SECOND THOUGHTS ON THE SECOND ACT OF BANKRUPTCY:* AN OPEN LETTER TO THE NATIONAL BANKRUPTCY CONFERENCE

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Gentlemen:

In 1952, upon your recommendation, Congress made a number of changes in the Bankruptcy Act. These changes were said to be "non-controversial;" they were "what might be called clarifying and perfecting changes." Many of the changes seem good to us, but in at least one instance we think the draftsmen have caused more trouble than they saved. In Section 3a (2) of the statute, the old definition of preference as an act of bankruptcy was changed to incorporate the definition of preference found in Section 60a, which relates to transfers that the trustee can avoid in order to recover the property for the estate. We believe the incorporation by reference of Section 60a in Section 3a (2) will lead to confusion of the sort described below.

Since 1898, the Bankruptcy Act has required allegation of an act of bankruptcy in an involuntary petition. Of the six acts of bankruptcy now found in Section 3 of the statute, one of the most important is the second act, preferential transfer. Until 1952 Section 3a (2) defined that act as consisting of a person having "transferred, while insolvent, any portion of his property to one or more of his creditors with intent to prefer such creditors over his other creditors." Substantially all of what we may call common-law preferences came within the Section. After the 1938 amendment (the Chandler Act), under Section 3b a petition alleging a preference as the act of bankruptcy could be filed from the date of such transfer until four months after the date when the interest of the transferee became immune to attack by lien creditors and bona fide purchasers; insolvency of the debtor was tested either at the time the transfer occurred or at the time it became immune to attack.

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* The sections of the Bankruptcy Act pertinent to this letter are reprinted in an Appendix at page 892 *infra*.

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The subject of preferences is also treated in another part of the statute, Section 60. This section may be described as one of several statutory provisions giving the trustee power to set aside certain transfers previously made by the debtor and to recover the property for the estate. From 1898 to the present, intent to prefer has never been an element of a Section 60 preference. After 1938, Section 60 preferences also differed from Section 3 preferences in that some transfers for present consideration were preferential under the former section. This result was accomplished by "deeming" a present transfer to take place not when it was made but when it was perfected against attack by certain third persons. By thus postponing the effective date of the transfer, the consideration given for the transfer was made antecedent by legislative fiat. For example, a purchase-money chattel mortgage not recorded for several months became a preference under Section 60a if by applicable state law the chattel mortgage was void as to lien creditors while unrecorded and if the other statutory elements of a preference were present. While the trustee might set aside the chattel mortgage by virtue of Section 60, a creditor could not assert the execution of the mortgage as an act of bankruptcy because of the contemporaneous character of the transaction.

The 1952 Amendment was intended, at the very least, to bring the second act of bankruptcy (Section 3a (2)) and voidable preferences (Section 60a) closer together by striking the element of intent to prefer from the second act. Indisputably, the draftsmen achieved this objective when they defined the second act of bankruptcy by reference to Section 60a. As amended in 1952, Section 3a (2) now reads: "[The second act of bankruptcy shall consist of a person having] made or suffered a preferential transfer, as defined in subdivision a of section 60 of this Act." Since intent to prefer is now and always has been irrelevant in Section 60a, it is now also irrelevant to Section 3a (2).

But the question that puzzles us is this: did the draftsmen and Congress intend to do anything more by way of correlating Section 3 and Section 60? The legislative history is too cryptic and too ambiguous to provide a definite answer, but we are inclined to believe that more was intended than the elimination of intent to prefer from the second act of bankruptcy. In the first place, this result could have been achieved by little more than striking those words from the statute. In the second place, the House Report (H.R. REP. No. 2320, 82d Cong., 2d Sess. 5 (1952)) indicates clearly that the first act of bankruptcy (fraudulent conveyance) was to be changed to include any transfer voidable under Sections 67 and 70. This Report also suggests, though the inference is not a necessary one, that a similar cor-

relation was to be made between the second act of bankruptcy and Section 60.

Whatever Congress and the draftsmen intended, they have created problems of statutory interpretation that should have been avoided. The weakness of the technique of defining an act of bankruptcy by reference to the elements of a voidable preference lies in the different objectives of the two. Acts of bankruptcy find their function as allegations in a petition commencing a bankruptcy proceeding, *i.e.*, a set of facts occurring *prior* to the filing of a petition. On the other hand, the purpose of the voidable transfer concept is to enable the trustee to set aside a transfer *after* bankruptcy proceedings are under way and the filing of a petition is one of the facts necessary to establish a voidable transfer. The attempt to assimilate these two functions in the 1952 amendment has raised difficult problems:

> 1. When is the second act of bankruptcy committed; that is, what is the first date upon which there may be filed an involuntary petition alleging a preference as the act of bankruptcy?
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> 2. Is a contemporaneous but unperfected transfer now an act of bankruptcy?

Under the 1938 amendments (the Chandler Act), a Section 3 preference was made when a transfer of property to pay or secure a pre-existing debt actually occurred; a petition alleging the transfer and other elements of preference could be filed immediately. But the new language would, on its face, change that; as to property other than real property, a "preferential transfer, as defined in [Section 60a]" is, according to 60a (2), "deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property . . . could become superior to the rights of the transferee." Apply these words to a common commercial transaction—the execution of an unrecorded chattel mortgage by an insolvent debtor to secure a pre-existing obligation. Under applicable state law, the mortgage may be defeated by lien creditors until recorded. It seems obvious that a transfer, as that term is defined in Section 1 (30), has occurred; the transfer is certainly preferential in the common-law sense of the word. Moreover, it would clearly have been an act of bankruptcy prior to the amendment, and a petition alleging it could have been filed from the date the mortgage was executed. But apparently the transfer is not a preference within the meaning of the new Section 3a (2). It has not been recorded, and therefore it has not been "made or suffered," because Section 60a (2) "deems" the transfer to occur at the time when

a lien could not become superior to the rights of the transferee. However, the property could clearly be recovered by the trustee in a proceeding initiated on some other act, since under Section 60a (2) an unperfected transfer is deemed "made immediately before the filing of the petition."

There are other illustrations of the confusion that results from incorporating Section 60a into Section 3a (2), so that the date of the making of a preferential transfer is postponed until the transfer is perfected. In some states, failure to file a chattel mortgage within a reasonable time leaves the transaction vulnerable to lien creditors indefinitely. When the reasonable time has elapsed, such transfers can be perfected for bankruptcy purposes only by the filing of a petition. Thus these transfers never become acts of bankruptcy because they are not "made or suffered" until a petition is filed on some other ground. Other states regard a chattel mortgage as perfected by recording at any time. But a levy on the property before recordation will prevail; thus an unrecorded transfer is unperfected and hence not "made or suffered." Accordingly, a petition grounded on the second act of bankruptcy cannot be filed until the mortgage is recorded. In both illustrations, the execution of the chattel mortgage would have been an act of bankruptcy before 1952 if the other elements of a preference were present.

The foregoing analysis proceeds on what we think is a "natural" or "normal" reading of the interrelated sections involved. We recognize, however, that the pre-1952 effect of Section 3a (2) can be rescued by what seems to us a tortured construction of the new wording. That wording—stated again—is "made or suffered a preferential transfer, as defined in . . . [section 60a]." It can be argued that "defined in" qualifies only the word "preferential," and refers not at all to "made or suffered." "Made or suffered" in Section 3a (2) could then refer to the date when the transfer actually takes place, contrary to the Section 60a usage of the same phrase, which refers to the date when the transfer is perfected. By giving "made and suffered" a meaning in Section 3a (2) different from its meaning in Section 60a (1) and (2), the difficulties mentioned above disappear: the second act of bankruptcy is committed when the security instrument is executed, without regard to when, if ever, the transfer is perfected against claims of third persons.

If the draftsmen of the 1952 amendment intended to do no more than remove intent to prefer from the second act of bankruptcy, they have gone all around Robin's red barn to do it, and somebody is going to get lost trying to follow them. On the other hand, if they intended to include within the second act of bankruptcy the contemporaneous

but unperfected transfer made vulnerable to a trustee by Section 60a, they have failed of their purpose even though "made or suffered" be given the interpretation suggested above. Suppose a purchase-money chattel mortgage is executed by an insolvent debtor. Six months later the instrument is recorded and thereby rendered immune to attack in state proceedings. We have argued in the preceding paragraph that the transfer was "made or suffered" at the time the mortgage was executed. Granted that construction, however, no act of bankruptcy has been committed because the transfer is not for an antecedent consideration. Nevertheless, the transfer is vulnerable under Section 60, since it will be deemed "made" when perfected, *i.e.,* when recorded six months after execution, at which time the consideration is antecedent.

Thus the surface plausability of incorporating Section 60a into Section 3a (2) in order to correlate the two sections disappears upon investigation. "Made or suffered" would seem to relate either to the fictional date of making—the date the transfer is perfected—or to the date of actual making. If we adopt the former interpretation, a transaction voidable under Section 60 becomes an act of bankruptcy, but the date the petition can be filed is postponed until the transfer is perfected. If the transfer is never perfected, apparently a petition based on the transfer can never be filed. If we adopt the latter, the act of bankruptcy is committed and the petition can be filed on the date of execution, as under the old law, but contemporaneous, unperfected transactions will not be acts of bankruptcy.

There is, however, a possible though improbable reading of the statute that will (1) eliminate intent to prefer from Section 3, (2) leave the date of the commission of the second act of bankruptcy unchanged from the prior law, and (3) include contemporaneous, unperfected transactions within the second act of bankruptcy. First we can argue that any transfer that is voidable under Section 60 after the filing of a petition should also qualify as a ground *for* the filing of a petition. Further we can argue that the act of bankruptcy occurs and the petition alleging it can be filed at the time when the transfer would be a preference under Section 60 if a petition had been filed on another ground. This takes some further explaining, as we would be the first to admit. Take the case of a chattel mortgage executed to secure an antecedent debt but not recorded and therefore not good against lien creditors under applicable state law. Any time thereafter, the filing of a bankruptcy petition (say, on grounds that the debtor had been put into receivership) will render the mortgage voidable under Section 60. Since the filing of a petition any time after execution would have made the mortgage a Section 60 preference, it can be argued that the second act

of bankruptcy occurred when the mortgage was executed and that a petition alleging the transfer could have been filed from the date of execution. As to these transfers, "made or suffered" in Section 3a relates to the date the transfer was in fact made.

Upon the same reasoning, a contemporaneous, unperfected transaction can be made into an act of bankruptcy. Under Section 60a (7) certain transfers not perfected within a maximum of twenty-one days are preferences. When the grace period for such transfers expires, the filing of a petition renders the transfer voidable. Since the transfer may thus become a Section 60 preference at the end of twenty-one days, it should also become an act of bankruptcy at such time. As to these contemporaneous but unperfected transfers, "made or suffered" in Section 3a relates to the date when the period of grace expires. By interpreting "made or suffered" as relating to two different dates, depending upon the nature of the transfer, we can make an act of bankruptcy out of any transfer for an antecedent debt as well as any unperfected transfer for a present consideration, assuming the other elements of preference are present.

Of course, we must remember that some transfers are also "made and suffered" when perfected, because the statute says so in Section 60a (2). Therefore, "made and suffered," as used in the statute, may refer to three different points of time: the date of execution, the date the grace period expires, or the date of perfection. This is distributive reading of words with a vengeance. Perhaps the draftsmen contemplated this very reading—but we don't believe it.

Assigning three different and somewhat contradictory meanings to the same phrase is not the only means by which the probable purpose of the amendment can be accomplished. There is an alternative approach. It involves, however, an even more extreme fault in logic. We have pointed out that Section 60a (2) provides that if a transfer is not "made" because not perfected, "it shall be deemed to have been made immediately before the filing of the petition." This provision first appeared in substantially the same language in 1938, before the present problem arose. But perhaps it can be used for purposes not contemplated by the draftsmen of the Chandler Act. It is undoubtedly true that the filing of a valid petition—one which alleged a completed act of bankruptcy, such as a fraudulent conveyance—would cause an unperfected security transfer to be deemed "made." Is it also possible to say that an unperfected transfer becomes "made" by the filing of a petition alleging that very transfer as the act of bankruptcy? To give an affirmative answer, we must say that the act of bankruptcy which imparts validity to the petition acquires in turn its validity from the

filing of the petition. The transfer is "made" by the filing of the petition and the petition is good only because the transfer is made. This circular reading of the Act is bootstrapping in its most violent form. To "make" a transfer by the doing of an act which clearly presupposes that the same transfer has already been made is an idea which gives us some pause. We think it may have the same effect on others.

This reading, despite our distaste for it, will achieve fairly satisfactory results. Through it, an otherwise unperfected transfer to secure a pre-existing debt becomes "made" at the only date that really matters for purposes of the second act of bankruptcy—the time when some creditor wants to file a petition. We have seen above that a transfer simultaneous with the consideration for it becomes objectionable for bankruptcy purposes if unperfected at the expiration of a statutory grace period, a maximum of twenty-one days. If a petition in bankruptcy alleging that transfer is filed on the twenty-second day, the transfer would become "made" and thus would become the second act of bankruptcy at that time. Suppose, however, that some creditor files a petition alleging the transfer before the grace period has elapsed. A court might say that the transfer is thereby "made" within the grace period and rendered forever immune from attack, even though the petition must be dismissed because it does not allege an act of bankruptcy. Logical consistency would compel this conclusion, but one who reaches this stage of the problem has long since abandoned logic as a guide. Another possible solution is simply to declare that the transfer is not objectionable at that stage and is therefore not an act of bankruptcy.

Attacking the whole problem of "made and suffered" through the device of filing a petition also reconciles—too well, perhaps—another inconsistent usage of the words "made" and "perfected" which has been preserved in the Act. Section 3b retains the provision that insolvency for the purposes of the second act of bankruptcy is to be tested "either at the time when the transfer was made or at the time when it became perfected, as hereinabove provided." Prior to 1952 it was thereinabove provided that perfection occurred when the transfer was, in effect, no longer vulnerable in state proceedings. Under that language it was at least theoretically possible to adjudicate bankrupt a man who was then wholly solvent merely because he had been insolvent at a time—perhaps many months before—when he had transferred property to secure a pre-existing debt. But the "hereinabove provided" now includes reference to Section 60a also, and we have seen that under that section filing a petition may "make" an unperfected transfer. With regard to such transfers, the reference to "either" time has no meaning and insolvency in such cases is relevant only at the time the petition is filed. Since

that date alone controls, a solvent man could not now be declared a bankrupt under the second act of bankruptcy merely because he had been insolvent at the time of some previous unrecorded transfer. It can well be argued that this is a fortunate change: no good can come of bankruptcy in such circumstances. But there is absolutely no indication that such change in the time for testing insolvency was either intended or desired.

We have demonstrated the confusion that results from defining an act of bankruptcy by reference to an avoiding section of the statute. The source of the confusion, as we see it, is the mistaken notion that because Sections 3 and 60 both deal with preferences they are interchangeable. This notion overlooks the fact that the two sections have different objectives, which must be accomplished by different techniques. Section 60 serves two purposes: it declares certain transfers vulnerable to attack and it fixes the final date for determining such vulnerability. The section assumes that an act of bankruptcy has been committed and a petition filed. Section 3a, on the other hand, must be concerned with the grounds for filing a bankruptcy petition. If certain transfers are to be made the basis for putting a debtor into involuntary bankruptcy, Section 3a must not only set forth what these transfers are but also specify when they take place, for that is the *earliest date* on which a petition may be filed alleging such transfer as the act of bankruptcy. Whatever else the draftsmen accomplished by the 1952 Amendment, they unfortunately made this date uncertain and thereby frustrated the very purpose of the section they were amending.

Very truly yours,

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Appendix

THE BANKRUPTCY ACT

Sec. 3. Acts of Bankruptcy

(Prior to Amendment by the Act of July 7, 1952)

"a. Acts of bankruptcy by a person shall consist of his having . . . (2) transferred, while insolvent, any portion of his property to one or more of his creditors with intent to prefer such creditors over his other creditors. . . ." 30 Stat. 546 (1898), as amended, 52 Stat. 844, 11 U.S.C. § 21 (1946).

Sec. 3. Acts of Bankruptcy

(As Amended by the Act of July 7, 1952)

"a. Acts of bankruptcy by a person shall consist of his having . . . (2) made or suffered a preferential transfer, as defined in subdivision a of section 60 of this Act. . . ." 30 Stat. 546 (1898), as amended, 66 Stat. 421, 11 U.S.C.A. § 21 (Supp. 1953).

Sec. 60. Preferred Creditors

"a. (1) A preference is a transfer, as defined in this Act, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this Act, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.

"(2) For the purposes of subdivisions a and b of this section, a transfer of property other than real property shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee. A transfer of real property shall be deemed to have been made or suffered when it became so far perfected that no subsequent bona fide purchase from the debtor could create rights in such property superior to the rights of the transferee. If any transfer of real property is not so perfected against a bona fide purchase, or if any transfer of other property is not so perfected against such liens by legal or equitable proceedings prior to the filing of a petition initiating a proceeding under this Act, it shall be deemed to have been made immediately before the filing of the petition." 30 Stat. 562 (1898), as amended, 64 Stat. 25, 11 U.S.C. § 96(a) (Supp. 1952).