note 96, at 570.

¹¹² Indeed, the Commission uses an ordinary-course-of-business approach in the inventory exception to the antecedent-debt definition. Commission's Bill § 4-607(g)(1)(c).

¹¹³ 11 U.S.C. § 107(d) (1970). Commission's Bill § 4-608 and Judges' Bill § 4-609 contain the gist of § 67d. Commission's Report 20. Their simplification of the wording of the fraud provisions will introduce a variance between the federal anti-fraud law and the state's Uniform Fraudulent Conveyances Act.

Thus, it prevents the bankrupt from "hiding" his assets from his creditors by conveying them to others.¹¹⁴ The impact of this avoiding power, of course, helps achieve the preference aim of an equitable distribution of a bankrupt's assets to his unsecured creditors.¹¹⁵ Section 67d reaches conveyances by a bankrupt involving intentional fraud,¹¹⁶ constructive fraud,¹¹⁷ and partnership fraud.¹¹⁸ The proposals retain the section 67d treatment of intentional fraud¹¹⁹ although they modify the treatment of constructive and partnership fraud. The Commission's Bill also abolishes the rule of *Dean v. Davis*.¹²⁰

A. Conveyances Involving Constructive Fraud

Under the present Bankruptcy Act, a conveyance is constructively fraudulent if the bankrupt received less than fair consideration for his transfer and (1) he was insolvent or thereby became insolvent, (2) he was engaged or about to engage in business for which the property remaining in his hands was unreasonably small capital, or (3) he intended to incur or believed that he would incur debts beyond his ability to pay.¹²¹ The proposals keep these criteria, but they replace "fair consideration" with "reasonably equivalent value."¹²² This change amounts to an elimination of the good-faith element which was contained in "fair consideration".¹²³ The requirement that a transferee act in good faith serves no policy of bankruptcy and is properly eliminated by the proposals.¹²⁴

¹¹⁴ 1 G. GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES §1 (rev. ed. 1940).

¹¹⁵ The recovery of an asset, for the benefit of the distributable estate, conveyed by the bankrupt to defraud his creditors, increases the fair share which each of his unsecured creditors receives and thus furthers equitable distribution. See note 26 *supra*; cf. Commission's Report 18. In general, a fraudulent conveyance may differ from a preference by harming only a specific creditor's right of realization rather than harming all of a bankrupt's creditors. G. GLENN, *supra* note 114. It has also been suggested that fraudulent conveyance differs from a preference in that the debtor can personally benefit from the transfer. 3 COLLIER ¶ 60.03. However, it seems possible that a debtor could receive a personal benefit such as post-bankruptcy credit in return for preferring a creditor.

¹¹⁶ Bankruptcy Act § 67d(2)(d), 11 U.S.C. § 107(d)(2)(d) (1970).

¹¹⁷ *Id.* § 67d(2)(a)-(c), 11 U.S.C. § 107(d)(2)(a)-(c) (1970).

¹¹⁸ *Id.* § 67d(4), 11 U.S.C. § 107(d)(4) (1970).

¹¹⁹ Commission's Bill § 4-608(a)(1); Judges' Bill § 4-609(a)(1).

¹²⁰ See notes 133-38 and accompanying text *infra*.

¹²¹ Bankruptcy Act § 67d(2)(a)-(c), 11 U.S.C. § 107(d)(2)(a)-(c) (1970).

¹²² Commission's Bill § 4-608(a)(2); Judges' Bill § 4-609(a)(2).

¹²³ Section 67d(1)(e) defines fair consideration in terms of a creditor's good faith. Bankruptcy Act § 67d(1)(e), 11 U.S.C. § 107(d)(1)(e) (1970); *Inland Security Co. v. Kirshner*, 382 F. Supp. 338, 347 (W.D. Mo. 1974); *De Aragon v. Chase Manhattan Bank*, 322 F. Supp. 1006, 1009-10 (D.P.R. 1971), *aff'd*, 457 F.2d 263 (1st Cir. 1972); 4 COLLIER ¶ 67.33.

¹²⁴ Elimination of the good faith element ensures the vitality of the preference exemptions. In *Bullard v. Aluminum Co. of America*, 468 F.2d 11 (7th Cir. 1972), a trustee

The proposals also modify the existing constructive-fraud provisions by eliminating the distinction drawn in section 67d between existing creditors and future creditors. Under section 67d any insolvency fraudulent conveyance is fraudulent only as to then existing creditors of the bankrupt while the other types of constructive fraud are deemed fraudulent as to future creditors as well.¹²⁵ This distinction serves no apparent purpose and is properly omitted by the proposals.¹²⁶

B. *Partnership Fraud*

Both proposals keep the section 67d measure declaring that the transfer of property owned by an insolvent partnership to a partner in his personal capacity is a fraudulent conveyance.¹²⁷ The need to invalidate these transfers arises from the so-called "jingle" rule under which the trustee applies partnership property to partnership debts and property of the individual partners to their individual debts.¹²⁸ Thus, a transfer of an asset owned by the partnership to a partner harms the partnership creditors because the personal creditors of that partner have priority claims to the asset under the jingle rule. By eliminating that portion of the jingle rule which marshals a partner's property to his individual creditors, the proposals appear to diminish the significance of this avoiding power.¹²⁹ However, the need for this power yet exists because the proposals retain that portion of the jingle rule that

successfully avoided a bankrupt's transfer to one of his creditors in satisfaction of an antecedent debt by arguing that the creditor lacked good faith due to his knowledge of the bankrupt's precarious financial position. The trustee could not use the preference power because the transfer had occurred more than four months before bankruptcy. An enterprising trustee might use *Bullard* to attack transactions that are exempted from the preference provision. Eliminating the good-faith element safeguards those transactions exempted from the operation of the preference proscription from attack under the flexible doctrine of fraudulent conveyances. See generally W. WARREN & W. HOGAN, *CASES AND MATERIALS ON DEBTOR-CREDITOR LAW* 420-21 (1974).

¹²⁵ Bankruptcy Act § 67d(2), 11 U.S.C. § 107(d)(2) (1970).

¹²⁶ Professor Glenn suggests that this distinction is necessary because the debtor's act must be related to his subsequent debt. 1 G. GLENN, *supra* note 114, § 319. This reason does not explain why the act protects the future creditors of a business with inadequate capital but not the future creditors of a person who is insolvent and thus has inadequate personal capital. In addition, it ignores the fact that the fraud provision aids the bankruptcy goal of equality of distribution. See note 115 *supra*.

¹²⁷ Commission's Bill § 4-608(b); Judges' Bill § 4-609(c).

¹²⁸ Bankruptcy Act § 5g, 11 U.S.C. § 23(g) (1970). See generally Kennedy, *A New Deal for Partnership Bankruptcy*, 60 COLUM. L. REV. 610 (1960); Mac Lachlan, *Partnership Bankruptcy*, 65 COM. L.J. 253 (1960).

¹²⁹ Kennedy *supra* note 128, at 621-24; Mac Lachlan, *supra* note 128, at 258. Section 4-405(f) and § 5-202 of the Commission's Bill and § 4-405(f) and § 5-201 of the Judges' Bill eliminate this portion of the jingle rule.

marshals partnership property to partnership creditors.¹³⁰ Thus, if a bankrupt transfers a partnership asset to a partner, although the partnership creditors still have claims on the asset equal to those of the partner's personal creditors, the partnership creditors no longer have a superior claim to it.¹³¹ The proposals also abandon the section 67d clause that makes a partnership transfer to a non-partner fraudulent, because this type of conveyance is covered by the constructive-fraud and intentional-fraud provisions.¹³²

C. *The Dean v. Davis Rule*

*Dean v. Davis*¹³³ held fraudulent a mortgage given by the bankrupt to his brother-in-law in return for cash which was subsequently used to prefer a creditor of the bankrupt. Section 67d(3) was enacted in an attempt to codify this case.¹³⁴ The Judges' Bill keeps a simplified version of section 67d(3)¹³⁵ while the Commission's Bill abandons this rule.¹³⁶ The Commission's approach appears to be the better one. The *Dean* problem can best be handled by having the trustee avoid the preference under the preference provisions.¹³⁷ By recapturing the preferentially conveyed property, a virtual rescission of the initial transactions occurs as the preferred creditor is returned to his original position while the secured creditor receives the equivalent of his advance. Commercial considerations make this result superior to that occurring under section 67d(3). Section 67d(3) hinders the ability of a troubled busi-

¹³⁰ Commission's Bill § 4-405, Note 14.

¹³¹ For example, if the assets of the *A & B* partnership are sufficient to satisfy its creditors, these creditors will receive all of the *A & B* partnership assets and be fully satisfied. Commission's Bill § 4-405, Note 14. If the *A & B* partnership transfers one of its assets to Mr. *A*, which makes the *A & B* assets insufficient to satisfy the *A & B* creditors, then the *A & B* creditors could seek recovery against Mr. *A*'s personal assets. Commission's Bill § 5-202; Judges' Bill § 5-201. If Mr. *A* is personally insolvent, the *A & B* partnership creditors can force Mr. *A* into bankruptcy and share pro rata with Mr. *A*'s individual creditors in the distribution of Mr. *A*'s estate. Commission's Bill § 5-202, Note 2; Proposals § 4-405(f). However, because the *A & B* partnership creditors only get a pro rata share of their claim, they receive less than they would have received if the partnership asset had never been transferred to Mr. *A*.

¹³² Commission's Bill § 4-608, Note 7.

¹³³ 242 U.S. 438 (1917).

¹³⁴ W. WARREN & W. HOGAN, *supra* note 124, at 389 n.1.

¹³⁵ Judges' Bill § 4-609(b).

¹³⁶ Commission's Bill § 4-608, Note 3.

¹³⁷ In *Aulick v. Largent*, 295 F.2d 41 (4th Cir. 1961), the court voided a preference given to the creditor which was associated with a fraudulent conveyance. *Aulick* involved the transfer of securities by the debtor to a third party in return for the third party's endorsing a note of the bankrupt's which was given to a creditor. *Id.* at 42-43. The court referred to *Dean* in avoiding the endorsed note given to the creditor. *Id.* at 48. This case is criticized in 7 VILL. L. REV. 468 (1962).

ness to obtain needed financing, because a creditor cannot assuredly protect himself against the possibility of the business failing since any security taken by him might be invalidated in a later bankruptcy proceeding upon a showing that the business had used his money to pay off one of its prior creditors.¹³⁸ Under the Commission's "rescission" approach, the secured creditor keeps his security in the bankruptcy proceeding; thus, there is no deterrence to the extension of credit to a troubled business.

D. *Time of a Fraudulent Conveyance*

Section 67d reaches only those fraudulent transfers made within one year of bankruptcy.¹³⁹ Both proposals retain this limitation period except for fraudulent partnership conveyances, for which no limiting period is provided.¹⁴⁰ The Commission fails to give any explanation for not limiting the trustee's power in this one area. The policy favoring security of transactions, which underlies the concept of a limitations period, suggests that this change in existing law is unwise.

Existing law, which deems a transfer to be made when it is perfected, continues under the proposals.¹⁴¹ Both proposals, however, change the current meaning of "perfection" from perfection against a bona fide purchaser to perfection effective against a bona fide purchaser other than a buyer in the ordinary course of business.¹⁴² Under the Uniform Commercial Code a buyer in the ordinary course of business cuts off the security interest of his seller's creditor.¹⁴³ If the term "bona fide purchaser" is interpreted to include the rights of the Code's buyer in the ordinary course, a secured creditor of a seller would never appear to meet the existing perfection test.¹⁴⁴ The proposals thus introduce a much

¹³⁸ A business suffering from financial difficulties might naturally be required to give security for a new loan. However, if the new creditor knows that his loan will be used to pay some but not all of the then existing debts, the new creditor's security is vulnerable to § 67d(3). Thus, § 67d(3) had hindered the obtaining of credit by troubled businesses. Commission's Bill § 4-608, Note 3; Commission's Report 212.

¹³⁹ Bankruptcy Act § 67d(2),(4), 11 U.S.C. § 107(d)(2),(4) (1970). The one-year limitation acts as a statute of limitations. 4 COLLIER ¶ 67.34, at 516.

¹⁴⁰ Commission's Bill § 4-608(a); Judges' Bill § 4-609(a).

¹⁴¹ Commission's Bill § 4-608(d)(1); Judges' Bill § 4-609(e)(1).

¹⁴² *Id.*

¹⁴³ UNIFORM COMMERCIAL CODE § 9-307(1). A buyer in the ordinary course cuts off a perfected security interest of a creditor as well as an unperfected security interest of the seller's creditor. UNIFORM COMMERCIAL CODE § 9-307, Comment 1.

¹⁴⁴ If the bona-fide-purchaser test of § 67d(5) includes a buyer in the ordinary course, even a perfected security interest could not pass the § 67d(5) test and thus a secured creditor would always be deemed to have made a transfer at the date of bankruptcy.

needed element of harmony between bankruptcy law and the Code.

III

THE AVOIDING POWER OF THE TRUSTEE UNDER STATE LAW

A. *The Strong-Arm Clause and the Hypothetical Lien Creditor*

The problem of creditors appearing in bankruptcy with liens whose existence was unknown to the bankrupt's other creditors led to the enactment of section 70c.¹⁴⁵ It gives the trustee the power to avoid transactions that could be set aside under state law by certain types of creditors of the bankrupt. The Bankruptcy Act considers the trustee to possess on the date of bankruptcy the rights existing under state law of (1) a creditor who obtained a judgment against the bankrupt, (2) a creditor who obtained an execution returned unsatisfied against the bankrupt, and (3) a creditor who obtained a lien on the bankrupt's property by legal or equitable proceedings.¹⁴⁶ Although the proposals give the trustee the rights of the second and third types of creditors, they strip him of the first because he gains no additional rights by having the status of a judgment creditor.¹⁴⁷ The magnitude of the trustee's power as a lien creditor under state law has led to this portion of section 70c being described as the "strong-arm clause."¹⁴⁸ Under current state law, the Uniform Commercial Code, the clause gives the trustee the power to invalidate unperfected security interests.¹⁴⁹

Section 70c adds at the end of the strong-arm clause the phrase "whether or not such a creditor exists." This phrase adds a hypothetical quality to the trustee's status. Problems arise over the impact, if any, of the existence of actual creditors on the hypothetical nature of this status.¹⁵⁰ Prior to the 1972 amendments of the

¹⁴⁵ *E.g.*, *Southern Dairies, Inc. v. Banks*, 92 F.2d 282, 285 (4th Cir. 1937), *cert. denied*, 302 U.S. 761 (1937); 4A COLLIER ¶ 70.45.

¹⁴⁶ Bankruptcy Act § 70c, 11 U.S.C. § 110(c) (1970).

¹⁴⁷ Commission's Bill § 4-604, Note 1; Countryman, *The Use of State Law in Bankruptcy Cases (Part II)*, 47 N.Y.U.L. Rev. 631, 649 (1972).

¹⁴⁸ 4A COLLIER ¶ 70.45.

¹⁴⁹ 4A COLLIER ¶ 70.49, at 596; Countryman, *supra* note 147, at 651-56.

¹⁵⁰ For example, in *Constance v. Harvey*, 215 F.2d 571 (2d Cir. 1954), *cert. denied*, 348 U.S. 913 (1955), the court interpreted the hypothetical nature of the trustee's power to mean that the trustee was deemed to have extended credit during a delay in perfection. Under

Code, it implied that if all of the actual creditors of a bankrupt had knowledge of an unperfected security interest, then the trustee as well had knowledge of that security interest.¹⁵¹ The attribution of such knowledge to the trustee precludes him from avoiding that unperfected interest.¹⁵² Both proposals prevent the knowledge of actual creditors from affecting the trustee's status.¹⁵³ Since the strong-arm clause is not based on a theory of subrogating the trustee to the rights of actual creditors, the knowledge of actual creditors should not affect the trustee's status. A second difficulty surfaced when the Ninth Circuit decided *Pacific Finance Corp. v. Edwards*,¹⁵⁴ which held that although the hypothetical nature of the trustee's status obviates the need for the existence of an actual lien creditor, the trustee cannot invalidate a security interest unless he proves that an actual creditor exists who, *if armed with a lien*, could defeat the challenged security interest. Interpreting the section 70c power of the trustee as requiring the existence of an actual creditor seems to make redundant the power given to the trustee in section 70e as a virtual subrogee of the rights under state law of the bankrupt's actual creditors.¹⁵⁵ Unfortunately, the Commission's Bill fails to clarify this problem. The Judges' Bill, however, wisely overrules *Pacific Finance*, thereby harmonizing the trustee's power under the section 70c strong-arm clause with his power under section 70e as a subrogee to the rights of existing creditors.¹⁵⁶

state law this interpretation permitted the trustee to avoid the tardily perfected security interest. After *Constance* a trustee appeared to be able to avoid tardily perfected security interests even though no actual creditor extended credit in the interval before perfection. W. WARREN & W. HOGAN, *supra* note 124, at 357. The Supreme Court in *Lewis v. Manufacturers Nat'l Bank*, 364 U.S. 603 (1961), overruled *Constance* and held that all of the trustee's hypothetical rights as a lien creditor arise on the date of bankruptcy.

¹⁵¹ UNIFORM COMMERCIAL CODE § 9-301(3) (1968 version); Countryman, *supra* note 147, at 653-54.

¹⁵² UNIFORM COMMERCIAL CODE § 9-301(1)(b) (1968 version); Countryman, *supra* note 147, at 653.

¹⁵³ The last sentence of § 4-604(a) of the proposals provides that the trustee's rights and powers are "not . . . affected by his own knowledge or that of any or all creditors."

¹⁵⁴ 304 F.2d 224 (9th Cir. 1962).

¹⁵⁵ To have meaning, § 70c must create powers which are apart from those conferred under § 70e. Thus, *Pacific Finance* should not have required the existence of an actual creditor because § 70e confers powers on the trustee based on the existence of actual creditors. King, *Pacific Finance Corporation v. Edwards: Another Misreading of Section 70c of the Bankruptcy Act*, 63 COLUM. L. REV. 232, 238 (1963). Cf. 4A COLLIER ¶ 70.50.

¹⁵⁶ The second sentence of the Judges' Bill § 4-604(a) provides that the trustee's powers are "not dependent upon the existence of a creditor whose hypothetical possession of such rights and powers would invalidate or take a position superior to any lien, transfer, or encumbrance."

B. *The Trustee's Avoiding Power as Subrogee of Actual Creditors*

1. *Permissible Creditor Roles*

Section 70e grants the trustee the power to avoid transfers by the bankrupt that could be set aside under state law by actual creditors who have claims provable under section 63 against the bankrupt.¹⁵⁷ In order to be provable, a claim *must* fit into one of nine categories.¹⁵⁸ Both proposals modify section 70e by replacing the requirement that a claim be provable with one that it be allowable.¹⁵⁹ The proposals define an allowable claim as one which does *not* fit within one of eight categories.¹⁶⁰ Since section 63 takes an inclusionary approach in defining provability while the proposals follow an exclusionary approach in defining allowability, claims that were not provable under section 63 might be allowable under the proposals.¹⁶¹ Thus, the proposals appear to strengthen the trustee's avoiding power as a virtual subrogee of the actual creditors of a bankrupt.¹⁶²

Some commentators have suggested that section 70e grants the trustee the rights of any actual secured creditor of the bankrupt.¹⁶³ Possession of these rights would make the strong-arm clause largely superfluous because the Uniform Commercial Code gives a secured creditor priority over a lien creditor.¹⁶⁴ The proposals wisely reject this approach and restrict the trustee's rights to those of unsecured creditors.¹⁶⁵

2. *Magnitude and Scope of the Trustee's Avoiding Power*

Section 70e appears to subrogate the trustee to the rights exercisable under state law by the bankrupt's actual creditors. A

¹⁵⁷ Bankruptcy Act § 70e, 11 U.S.C. § 110e (1970).

¹⁵⁸ *Id.* § 63, 11 U.S.C. § 103 (1970).

¹⁵⁹ Commission's Bill § 4-604(b); Judges' Bill § 4-604(b).

¹⁶⁰ Commission's Bill § 4-403(b); Judges' Bill § 4-403(b).

¹⁶¹ For example, the proposals allow intentional tort claims which were not provable under Section 63. Commission's Bill § 4-403, Note 2.

¹⁶² The proposals' creation of new claimants upon the distributable estate mandates expanding the trustee's power in order that bankruptcy treat the newly-recognized claims in the same manner as claims recognized under the current act.

¹⁶³ See, e.g., Countryman, *The Use of State Law in Bankruptcy Cases (Part II)*, 47 N.Y.U.L. REV. 631, 657-61 (1972); Kennedy, *The Trustee in Bankruptcy as a Secured Creditor under the Uniform Commercial Code*, 65 MICH. L. REV. 1419, 1420-28 (1967).

¹⁶⁴ UNIFORM COMMERCIAL CODE § 9-301 (1)(b), (4). See Kennedy, *supra* note 163 at 1434, 1440.

¹⁶⁵ The proposals contain a clause requiring that the claims be allowed in a "Chapter V

bankrupt's transfer to a third party may be vulnerable to an attack under state law by one but not all of the bankrupt's creditors. Subrogation theory suggests that in such a case the trustee's recovery under section 70e would be limited to the extent of this creditor's claim and would be for the benefit of this creditor. However, under the doctrine of *Moore v. Bay*,¹⁶⁶ which is codified in the Judges' Bill,¹⁶⁷ a transaction partially vulnerable to the attack of an existing creditor may be completely avoided by the trustee for the benefit of all of the general creditors. The rationales advanced to justify the *Moore v. Bay* rule are that it helps the creditor who could have attacked the transfer, it punishes the fraudulent bankrupt, and it fulfills the congressional intent.¹⁶⁸ With respect to the first rationale, it is clear that, unlike the subrogation approach, which would completely satisfy this creditor's claim, the *Moore v. Bay* rule recovers for the distributable estate from which this creditor gets only a percentage of his claim measured by the claims of all of the other creditors of the bankrupt. The justification provided by the second rationale is just as weak. Fraudulent conduct by a bankrupt should be dealt with by the fraudulent-conveyance provisions. Finally, prior congressional intent, by itself, provides no justification for retaining the rule. Although the Uniform Commercial Code has greatly limited the impact of *Moore v. Bay*,¹⁶⁹ the Commission has wisely abandoned the doctrine and adopted the subrogation approach.¹⁷⁰

IV

NEWLY CREATED AVOIDING POWERS FOR THE TRUSTEES

The proposals give the trustee some new avoiding powers. In a reorganization proceeding under Chapter VII of the Commission's case." Commission's Bill § 4-604(b)(1); Judges' Bill § 4-604(b)(1). This precludes the trustee from asserting the rights of a secured creditor since § 5-101(b) only permits creditors to participate to the extent that they lack secured status. Commission's Bill § 4-607, Note 5.

¹⁶⁶ 284 U.S. 4 (1931).

¹⁶⁷ Judges' Bill § 4-604(b)(1) ("for the benefit of the estate").

¹⁶⁸ G. GLENN, *supra* note 114, §§ 326, 505; Schwartz, *Moore v. Bay: Should Its Rule Be Abolished*, 29 REF. J. 67 (1955); Note, *The Trustee in Bankruptcy and the Secured Creditor*, 17 ARK. L. REV. 47, 56 (1962); Note, *Suits by Representatives to Set Aside Fraudulent Conveyances*, 45 YALE L.J. 504, 506-07 (1936).

¹⁶⁹ Under the Commercial Code a creditor must levy in the gap between the creation of a security interest and the perfection of that interest in order to have priority over that security interest. UNIFORM COMMERCIAL CODE § 9-301(1)(b). In *Moore v. Bay* the applicable state law apparently gave priority to a nonlevying gap creditor over the security interest. Thus, the Code's change in state law greatly restricts the impact of *Moore v. Bay* on commercial transactions. Countryman, *supra* note 163, at 656-57; Hawkland, *The Impact of the Commercial Code on the Doctrine of Moore v. Bay*, 67 COM. L.J. 359, 361 (1962).

¹⁷⁰ Commission's Bill § 4-604(b)(1) ("to extent of such allowable claim or claims for the benefit of such creditor or creditors").

Bill, the trustee appears to have been given a de facto avoiding power. The possible existence of this power can be illustrated by the following example. Assume that an inventory creditor has a perfected security interest in item *A* of the bankrupt's inventory and has an after-acquired property clause in his security agreement. If the bankrupt is in a Chapter VII Reorganization, the trustee has the right to "use" the inventory.¹⁷¹ If the trustee sells item *A*, the secured creditor loses his security interest in that item.¹⁷² If the trustee then buys a new asset for the bankrupt's inventory, item *B*, the secured creditor would expect to have an equivalent security interest in item *B* due to his after-acquired clause. However, section 7-203(a)(2) of the Commission's Bill renders his after-acquired property clause inoperative. If the bankrupt then converts to a liquidation proceeding, the secured party appears to have lost his secured position. This interpretation of section 7-203 would give the trustee the power to invalidate perfected security interests; but little reason exists for allowing the trustee to have such a power since it would inhibit the incentive for becoming a secured creditor. Although section 7-203 can also be interpreted as not giving the trustee this new power,¹⁷³ the Commission should redraft it to preclude the above interpretation. The Judges' Bill contains no section similar to the Commission's section 7-203.

Both proposals add a new avoiding power to the trustee's already impressive arsenal against insiders. Any of the bankrupt's property transferred within one year of bankruptcy to an insider for his rendering of personal services to the bankrupt may be recovered by the trustee to the extent that the value of the property conveyed exceeds the reasonable value of the services rendered.¹⁷⁴ Even if an insider survives the preference and fraud

¹⁷¹ Commission's Bill § 7-203(a)(1). The trustee may use the property until the secured creditor terminates the stay of § 4-501.

¹⁷² UNIFORM COMMERCIAL CODE § 9-307(1).

¹⁷³ Arguably the conversion would require the trustee to recognize the after-acquired property interests. Section 4-312(1) provides that a converted Chapter V proceeding is treated for most purposes as if it began on the date of the filing of the Chapter VII petition. In a sale of an asset under Chapter V, a secured creditor's interest must be protected. Commission's Bill § 5-203(b). If the § 4-312(1) principle applies to the earlier sale of the secured asset, then the conversion into the Chapter V proceeding restores the secured creditor's position. One commentator has suggested that § 7-203 merely codifies existing law as expressed in *In re Bermec Corp.*, 445 F.2d 367 (2d Cir. 1971), and does not create any new avoiding power. Murphy, *Restraint and Reimbursement: The Secured Creditor in Reorganization and Arrangement Proceedings*, 30 Bus. L. 15, 48 (1974).

¹⁷⁴ Commission's Bill § 4-311(c); Judges' Bill § 4-314(c). The Judges' Bill might be giving the trustee a new power in its preference section by voiding perfected security

attacks, he could still be vulnerable under this provision. Sadly, the proposals fail to state guidelines for a court to use in determining the reasonable value of an insider's services.

CONCLUSION

The proposals have made an impressive effort to restructure and strengthen, in the light of modern commercial practices, the trustee's avoiding powers by creating the non-insider provision to meet the goals of a preference proscription. To deal with the special problems of insider creditors, the proposals create a second type of preference-attacking provision. At the same time, the drafters realized that several competing non-preference policies are important in this area and created a series of exceptions. Unfortunately, the wording of these exemptions is too loose, thereby allowing some undesirable results. The proposals modernize and simplify the trustee's power to avoid fraudulent conveyances while clarifying his powers under state law and adding an important new power. Overall, both proposals have done a laudable job in remaking the trustee's sword to function more effectively in modern commercial transactions. But further attention should be given to the problems identified in this Note to ensure the success of bankruptcy-law reform.

Lewis U. Davis, Jr.

interests on collateral purchased by the bankrupt on credit during the preference time period but not fully paid for by the time of bankruptcy. Judges' Bill § 4-607(e). It is unclear whether this provision, which is listed as an "exception" to the preference section, only applies to interests attacked under the preference provision or applies generally to all perfected security interests. It is also unclear what effect § 4-606(e) has on the specific preference exemptions such as the inventory exception.