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James W. Eardley

William P. Murray

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## ASSIGNMENTS OF ACCOUNTS RECEIVABLE UNDER PUBLIC LAW 461.

To the mind of a lawyer, the established practice of businessmen of making secret assignments of accounts receivable seems bordering on the fraudulent. From the latter's viewpoint, however, it is oftentimes a matter of economic necessity that he keep such assignments secret. Very little business done today is on the "cash and carry" basis. If John Doe is to be successful in the commercial world, generally others must rely on his business acumen by extending to him financial assistance in order that he might realize a profit both for himself and them. Since financial assistance is all-important, it is the prime consideration of the average businessman that the methods of obtaining it be protected.

One of the main factors in the extension of financial assistance is one's business ability. A lack of this ability, evidenced by insolvency, almost always precludes the obtaining of credit. An assignment of accounts receivable is rarely, if ever, made when the assignor is solvent, although it is a well-known fact that insolvency doesn't mean bankruptcy. For this reason, it is mandatory that assignments of accounts receivable be kept as secret as possible. If it were otherwise, the debtor would, in practically every instance, be unsuccessful in obtaining further credit.

The leading case on the subject of assignments of accounts receivable is Corn Exchange National Bank & Trust Co., Philadelphia, et al. v Klauder.<sup>1</sup> An assignment was made by the bankrupt to one of his creditors as security for a debt. At all times relevant it was the law of Pennsylvania, where these transactions took place, that the rights of the first assignee to give notice of the assignment to the debtors were superior to the rights of any prior or subsequent assignee. The assignee had not given notice to the debtor at the time the assignor was adjudicated a bankrupt. The trustee chose to avoid this assignment as a preferential transfer under section 60 (a) of the Bankruptcy Act of 1898,<sup>2</sup> as amended by the Chandler Act of June 22, 1938.<sup>3</sup> That amendment provided:

"A preference is a transfer, as defined in this Act, of any of the property of the debtor to or for the benefit of the creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before filing by or against him of the petition in bankruptcy, or of the original petition under chapter X, XI, XII, or XIII of 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. For the purposes of subdivisions a and b of this section, the transfer shall be deemed to have been made at the time when it became so far perfected

1. 318 U.S. 434 (1943).

2. 30 Stat. 562 (1898), 11 U.S.C. sec. 96 (1946).

3. 52 Stat. 840, 869, 870 (1938), 11 U.S.C. sec. 96 (1946).

that no bona-fide purchaser from the debtor and no creditor could thereafter have acquired any rights in the property so transferred superior to the rights of the transferee therein, and, if such transfer is not so perfected prior to the filing of the petition in bankruptcy or of the original petition under chapter X, XI, XII, or XIII of this Act is shall be deemed to have been made immediately before bankruptcy.” 4

The Supreme Court of the United States upheld the contention of the trustee and held that since a subsequent good-faith assignee of the same accounts receivable could have obtained greater rights than those of the first assignee - by giving notice - it was a voidable preference. In this respect, the Court said: “This is undoubtedly the effect of a literal reading of the Act. Its apparent command is to test the effectiveness of a transfer, as against the trustee, by the standards which applicable state law would enforce against a good-faith purchaser.” 5 The trustee, therefore, stands in the shoes of a hypothetical subsequent bona-fide purchaser for value. If such an assignee could have asserted rights superior to the rights of the transferee, so too, then, may the trustee.

A broader application of this test is found in the case of In re Vardaman Shoe Co. 6 Again there was an assignment of accounts receivable made in good faith and for present value. No notice of the assignment was given to the debtors. The assignment was made in Missouri, but the parties to it agreed that the law of Illinois would apply to the construction of the assignment. The Missouri law gave priority to the assignee who is first to notify, whereas Illinois held to the “first in point of time” rule. The District Court did not resolve this conflict of laws issue, holding that in either state the bona-fide purchaser test would give the trustee rights superior to those of the assignee. The Court pointed out that “. . .if the trustee’s position were to be determined according to the Missouri rule, the decision in this case would necessarily follow that of the Klauder case.”7 Then the Court broadened the rule of the Klauder case, supra, declaring that even in a jurisdiction that holds to the Illinois rule, a superior right may be acquired by a good-faith subsequent assignee who obtains payment or satisfaction from the obligor, or judgment against the obligor, or a novation, or delivery of a tangible token or writing, surrender of which is required by the obligor’s contract for enforcement. 8

With the holding of this case it became almost impossible for the businessman to obtain financial assistance by the assignments of accounts receivable for present consideration in any jurisdiction. The Klauder case, supra, had destroyed the possibility of making assignments of this nature in those jurisdictions that hold to the “prior notice” rule, and shortly thereafter the Vardaman case, supra, destroyed that possibility in those jurisdictions which advocate the “first in point of time” rule. After 1943, it was evident that all assignments of accounts receivable made for a present, fair consideration were potential voidable preferences under the Chandler Amendment. Receivables often are assigned only when credit in a similar amount is not available through other channels. 9 One of the businessman’s sources of credit was

4. Ibid.

5. 318 U.S. 434, 436, 437 (1943).

6. 52 F. Supp. 562 (E.D. Mo. 1943).

7. Id. at 565.

8. Restatement, Contracts sec. 173 (1932).

9. Saulnier and Jacoby, Accounts Receivable Financing (National Bureau of Economic Research, 1943) note 10, pp. 6, 21 et seq., 61 et seq.

blocked, thereby. For the insolvent businessman it practically amounts to commercial failure.

It is indeed unfortunate, as is pointed out in the House Report No. 1293, 81st Cong., 1st Sess. 5 (1949), that the Vardaman case, supra, was not appealed. That its holding might have reversed is indicated in the case of In re Rosen et al. <sup>10</sup> As in the other two cases, an assignment of accounts receivable was made. The transaction was entered into in New Jersey where in the rule of "first in point of time" prevails. The assignment was held to be valid, not voidable by the trustee, inasmuch as New Jersey law made this transfer superior to any subsequent transfer. The Court added that it makes no difference which rule applies, since under neither would the trustee hold as a bona-fide purchaser.

" . . . (E)vents taking place after the two assignments have changed the situation between the first and second assignee. The courts allow the latter to keep what he has reduced to possession. This is not by reason of his later assignment, but by reason of what he has done following it. . . . However explained, the favored position acquired by the subsequent assignee in the situations noted in Restatement, Contracts (1932) sec. 173, comes not from his status as bona fide purchaser, but from his activities following his belated assignment." <sup>11</sup>

Even though the Court was reluctant to express an opinion on the Vardaman case, supra, a seemingly anomalous situation exists, since the decision is directly opposite to that of the earlier case.

Rather obviously, the businessman was in a somewhat anxious position. Two circuits had reached opposing conclusions with respect to the same question: Are assignments of accounts receivable taken in good faith and for present consideration voidable preferences under section 60 (a) of the Bankruptcy Act? The other eight circuits had never been presented with the problem. Only in the third circuit, therefore, by virtue of the Rosen case, supra, could the businessman feel fairly secure in these assignments.

To meet this problem, Congress passed a further amendment to section 60 (a). <sup>12</sup> The legislature felt that it was necessary to ". . . remove the resultant serious doubts that now exist among banks, factors, and other extenders of credit upon the validity of security taken in good faith and for present value. The present language of the Act tends to impede and choke the flow of credit, principally to small-businessmen, and the object of the bill is to free its channels." <sup>13</sup> Congress further pointed out that one of the objectives of the bill was to change the trustee's position, with regard to personal property, <sup>14</sup> from that of a potential bona-fide purchaser to that of a lien creditor. <sup>15</sup> This amendment was intended to overcome the effects of the Vardaman case, supra, by substituting the hypothetical transaction -

10. 157 F. 2d 997 (3d Cir. 1946).

11. Id. at 1001.

12. P.L. 461, sec. 1, para. 2, 81st Cong., 2d Sess. (1950).

13. House Report No. 1293, 81st Cong., 1st Sess. 3, 4 (1949).

14. ". . . 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 purchaser from the debtor could create rights in such property superior to the rights of the transferee." P.L. 461, sec. 1, para. 2, 81st Cong., 2d Sess. (1950).

15. "(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. . . ." Ibid.

the obtaining of a lien - for the hypothetical person - the bona-fide purchaser. In other words, whereas the Court in the Vardaman case, supra, had looked to the potential acts of the bona-fide purchaser in order to show a superior right in him, and thus in the trustee, now the amendment would seem to compel the Court to look solely to the transaction itself. The acts of the lienholder, however, for the purposes of the new test, are so inseparably entwined with the transaction that in looking at the one, the Court must necessarily look at the other. The Act itself points up this inseparability:

“(5) A lien obtainable by legal or equitable proceedings could become superior to the rights of a transferee. . . .within the meaning of paragraph (2), if such consequences would follow only from the lien. . . .itself, or from such lien. . . .followed by any step wholly within the control of the respective lien holder. . . ., with or without the aid of ministerial action by public officials. . .” 16

That Public Law 461 has changed the law as it existed in reference to assignments of accounts receivable is doubtful, in which case the businessman is in no better position than after the Rosen case, supra. This criticism can be supported by a hypothetical situation which enables the trustee to take the same position he has taken since 1943. The position the trustee could assume, in a case arising under the new amendment, 17 is that of a creditor of the assignor who garnishees the debt which was the subject matter of the assignment, made beyond the four-month period. This situation is similar to the one that existed in the case of Harris v. Balk. 18 Assume that A is the debtor of the assignor, B. B has assigned his accounts receivable to C. One of the accounts assigned is the debt A owes B. D is the creditor of B, and notifies B that he is going to commence garnishment proceedings against A. When B fails to participate in the action, having had actual notice, any rights which are due him, and which his assignee has now acquired by reason of assignment, are destroyed. B can no longer recover payment from A for that amount that A is adjudged to owe D, by reason of the garnishment proceedings. It is possible, therefore, for D, the hypothetical lien holder, to obtain a right “. . .superior to the rights of the transferee. . . .” 19 to the accounts receivable. The trustee need only put himself in the position of D to avoid the transfer.

Although such a situation is unlikely to occur in actuality, still the Bankruptcy Act, allowing for these hypothetical situations, 20 leaves the door open for the trustee to make use of any factual possibility, whether likely or not. The only limitation on the lien holder is that he require no “. . .agreement or

16. Ibid.

17. At the time of writing, no decisions have been made interpreting P.L. 461.

18. A citizen of North Carolina who owed money to another citizen of that State, was, while temporarily in Maryland, garnisheed by a creditor of the man to whom he owed the money. Judgment was duly entered according to Maryland practice and paid. Thereafter the garnishee was sued in North Carolina by the original creditor and set up the garnishee judgment and payment, but the North Carolina courts held that as the situs of the debt was in North Carolina the Maryland judgment was not a bar and awarded judgment against him. The Supreme Court of the United States reversed holding that the Maryland judgment was a bar to the subsequent proceedings in North Carolina, inasmuch as the judgment was properly obtained, and the original creditor had been notified of the judgment within the prescribed statutory period. Failure on the part of the garnishee to notify his creditor would have subjected him to the payment of the same debt twice. 196 U.S. 215 (1905).

19. P.L. 461, sec. 1, para. 2, 81st Cong., 2d Sess. (1950).

20. Id. at para. 3.

concurrence of any third party . . . further judicial action, or ruling.” 21 That negative requirement is met in this hypothetical situation, because B need not agree nor concur with D’s actions in order to effectuate this lien.

It appears that the recent amendment has failed to change the existing law with respect to assignments of accounts receivable. For the businessman there is at least serious doubt that he is in a better position today than in 1943.

James W. Eardley  
William P. Murray

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21. Id. at para. 5.