



1967

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Recommended Citation

King, Lawrence P. (1967) "Statutory Liens--1966 Amendment of Section 67 of the Bankruptcy Act," *Kentucky Law Journal*: Vol. 55 : Iss. 3 , Article 2.

Available at: <https://uknowledge.uky.edu/klj/vol55/iss3/2>

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Statutory Liens--1966 Amendment of Section 67 of the Bankruptcy Act

BY LAWRENCE P. KING*

I. INTRODUCTION

Prior to the 1966 amendments to the Bankruptcy Act,¹ subdivisions (b) and (c) of section 67 were two parts of the statute which were difficult to interpret. In essence, subdivision (b) provided for the continuing validity of statutory liens in a bankruptcy proceeding whether or not such liens were within the prohibitive voidable preference provisions of section 60 of the Act.² It was not possible, however, to look solely to subdivision (b), but it was also necessary to consider subdivision (c), which provided that almost all statutory liens given validity were rendered invalid and ineffective against a trustee in bankruptcy.³ Essentially the only

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¹ Pub. L. No. 89-495, 89th Cong., 2d. Sess. §§ 1-4 (July 5, 1966).

² Bankruptcy Act § 67(b) read as follows:

The provisions of section 60 of this Act to the contrary notwithstanding, statutory liens in favor of employees, contractors, mechanics, landlords, or other classes of persons, and statutory liens for taxes and debts owing to the United States or to any State or any subdivision thereof, created or recognized by the laws of the United States or of any State, may be valid against the trustee, even though arising or perfected while the debtor is insolvent and within four months prior to the filing of the petition initiating a proceeding under this Act by or against him. Where by such laws such liens are required to be perfected and arise but are not perfected before bankruptcy, they may nevertheless be valid, if perfected within the time permitted by and in accordance with the requirements of such laws, except that if such laws require the liens to be perfected by the seizure of the property, they shall instead be perfected by filing notice thereof with the court.

³ Bankruptcy Act § 67(c) read as follows:

Where not enforced by sale before the filing of a petition initiating a proceeding under this Act, and except where the estate of the bankrupt is solvent: (1) though valid against the trustee under subdivision b of this section, statutory liens, including liens for taxes on debts owing to

(Continued on next page)

types of statutory liens granted full recognition in bankruptcy were liens on real property and those on personal property if the lienor had possession. With one exception, all other types of statutory liens were rendered invalid against a trustee in bankruptcy; the exception was provided for statutory liens for rent and federal taxes, which were recognized but subordinated to the first two priorities of section 64 (a).⁴

Even though subdivisions (b) and (c) of section 67 referred solely to statutory liens, the Bankruptcy Act did not provide a definition, although it did provide some non-exhaustive examples in subdivision (b). An even more difficult problem was present in the earlier version because of the subordination feature of federal tax liens and liens for rent in subdivision (c). It was a problem of circuitry and was resolved in three different ways by various courts.⁵

II. DEFINITION OF STATUTORY LIEN

The 1966 amendments have attempted to deal with all these problems and provide a statutory solution. First, section 1 of the

(Footnote continued from preceding page)

the United States or to any State or any subdivision thereof, on personal property not accompanied by possession of such property, and liens, whether statutory or not, of distress for rent shall be postponed in payment to the debts specified in clauses (1) and (2) of subdivision a of section 64 of this Act and such liens for wages or for rent shall be restricted in the amount of their payment to the same extent as provided for wages and rent respectively in subdivision a of section 64 of this Act; and (2) the provisions for subdivision b of this section to the contrary notwithstanding, statutory liens created or recognized by the laws of any State for debts owing to any person, including any State or any subdivision thereof, on personal property not accompanied by possession, or of or by levy upon or by sequestration or distraint of, such property, shall not be valid against the trustee: *Provided, however*, That so much of clause (1) of this subdivision c as restricts liens for wages and rent and clause (2) of this subdivision c shall not apply in proceedings under chapter X of this Act, unless an order shall be entered therein directing that bankruptcy be proceeded with, or in proceedings under section 77 of this Act. The court may on due notice order so much of any lien in excess of the restricted amount under clause (1) and any lien invalid under clause (2) of this subdivision c to be preserved for the benefit of the estate and, in any such event, such lien for the excess and such invalid lien, as the case may be, shall pass to the trustee.

⁴ Bankruptcy Act § 64(a) (1) and (2) lists the first two priorities as administration expenses and wage claims limited in amount and time of accrual. All of the priorities in § 64(a) are paid from the general estate after secured creditors have been satisfied.

⁵ *E.g.*, *New Orleans v. Harrell*, 134 F.2d 399 (5th Cir. 1943). *Contra*, *In re Quaker City Uniform Co., Inc.*, 238 F.2d 155 (3d Cir. 1956); and for a third order of distribution, *California State Dep't of Employment v. United States*, 210 F.2d 242 (9th Cir. 1954); *In re American Zyploptic Co., Inc.*, 181 F. Supp. 77 (E.D.N.Y. 1960); *In re Empire Granite Co.*, 42 F. Supp. 450 (M.D. Ga. 1942). See 4 COLLIER, BANKRUPTCY ¶67.27[3] (14th ed. 1954).

Act has been amended to define a statutory lien.⁶ By inserting subdivision 29 (a) in section 1, a statutory lien is defined to be

a lien arising solely by force of statute upon specified circumstances or conditions, but shall not include any lien provided by or dependent upon an agreement to give security, whether or not such lien is also provided by or is also dependent upon statute and whether or not the agreement or lien is made fully effective by statute.⁷

This definition is of value not only because of its insertion but also because the important substantive and operative provisions of subdivisions (b) and (c) of section 67 refer solely to the statutory lien. It is of even greater importance because there were situations where courts had difficulty differentiating between statutory and consensual liens.⁸ Clearly the consensual lien is not encompassed within the operative effects of subdivisions (b) and (c) of section 67. By the same token, the statutory lien is not within the operative effects of section 60 of the Bankruptcy Act.⁹ In those few instances where difficulty arose, the courts tended to treat some types of consensual liens as statutory liens. Now, by definition, a statutory lien is one arising solely by force of statute. Many of the consensual type liens, while arising by force of agreement rather than by force of statute, are specifically and in detail regulated by other statutes. Examples of these liens include the chattel mortgage, the factor's lien, and a security interest under

⁶ Bankruptcy Act § 1(29a) as amended, Pub. L. No. 89-495, 89th Cong., 2d Sess. § 1 (July 5, 1966).

⁷ *Ibid.*

⁸ See *In re Quaker City Uniform Co., Inc.* (3d Cir. 1956) (first opinion, not officially reported), wherein the court stated that § 67(c)

also postpones the liens of the chattel mortgagees, and we cannot agree with the *assumption which apparently has guided the parties in this appeal* that the liens of the chattel mortgagees are not postponed. The liens of the chattel mortgagees in this case fit exactly the type of liens that are postponed in payment by Section 67(c). They are statutory liens under Pennsylvania law; they are on personal property and were not accompanied by possession.

This opinion was withdrawn and replaced by a later one reported at 238 F.2d 155 (3d Cir. 1956) wherein, on this point, the court (at pp. 158-59) concluded:

It is not necessary to decide whether or not a Pennsylvania chattel mortgage is a 'statutory lien' within the meaning of section 67, sub. c. . . . For the purposes of this opinion, however, we shall *assume* that it is not a 'statutory lien' within the purview of section 67.

See also *In re Tele-Tone Radio Corp.*, 133 F. Supp. 739 (D.N.J. 1955), where the court correctly concluded that liens under Factor's Lien Acts were consensual and not statutory.

⁹ Bankruptcy Act § 67(b).

Article Nine of the Uniform Commercial Code. Even though there is statutory regulation of almost all consensual liens, the important factor is that the lien itself does not arise because of, or by virtue of, the statute itself. It arises solely because of an agreement between the debtor and the creditor. In the absence of an agreement, there will not be a consensual lien.

On the other hand, a statutory lien can and will arise in the absence of an agreement, and it is not dependent upon agreement. As a matter of fact, it presupposes that there is no prior, contemporaneous, or subsequent agreement between the parties. The lien arises by operation of law out of some economic relationship between the parties, and its purpose is to protect a certain economic group.¹⁰ Examples include the laborer or materialman who is given a mechanic's lien, the repairman who is given a garageman's lien, however termed in local statute, and the various levels of government which are given statutory liens for unpaid taxes, provided that necessary procedural steps are taken. By virtue of the definition now contained in section 1 [29 (a)] of the Bankruptcy Act, the courts should not have any difficulty distinguishing between consensual and statutory liens.

In passing, it might be noted that there is a third type of lien, the judicial lien.¹¹ A judicial lien arises out of judicial proceedings; examples include the judgment lien, the attachment lien, and the garnishment lien. As far as the Bankruptcy Act is concerned, the judicial lien is governed by section 67 (a), which treats only this subject. It also falls within the provisions of section 60 and subdivisions (c) and (e) of section 70, since there is no limiting effect in section 67 (a) which would exclude it from the latter two sections.¹²

¹⁰ See 4 COLLIER, BANKRUPTCY ¶67.20[2] (14th ed. 1954).

¹¹ A judicial lien is not defined specifically in the Bankruptcy Act, but in § 67(a) it is a lien "obtained by attachment, judgment, levy or other legal or equitable process or proceeding. . . ."

¹² Bankruptcy Act § 67(a): judicial liens are invalid if obtained within four months before the filing of the bankruptcy petition when the debtor was insolvent or in fraud of the Act's provisions.

Bankruptcy Act §§ 60(a), (b): a judicial lien may also be a voidable preference if meeting the requisite elements.

Bankruptcy Act § 70(c): a judicial lien unperfected at the time of the filing of the petition is invalid against the trustee who has rights of a judicial lien creditor.

Bankruptcy Act § 70(e): if the judicial lien is voidable by any existing creditor with a provable claim, the trustee may invalidate it.

The definition of statutory lien in section 1 [29 (a)] has particular relevance to subdivisions (b) and (c) of section 67. Before any interpretation or application of these subdivisions can be made, it is first necessary to decide if the particular lien involved is statutory. Under the 1966 amendment, the first inquiry will be directed to the definition in order to determine which type lien is involved. After deciding that the lien is statutory, reference can be made to subdivisions (b) and (c) of section 67 in order to determine the lien's validity against a trustee in bankruptcy.

III. AMENDING SECTION 67 (c).

As mentioned earlier, subdivisions (b) and (c) of section 67 were quite difficult to interpret prior to the 1966 amendment. This was caused by the three-step procedure that had to be followed in order to make sense out of these two subdivisions. It was suggested that section 67 (b) completely validated all statutory liens even though they might satisfy the requirements of section 60 and become a voidable preference. It was also suggested that it was necessary to look to subdivision (c) in order to determine which liens were validated, which were invalidated, and which were validated but subordinated. Prior to 1966, subdivision (c) (1) stated that statutory liens on personal property not accompanied by possession, even though such liens were valid under subdivision (b), were subordinated to the first two priorities of section 64.¹³ Thus, the first restriction was that a valid statutory lien on personal property unaccompanied by possession would not be wholly validated in a bankruptcy proceeding, but would assume in essence a third priority, after administration expenses and wage claims.

It was important to recognize, however, that even at this point one could not stop reading the statutory provisions. By going to subdivision (c) (2), one found that all statutory liens, except federal tax liens and liens for distress of rent, were invalid against the trustee.¹⁴ In other words, under subdivision (c) (2) if there was a state-created statutory lien on personal property not accompanied by possession, levy, sequestration, or distraint, such statutory lien was wholly invalid against the trustee in bank-

¹³ See note 3 *supra*.

¹⁴ *Ibid*.

ruptcy regardless of subdivisions (b) and (c) (1). Thus, by following through from the beginning of section 67 (b) it was found that the only types of statutory liens on personal property not accompanied by possession or levy that would have any validity in bankruptcy proceedings were the federal tax lien and the rent lien. These two liens were only partially effective since subdivision (c) (1) subordinated them to the administration expenses and wage claims which constituted the first two priorities in section 64.¹⁵

The 1966 amendments¹⁶ changed this situation. The test of possession was taken out of subdivision (c), and a more detailed listing of tests was inserted. The new subdivision (c) in section 67 provides:

(1) The following liens shall be invalid against the trustee:

(A) every statutory lien which first becomes effective upon the insolvency of the debtor, or upon distribution or liquidation of his property, or upon execution against his property levied at the instance of one other than the lienor;

(B) every statutory lien which is not perfected or enforceable at the date of bankruptcy against one acquiring the rights of a bona fide purchaser from the debtor on that date, whether or not such purchaser exists: *Provided*, That where a statutory lien is not invalid at the date of bankruptcy against the trustee under subdivision c of section 70 of this Act and is required by applicable lien law to be perfected in order to be valid against a subsequent bona fide purchaser, such a lien may nevertheless be valid under this subdivision if perfected within the time permitted by and in accordance with the requirements of such law: *And provided further*, That if applicable lien law requires a lien valid against a trustee under section 70, subdivision c, to be perfected by the seizure of property it shall instead be perfected as permitted by this subdivision c of section 67 by filing notice thereof with the court;

(C) every statutory lien for rent and every lien of

¹⁵ By analyzing the provisions of the former statute, it is seen that every lien within clause (2) falls within the subordination feature of clause (1); but the reverse is not true. Clause (1) subordinates all liens, and clause (2) wholly invalidates most of the same ones except the two mentioned in the text. These two are subordinated by clause (1).

¹⁶ Pub. L. No. 89-495, 89th Cong., 2d. Sess. §§ 2-4 (July 5, 1966).

distress for rent, whether statutory or not. A right of distress for rent which creates a security interest in property shall be deemed a lien for the purposes of this subdivision c.

(2) The court may, on due notice, order any of the aforesaid liens invalidated against the trustee to be preserved for the benefit of the estate and in that event the lien shall pass to the trustee. A lien not preserved for the benefit of the estate but invalidated against the trustee shall be invalid as against all liens indefeasible in bankruptcy so as to have the effect of promoting liens indefeasible in bankruptcy which would otherwise be subordinate to such invalidated lien. Claims for wages, taxes, and rent secured by liens hereby invalidated or preserved shall be respectively allowable with priority and restricted as are debts therefor entitled to priority under clauses (2), (4), and (5) of subdivision a of section 64 of this Act, even though not otherwise granted priority.

(3) Every tax lien on personal property not accompanied by possession shall be postponed in payment to the debts specified in clauses (1) and (2) of subdivision a of section 64 of this Act. Where such a tax lien is prior in right to liens indefeasible in bankruptcy, the court shall order payment from the proceeds derived from the sale of the personal property to which the tax lien attaches, less the actual cost of that sale, of an amount not in excess of the tax lien, to the debts specified in clauses (1) and (2) of subdivision a of section 64 of this Act. If the amount realized from the sale exceeds the total of such debts, after allowing for prior indefeasible liens and the cost of the sale, the excess up to the amount of the difference between the total paid to the debts specified in clauses (1) and (2) of subdivision a in section 64 of this Act and the amount of the tax lien, is to be paid to the holder of the tax lien.

(4) Where a penalty not allowable under subdivision j of section 57 is secured by a lien, the portion of the lien securing such penalty shall not be eligible for preservation under this subdivision c.

(5) This subdivision c shall not apply to liens enforced by sale before the filing of the petition nor to liens against property set aside to the bankrupt as exempt, nor to liens against property abandoned by the trustee or unadministered in bankruptcy for any reason and shall not apply in proceedings under section 77 of this Act, nor in proceedings under chapter X of this Act unless an order has been entered directing that bankruptcy be proceeded with.

IV. SCOPE OF SECTION 67 (c).

First to be noted is the scope of subdivision (c). Under subdivision (c) (5) it is clear that section 67 (c) regarding statutory liens has no application to Chapter X proceedings under the Bankruptcy Act.¹⁷ Prior to the 1966 amendments, while it seemed clear that this section was not applicable to Chapter X proceedings, there was case law to the contrary, and the language in the statute itself was not entirely free from doubt.¹⁸ However, by virtue of the amendment, the doubt has been removed and there is clearly no application to corporate reorganizations unless a straight bankruptcy proceeding supercedes it. Thus, the only provision applicable to Chapter X proceedings with regard to statutory liens is subdivision (b) of section 67 which validates such liens against the trustee regardless of whether they might have fallen within the provisions of section 60 of the Bankruptcy Act.¹⁹

In addition, 67 (c) will not apply to any statutory lien on the bankrupt's exempt property,²⁰ to any liens upon property which the trustee has abandoned (which he may do usually by order of the court),²¹ or to property which for some reason is not administered in the bankruptcy proceedings. Section 67 (c) will not apply to statutory liens which prior to the filing of the petition have been enforced by a sale of that property. Finally, the statutory lien and the provisions of subsection (c) with regard to it will have no application in section 77 proceedings.²²

As far as other proceedings under the Bankruptcy Act are concerned, including straight bankruptcy within the first seven

¹⁷ Chapter X proceedings deal exclusively with corporate reorganizations. See the Bankruptcy Act §§ 101-276 as discussed in COLLIER, BANKRUPTCY, vols. 6, 6A.

¹⁸ *In re American Health Studios, Inc.*, 178 F. Supp. 553 (S.D. Tex. 1959). (§ 67(c)(1) applicable in Chapter X proceeding to postpone federal tax lien to administrative expenses even though § 102 of Chapter X expressly makes § 64 and its priority provisions inapplicable.) For criticism of this case and the contra argument, see 6 COLLIER, BANKRUPTCY ¶ 1.07[1] (14th ed. 1965). See also 4 COLLIER, BANKRUPTCY ¶ 67.20[8] (14th ed. 1954).

¹⁹ Nothing in Chapter X makes § 67(b) inapplicable. Section 67(b) refers to statutory liens arising "within four months prior to the filing of the petition initiating a proceeding under this Act. . . ." A Chapter X petition initiates a proceeding under the Bankruptcy Act.

²⁰ The trustee does not succeed to title in a bankrupt's exempt property. Bankruptcy Act § 70(a).

²¹ See 4 COLLIER, BANKRUPTCY ¶ 70.42 (14th ed. 1959).

²² Providing for the reorganization of railroads.

chapters, if subsection (c) applies, it is necessary to see which statutory liens are validated, which are invalidated, and which are subordinated. A quick reading of subsection (c) will immediately show two things. First, the circuitry question that came up prior to this amendment is now resolved by statute.²³ Secondly, a prior problem which had been resolved by a decision of the United States Supreme Court is also resolved by statute. The statute now provides in section 67(c)(4) that tax penalties, although part of a tax lien, are still to be governed by section 57; this provision, in effect, renders them non-allowable claims.²⁴

V. TESTS FOR VALIDATION

Finally, it is readily apparent that subsection (c) has been almost completely reworded.²⁵ Under the earlier version of subsection (c) a distinction was made between real and personal property, and a standard of possession was incorporated. However, according to the Senate Report accompanying the 1966 bill,

a recent reexamination of State lien statutes has shown that neither the standard of possession nor the distinction between real and personal property is an entirely satisfactory criterion. Some liens which are genuine property rights are

²³ See cases cited in note 5 *supra* and text under heading "VII. Priority Circuitry—How Resolved" *infra*.

²⁴ § 57(j) renders penalties imposed for delinquent taxes non-allowable unless some pecuniary loss can be shown. The federal government argued that this section applied only to non-liened tax penalties, and when there was a tax lien including penalties the whole amount was validated under § 67(c) as a lien claim. The Supreme Court disagreed with this argument and has held that the penalties, whether or not part of a tax lien, were non-allowable because of § 57(j), thus resolving a pre-existing conflict among the circuits. *Simonson v. Granquist*, 369 U.S. 38 (1962). The conflicting lower court decisions are represented by: *United States v. Mighell*, 273 F.2d 682 (10th Cir. 1959); *Grimland v. United States*, 206 F.2d 599 (10th Cir. 1953) (liened penalties allowable). *Contra*, *United States v. Harrington*, 269 F.2d 719 (4th Cir. 1959); *In re C. J. Dick Touring Co.*, 161 F. Supp. 751 (S.D. Tex. 1958), *aff'd sub nom.* *United States v. Phillips*, 267 F.2d 374 (5th Cir. 1959).

²⁵ In addition, § 67(c) now incorporates some of the language of former § 67(b). For former § 67(b), see note 2 *supra*. Section 67(b) was also amended by the same legislation (note 1 *supra*) so that it now reads:

The provisions of section 60 of this Act to the contrary notwithstanding and except as otherwise provided in subdivision c of this section, statutory liens in favor of employees, contractors, mechanics, or any other class of persons, and statutory liens for taxes and debts owing to the United States or to any State or subdivision thereof, created or recognized by the laws of the United States or any State, may be valid against the trustee, even though arising or perfected while the debtor is insolvent and within four months prior to the filing of the petition initiating a proceeding under this Act by or against him.

affected and others which were essentially State-created priorities escape.²⁶

In order to complement the Bankruptcy Act's system of distribution of assets, the possession standard was eliminated, and there is now no possessory distinction between real and personal property.²⁷ Instead of these tests, the statutory lien is made ineffective if it falls within the categories specifically set out in paragraphs (A), (B), and (C) of section 67 (c) (1). These categories include the following:

1. *The Statutory Lien May Invalidate Itself.*—If the statutory lien becomes effective only upon the insolvency of the debtor, or if there is a liquidation of his property or a provision with similar effect, paragraph (A) invalidates it. This has nothing to do with a consensual lien or an agreement that might have particular operative provisions in the event of insolvency or liquidation of the debtor. The lien included is one created by a local statute, and it

²⁶ S. REP. No. 1159 on H.R. 136, incorporating H.R. No. 686, 89th Cong., 2d Sess. (1966), U.S. CODE CONG. & AD. NEWS 2026-27 (No. 7, Aug. 20, 1966). See also 4 COLLIER, BANKRUPTCY §67.20[3] at 191-92:

The significance of the "inherent differences" in statutory liens on realty and personalty for the purposes of the subdivision here is by no means self-evident. The distinction between what is real property and what is personal property is at best shadowy in many places, as any text on the law of property will testify; yet the tenuous line that must often be drawn under § 67c will at times become determinative of substantive rights, saving something to defray administrative expenses and possibly to pay a portion of the bankrupt's employees' past earnings if the lien is held to fall on personal property, otherwise not. Most of the congeries of liens created by statute not only may attach to real property but frequently are limited to the debtor's realty. Landlords' liens, by their very nature, bind only the tenants' personalty, but statutory liens confined to personal property constitute exceptions to the general tenor of statutory liens. Indeed, while perhaps no verification of this opinion is possible, it is believed that tax liens and other types of liens (except landlords' liens) which tend to consume debtors' estates by virtue of their accumulation are generally not liens on bankrupts' personal property but rather liens agglomerating against land, buildings, fixtures, and such real assets. Even with respect to liens against the bankrupt's personalty all statutory liens requiring possession to support them also prevail under subdivision c, even against debts entitled to a first and second priority, except, it would seem, liens of distress for rent. Statutory liens on realty are no more steeped in history nor traditionally sacrosanct than liens acquired against such property through legal proceedings, rendered subject to absolute and complete nullification if within the broad, sweeping provisions of §67a. Indeed, it was uncertain whether statutory liens on any kind of property could be perfected after bankruptcy until the Act of 1938 expressly so provided in §67b. There would seem to be neither more iconoclasm nor greater practical difficulty in subordinating statutory liens on realty to priorities (1) and (2) of §64a than in subordinating liens on personalty. (Footnotes omitted.)

²⁷ See S. REP. No. 1159, *supra* note 26.

arises only when there is an act or occurrence mentioned in paragraph (A). Essentially, this type of statute is an attempt to create a state priority which, of course, should not be recognized in a bankruptcy situation.²⁸ No statutory lien existed prior to the insolvency of liquidation or was created by the filing of the petition in bankruptcy. Therefore, since there was no prior property right, one should not be recognized solely for purposes of distribution.

2. *The Statutory Lien May Be Invalidated by a BFP*—A statutory lien is invalidated if it is not perfected against a bona fide purchaser by the time the petition in bankruptcy is filed. This amendment brings back into the Bankruptcy Act a bona fide purchaser test which on other occasions raised serious problems that resulted in its elimination. This was particularly true when the bona fide purchaser test, which was contained in section 60, was later changed to a judicial lien creditor test by amendment in 1950.²⁹ However, the subsequent bona fide purchaser test is reactivated and is the standard to be used in order to determine the validity of the statutory lien.³⁰ If the statutory lien is not perfected according to the requirements of state law prior to the filing of the petition so that it is effective against a subsequent bona fide purchaser, then it will be subject to attack by a trustee in bankruptcy. Whether a subsequent bona fide purchaser could have obtained superior rights over those of the statutory lienor is a matter of state law and reference must be made to it. The Bankruptcy Act and section 67 (c) do not respond to that question in any way.

This provision, however, has to be read with paragraph (B) because a qualifying feature is included therein. It states that, if the statutory lien is effective against judicial lien creditors and would not be invalidated by section 70 (c) of the Bankruptcy Act,

²⁸ See S. REP. No. 1159, *supra* note 26, at 2027.

²⁹ Prior to 1950, § 60 used a bona fide purchaser test to determine the date of perfection of a transfer of personal property. The inherent difficulty of such a test was brought to light in *Corn Exchange Nat'l Bank & Trust Co. v. Klauer*, 318 U.S. 434 (1943), and § 60 was finally amended in 1950 to substitute a judicial lien creditor test. 64 Stat. 24 (1950). For further discussion, see COLLIER, *BANKRUPTCY* ¶¶ 60.37-60.40 (14th ed. 1964).

³⁰ Prior to the 1966 amendment § 67(b), (c) did not expressly contain a test to determine perfection of the statutory lien; presumably the judicial lien creditor test in § 70(c) would be relevant. See 4 COLLIER, *BANKRUPTCY* 186 (14th ed. 1954).

then a further step is required in order to perfect the lien against bona fide purchasers. If that particular step is taken within the required time period, the lien will be effective against the trustee in bankruptcy. It should also be mentioned that under this amendment, if the particular applicable step required for perfection under state law is a seizure of the property, then instead of requiring seizure after the filing of the petition, it is sufficient if the lienor files notice of his lien with the bankruptcy court.³¹ Obviously, as to this last point, it would be impossible, or at least a procedural headache, for the lienor to try to seize the property. Once the petition in bankruptcy has been filed, all property belonging to the bankrupt comes within the jurisdiction of the bankruptcy court,³² and in order for the lienor to attempt to reclaim it, he would have to file a petition asserting his rights. To obviate the necessity for the filing of a reclamation petition in order to obtain possession of the property, this provision was inserted so that only notice to the bankruptcy court is required and it will have the same effect as if the property had been seized.

Under this test two things are important. First, it is the subsequent bona fide purchaser test that is used. Secondly, in a limited number of situations perhaps, there is a specific cross-reference made to the application of section 70 (c) of the Bankruptcy Act.³³ Once the bankruptcy petition has been filed, the lienor desiring to assert a statutory lien must make several determinations. Does he have a statutory lien effective under state law as against subsequent bona fide purchasers? If not, is it effective against judgment and judicial lien creditors, and is there some step under the state statute which he could take, but has not yet taken, that would perfect the lien against subsequent bona fide purchasers? If these are affirmatively answered, then the question becomes, "Is there a time requirement for taking the necessary action, and has it expired?" If there is a step to be taken and the time has not expired, then the lienor still has a way of

³¹ This element is taken from the language in former § 67(b). See *supra* note 2.

³² See, e.g., Bankruptcy Act §§ 2, 70(a); *Isaacs v. Hobbs Tie & Lumber Co.*, 282 U.S. 734 (1931).

³³ Bankruptcy Act § 70(c) was also amended in 1966, Pub. L. No. 89-495, 89th Cong., 2d Sess. § 5 (July 5, 1966). Among other things it delimits the trustee's status by providing that he has the rights of a judgment creditor, a creditor with an execution returned unsatisfied, and a judicial lien creditor, regardless of whether such creditor actually exists.

validating and perfecting his lien. This would fall within the proviso of paragraph (B), and he would be able to perform anything required, unless it was a seizure of the property. In the latter event, he should simply file a notice within the proper time period with the bankruptcy court. Of course, this presupposes knowledge on his part of the pendency of the bankruptcy action. If the step required is not seizure, then he should do whatever is necessary and possible to insure the perfection of his lien.

If certain elements are not present, then the lienholder will simply be out of luck. For example, if he has not taken steps necessary, and there is no time left for performance once the petition has been filed or if the lien is not effective under section 70 (c), then the lien can be invalidated by the trustee in bankruptcy since it is not perfected. The same result obtains where state law gives subsequent bona fide purchasers a superior right even though all steps necessary for the creation of the lien have been taken. If the state law declares the lien created by the particular statute valid only as against subsequent creditors, including subsequent judicial lien creditors, then, by omission, the subsequent bona fide purchaser has full protection from the statutory lienor, and the trustee in bankruptcy stands in his shoes. Under this subsection, the trustee in bankruptcy is given the status of a subsequent bona fide purchaser.³⁴

3. *Rent Liens Invalidated.*—Statutory liens for rent and liens of distress for rent are wholly invalidated against the trustee in bankruptcy by section 67 (c). This is a marked change from prior law, which made rent liens valid against the trustee but subordinated to the first two priorities in section 64.³⁵ The 1966 amendment, however, provides some protection for the rent lienor by entitling his lien to a fifth priority in section 64 (a). Section 67 (c) (2) declares that, "Claims for wages, taxes, and rent secured by liens hereby invalidated . . . shall be . . . allowable with priority and restricted as are debts therefore entitled to priority under clauses (2), (4), and (5) of subdivision (a) of section 64 . . . even though not otherwise granted priority."

Under section 64 (a) (5) of the Bankruptcy Act, a fifth priority

³⁴ As to the trustee's status vis-a-vis a federal tax lien, see text at "VIII. Tax Liens: Trustee As Judgment Creditor" *infra*.

³⁵ See *supra* note 3.

is given to a rent claim if it enjoys that privilege under applicable state law. The rent priority is limited to the rent that is due for the actual use of the premises and which was incurred within three months prior to the date of bankruptcy. The 1966 amendments changed this provision by requiring reference to section 67 (c) (2).³⁶ The relevant language in section 67 (c) (1) and (2) invalidates the rent lien as a statutory lien, but accords it the former priority enjoyed under section 64 (a) (5), even though it is otherwise not granted one. Prior to this amendment, when only section 64 (a) (5) related to the rent priority, a priority existed only if the state law recognized one for rent claims. This was the only instance where the priority provisions of the Bankruptcy Act incorporated state-created priorities and allowed them to have any effect.³⁷ If state law did not give a priority to rent claims, then the fifth priority in the Bankruptcy Act would be immaterial and have no effect. The landlord in the bankruptcy proceeding would not have any priority. If he had a lien under state law, it would be governed by section 67 (c), and if it was a lien for distress of rent or was accompanied by possession, then he would have a valid lien; but it would be third priority, subordinated to administration and wage claims. Now, however, his lien is wholly ineffective as a statutory lien under section 67 (c). This is true regardless of whether state law recognizes a priority for landlords' claims, as the rent claim is given a fifth priority under section 64 because of the language in section 67 (c) (2). The only qualification that must be met is that the rent claim be secured by a lien. If it is an unsecured rent claim, then the ordinary provision of section 64 (a) (5) prevails and the landlord is entitled only to the priority given him by state law.

Section 64 (a) (5) was also amended in 1966 by the same legislation to harmonize its provisions in this respect with the changes in sections 67 (c) (1) and (2). As amended, there is fifth priority for "a landlord who is entitled to priority by applicable State law or who is entitled to priority by paragraph (2) of subdivision (c) of section 67 of this Act."³⁸

³⁶ Pub. L. No. 89-495, 89th Cong., 2d Sess. § 2 (July 5, 1966).

³⁷ Bankruptcy Act § 64(a)(5) gave priority for "rent owing to a landlord who is entitled to priority by applicable State law."

³⁸ See *supra* note 36.

VI. TAX LIENS SUBORDINATED

Paragraph (3) of section 67 (c) subordinates every tax lien on personal property which is not accompanied by possession. The tax lien apparently includes both federal and state tax liens. Prior to the 1966 amendments, a possible interpretation was that section 67 (c) (2) postponed only the federal tax lien on personal property not accompanied by possession and wholly invalidated any state tax lien. This interpretation would depend on the definition of the word "debts" in former section 67 (c) (2). If a state tax lien was construed as a debt, then it would fall within the invalidating provision of that section. If it were not deemed a debt, it would be an effective statutory lien, but subordinated to administration expenses and wage claims.³⁹ However, under the new amendment every tax lien—city, state, and federal—on personal property not accompanied by possession is postponed to the first two priorities in section 64 (a).⁴⁰ Thus, in effect, these liens have a third priority coming after administration expenses and wage claims but before the priority claims listed in section 64 (a) (3). The purpose for subordination is abundantly clear.

The tax lien is a type of statutory lien from which the bankrupt's estate derives no benefit. Most statutory liens arise because they essentially contribute to the estate, *i.e.*, they enhance the value of the property upon which they attach. However, the tax lien arises only because of a delinquency in payments and is quite detrimental to the estate. A federal tax lien attaches to all the debtor's property; real or personal, tangible or intangible.⁴¹ Thus, in many instances, where there are tax liens in bankruptcy situations, they could exhaust the entire estate. While the tax lien obviously must come ahead of the general body of unsecured creditors, it was felt that there should be some money available to the two most needy priorities, administration expenses and wage claims. The postponement feature is carried forward and extended to tax liens on personal property not accompanied by

³⁹ See *Rochelle v. City of Dallas*, 264 F.2d 166 (5th Cir. 1959) ("debts" does not include city taxes); *accord, In re Baron*, 165 F. Supp. 186 (D. Conn. 1958). *Cf., In re Gordon*, 27 REF. J. 85 (1953) (invalidated city, county and state tax liens on personal property unaccompanied by possession). For further discussion, see 4 COLLIER, BANKRUPTCY ¶ 67.281[1] (14th ed. 1954).

⁴⁰ See S. REP. 1159, note 26 *supra*, at 2024.

⁴¹ INT. REV. CODE OF 1954, § 6321.

possession. If either of these two elements is not present, *i.e.*, if the lien is on real property or if the tax lien is accompanied by possession, then the subordination feature is not applicable and the lien will take first, just as any secured creditor would, if it is otherwise valid under section 67 (c) (1).

VII. PRIORITY CIRCUITY—HOW RESOLVED

Prior to the 1966 amendments, subordination created quite a circuitry of priority problem. The problem arose when there were two secured claims on the same property of the same debtor and bankruptcy ensued. One secured claim was represented by a federal tax lien or a rent lien which was superior by time or statute to the other secured claim, a consensual lien, *e.g.*, a chattel mortgage. The tax or rent lien, although subordinated to the administration and wage priorities, would be superior to the consensual lien. The consensual lien was indefeasible in bankruptcy, that is, absent the tax or rent lien, it was superior to the first two priorities. Thus, the circle was complete: the statutory lien was preferred to the consensual lien; the consensual lien was preferred to the first two priorities, and the first two priorities were preferred to the tax lien. How to break the circle?

Prior to the 1966 amendment, three decisional approaches were taken. In one approach, the consensual lien was satisfied ahead of the other two categories; the rationale was that since the consensual lien was indefeasible in bankruptcy the tax lien with its subordination feature should not affect it.⁴² While this result may be commendable, it unfortunately ignored the provisions of other statutes, such as the Internal Revenue Code. For example, the Internal Revenue Code in this situation may have required the particular consensual lien to be subordinated to the federal tax lien. The real effect of preferring the consensual lien to the federal tax lien once bankruptcy ensued was to ignore non-bankruptcy lien law.

⁴² *New Orleans v. Harrell*, 134 F.2d 399 (5th Cir. 1943). Under this approach, if the tax lien is for \$4,000 and a chattel mortgage exists for \$4,000 which under lien law is subordinate to the tax lien, and the two priority claims are \$1,000 each, and the property liquidates for \$5,000, the mortgagee gets \$4,000, administration expenses get \$1,000, and the tax lien and wage claimants get nothing. See also 4 COLLIER, BANKRUPTCY ¶ 67.27(3) (14th ed. 1954).

A second approach concluded that the order of priority should be administration and wage claims first, then the tax lien, and finally the consensual lien.⁴³ This was based on a theory of subordination by implication, which came from the Bankruptcy Act, section 67(c). The court reasoned that, since the Bankruptcy Act subordinated the rent lien, Congress meant also to subordinate whatever liens were under the rent lien. Thus, since the rent lien was subordinated to the first two priority claims, the consensual lien should also be subordinated. The unfortunate aspect of both the theory and its result was that other statutory provisions were ignored. The consensual lien would be subordinated only by a fortuitous happening or occurrence not within the control of the secured creditor. The secured creditor would be fully protected only if there was no rent or tax lien in the bankruptcy proceeding. Usually, the proceeds would be eaten up by the tax lien, especially if administration expenses and wage claims were also taken. This result was less than desirable.

A third and more complex method of reaching a more sensible result was adopted by other courts⁴⁴ and incorporated into the new legislation.⁴⁵ In effect, it first sets aside sufficient money from the sale of the property involved to satisfy the tax lien. Then the consensual lien is satisfied to the extent possible from the remaining proceeds of the sale. This step in the process has a double effect. First, it gives recognition to the law outside the Bankruptcy Act. It does this by recognizing the superiority of the tax lien over the consensual lien as required by the applicable state or federal statute. Secondly, by giving the consensual lien whatever funds remain, it recognizes the system of priorities incorporated within the Bankruptcy Act itself, *i.e.*, that the consensual lien is

⁴³ *In re Quaker City Uniform Co., Inc.*, 238 F.2d 155 (3d Cir. 1956), followed in *In re Einhorn Bros., Inc.*, 272 F.2d 434 (3d Cir. 1959). Under this approach, the distribution in the case set out *supra* note 42 would be: \$1,000 to administration expenses, \$1,000 to wage claimants, \$3,000 for the tax lien, and nothing for the mortgagee.

⁴⁴ *California State Dep't of Employment v. United States*, 210 F.2d 242 (9th Cir. 1954); *In re American Zyploptic Co., Inc.*, 181 F. Supp. 77 (E.D.N.Y. 1960); *In re Empire Granite Co.*, 42 F. Supp. 450 (M.D. Ga. 1942) (since this case was in the fifth circuit, it may be considered of little value because of the different approach subsequently taken in *New Orleans v. Harrell*, note 42 *supra*).

Under this approach, the distribution in the case set out *supra* note 42 would be: \$2,000 for the tax lien, \$1,000 for the mortgagee, and \$1,000 each for the priority claimants. See text at note 45 *infra*.

⁴⁵ Bankruptcy Act § 67(c)(3) as amended PUB. L. No. 89-495, 89th Cong., 2d Sess. § 4 (July 5, 1966) set out in text at note 16 *supra*.

to be paid before any of the priorities listed in section 64 (a) of the Act. The consensual lienor is now out of the picture. Then a second step in the process takes place. Former section 67 (c) would have required that a sufficient amount be taken from the funds set aside for the tax lien to satisfy the first two priorities in section 64 (a). The money given to the consensual lienor would not be disturbed. If there are sufficient funds to pay the first two priority claims, any remaining money would be used to satisfy the tax lien. If the funds are insufficient to satisfy the first two priority claims, the tax and consensual liens remain unsatisfied. This two-step process has the real effect of giving as much substance as possible to all the law involved, including the Bankruptcy Act and non-bankruptcy statutes. This approach, taken also under the new section 67 (c),⁴⁶ is a good method, which will achieve equitable results. Its most desirable feature is that it provides a statutory provision which resolves the circuitry problem, thereby ensuring uniformity of application throughout the United States. As mentioned in the Senate Report:

This solution thus avoids the situation where the fortuitous intercession of a subsequent tax lien may result in little or nothing being left for the secured creditor as occurred in Quaker City. At the same time, it prevents a lienor who has a lien subsequent to a tax lien from receiving more than he would get if bankruptcy had not occurred.

It should be noted, too, that in a case where there is not enough to pay the tax lien in full, any deficiency remains a claim which, under section 64a(4), is entitled to a priority on the unsecured assets of the estate. In addition, under present law, tax debts are not dischargeable, and any deficiency remains a claim against the debtor even after bankruptcy.⁴⁷

VIII. TAX LIENS: TRUSTEE AS JUDGMENT CREDITOR

The tax lien must be tested against two parts of section 67 (c). First, it must meet the provisions and standards in section 67 (c) (1); if it does, it falls within section 67 (c) (3), provided the lien is on personal property not accompanied by possession. Thus, the tax lien must be valid against the trustee under section 67 (c) (1)

⁴⁶ *Ibid.* The actual distribution scheme in terms of dollar amount is set out note 44 *supra*.

⁴⁷ S. REP. No. 1159, *supra* note 26, at 2022, 2030.

if it is ever to be valid, even on a subordinated basis under section 67 (c) (3). The effect of requiring reference to section 67 (c) (1) is to incorporate the provisions in section 70 (c), which was also amended.⁴⁸ In connection with the federal tax lien, an important change was made in section 70 (c) which incorporates the decision of the Supreme Court in *United States v. Speers*.⁴⁹ As a result of this holding, the trustee in bankruptcy was given the status, or recognized to have the status, of a judgment creditor so that he might come within the protective provisions of section 6323 of the Internal Revenue Code.

Prior to *Speers*, the federal courts of appeals disagreed on this point.⁵⁰ As far as the Internal Revenue Code was concerned, a federal tax lien was valid, even if unrecorded, against everyone except purchasers, judgment creditors, pledgees, and mortgagees.⁵¹ In order to be valid against these four groups, the Code required that the tax lien be recorded.⁵² The question then became whether the trustee in bankruptcy had the position of a judgment creditor. If he did, an unrecorded federal tax lien prior to bankruptcy was ineffective against him.⁵³ On this point of interpretation, a conflict developed.⁵⁴ It was subsequently resolved by the Supreme Court's decision that the trustee is a judgment creditor.⁵⁵ This decision was incorporated by amendment in section 70 (c), so that now the trustee has that status beyond any doubt.⁵⁶ Thus, for the federal tax lien to be effective even on a subordinated basis within section 67 (c) (3) it must be valid under section 67 (c) (1) against

⁴⁸ Pub. L. No. 89-495, 89th Cong., 2d Sess. § 5 (July 5, 1966).

⁴⁹ 382 U.S. 266 (1965).

⁵⁰ See, e.g., *Simonson v. Granquist*, 287 F.2d 489 (9th Cir. 1961); *In re Fidelity Tube Corp.*, 278 F.2d 776 (3d Cir. 1960); *Brust v. Sturr*, 237 F.2d 135 (2d Cir. 1956) (each holding that a trustee is not a judgment creditor within the meaning of the Internal Revenue Code, § 6323). For the view that a trustee is a judgment creditor within § 6323, see *United States v. Speers*, *supra* note 49, *In re Kurtz Roofing Co.*, 335 F.2d 311 (6th Cir. 1964).

⁵¹ INT. REV. CODE OF 1954, §§6322-23.

⁵² INT. REV. CODE OF 1954, § 6323.

⁵³ Bankruptcy Act § 70(c) provided that the trustee "shall be deemed vested . . . with all the rights, remedies, and powers of a creditor . . . holding a lien thereon by . . . [legal or equitable proceedings], whether or not such a creditor actually exists."

⁵⁴ See note 50 *supra*.

⁵⁵ *United States v. Speers*, 382 U.S. 266 (1965).

⁵⁶ Bankruptcy Act § 70(c), as amended, Pub. L. No. 89-495, 89th Cong., 2d Sess. § 5 (July 5, 1966); see note 33 *supra*. For legislative discussion of this amendment, see S. REP. NO. 999 ON H.R. 136; S. REP. NO. 1159 ON H.R. 136, 89th Cong., 2d Sess. § 5 (July 5, 1966); U.S. CODE CONG. & AD. NEWS 2010-14, 2030-32 (No. 7, Aug. 20, 1966).

the trustee in bankruptcy. In net result, the federal tax lien must be recorded prior to bankruptcy in order to meet the validating features of section 67 (c).

IX. PRESERVING THE LIEN

Finally, section 67 (c) as amended in 1966 carries forward the right of preservation given the trustee in bankruptcy. It provides that by order of the court an invalidated statutory lien may be preserved by the trustee for the benefit of the estate.⁵⁷ This is an extremely important provision because it prevents the stepping up of junior liens when a senior lien is invalidated. Thus, if the trustee invalidates a senior lien on property by virtue of the provisions of section 67 (c) and junior liens exist on the same property, he may preserve the senior lien to its full extent in order that the estate be benefited and the junior liens not receive a windfall. If the preservation feature were not included, the junior liens would step up to first place and presumably take all the proceeds of sale of the property.⁵⁸ By virtue of the preservation feature the estate receives the proceeds to the extent of the value of the senior lien. If anything remains after payment of the senior lien, it goes to the junior lienors.

An additional sentence was put in, however, which was not in the prior statute. This sentence provides:

A lien not preserved for the benefit of the estate but invalidated against the trustee shall be invalid as against all liens indefeasible in bankruptcy so as to have the effect of promoting liens indefeasible in bankruptcy which would otherwise be subordinate to such invalidated lien.⁵⁹

The effect of this statement is that the junior liens will obtain a windfall in the event that the senior lien, after invalidation, is not preserved for the benefit of the estate. The necessity of having this provision in the statute is not clear. Presumably, this result would have obtained if the trustee did not preserve the lien. Where there are junior liens and the trustee invalidates the senior lien, it would seem necessary that he request the court to preserve

⁵⁷ Bankruptcy Act § 67(c)(2), as amended PUB. L. No. 89-495, 89th Cong., 2d Sess. § 4 (July 5, 1966).

⁵⁸ See 4 COLLIER, BANKRUPTCY ¶ 67.28[2] (14th ed. 1954).

⁵⁹ See note 57 *supra*.

the lien for benefit of the estate. The point at which such preservation should not take place is not clear.

It can have real effect in a situation similar to that in the *Quaker City* case.⁶⁰ If a rent lien is involved, a problem could arise if state law made the rent lien superior to the consensual lien,⁶¹ which is indefeasible in bankruptcy and thus superior to all the unsecured claims. Under section 67 (c), as amended, the rent lien is wholly invalidated and the rent claimant has only a fifth priority under section 64. If section 67 (c) provided nothing further in this regard, the old circuitry problem would still exist, and presumably in a *Quaker City* jurisdiction the consensual lien would be subordinated to the rent lien. Thus, instead of being subordinated to only the first two priorities of section 64, it would be subordinated to the first four priorities in this section. The effect of the above quoted sentence is to ensure not only that this result does not obtain, but to deny any effect to the rent lien under section 67 (c). This would prefer the consensual lien, regardless of state law, and the rent lien would retain only its section 64 (a) (5) priority. This was mentioned in the Senate Report, which recognized that in some cases the result would be "a ranking of liens in bankruptcy different from what it would be apart from bankruptcy. . . ."⁶² While the difference was recognized, it was also pointed out that such a result may well be necessary to promote and make effective the scheme of distribution contemplated by the Bankruptcy Act.⁶³ In effect, therefore, the *Quaker City* case will have no further value as precedent.

X. CONCLUSION

In total, the amendments in section 67 are well conceived, and while there may be some disagreement with the language used, the intent and application should be fairly clear. It is unfortunate that section 67 (b) and (c) were not completely rewritten together so that one need not first look to the validity given by section 67 (b) and then to subsection (c) to determine which

⁶⁰ *In re Quaker City Uniform Co., Inc.*, 238 F.2d 155 (3d Cir. 1956); see note 43 *supra*.

⁶¹ If the applicable state statute so provides.

⁶² S. REP. No. 1159, *supra* note 26, at 2022, 2028.

⁶³ *Ibid.*

statutory liens are valid and which are invalid, and which subordinated. The virtue of the whole amendment is exemplified by the fact that many prior problems which would have required solution by the Supreme Court have been resolved and that the litigation aspect will be eliminated or at least much reduced.

From the point of view of the individual holding a statutory lien, the essential feature of the new amendment is that he must make sure his lien is properly perfected to be valid against subsequent bona fide purchasers. If so perfected, it will not be subject to attack by a trustee in bankruptcy.

The second basic feature of this new statute is that all tax liens on personal property not accompanied by possession are validated as long as perfection under state or federal law is complied with, but they are subordinated to the first two priorities of section 64 (a). Additionally, if there is a conflict of lien which formerly would have created a circuitry problem, the resolution of the problem is now defined by statute. Finally, an added advantage of the latest amendment is the incorporation of a definition of the term "statutory lien." This should free courts from unnecessary discussion and the risk of misinterpretation.

Section 67 (b) and (c) was one of the most complicated sections of the Bankruptcy Act. It is a compliment to the drafters of the amendments that these provisions were drafted so well, and passage of the amendments by both houses of Congress speaks well of their persuasive powers.