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Conflict: The Bankruptcy Act v. State Statutes

William H. Lake

CONFLICT: THE BANKRUPTCY ACT v. STATE STATUTES

*by William H. Lake**

I. INTRODUCTION

The Bankruptcy Act[1] was enacted by Congress pursuant to its express Constitutional authority to establish "uniform laws on the subject of bankruptcies throughout the United States; . . ."[2]

The express grant is "unrestricted and paramount"[3] and it "necessarily excludes state regulation."[4] "States may not pass or enforce laws to interfere with or compliment the Bankruptcy Act or to provide additional or auxiliary regulations."[5] The enactment of any federal bankruptcy act thus preempts the field, and supersedes state legislation having as its object the collection and distribution of the bankrupt's property and the discharge of his obligations. Consequently, state statutory or decisional law which conflicts with the language or purpose of any single provision of the Bankruptcy Act violates the Constitution's supremacy clause,[6] and is therefore invalid.[7]

As a direct consequence of such broad federal authority, one of the most widely litigated areas arising during bankruptcy proceedings involves the conflict between the provisions of the Bankruptcy Act and state statutes.

The resolution of such state-federal conflicts is best viewed in the context of the general purposes and workings of the Bankruptcy Act and its most recent history. In substance, the Bankruptcy Act is designed to serve as both a creditor's and debtor's remedy, though the

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* B.A., 1963 (University of California, Los Angeles); J.D., 1966 (Loyola University of Los Angeles).

1. Bankruptcy Act, 11 U.S.C. §§ 1 to 1103 (1970 & Supp. V 1975). [hereinafter cited as the Bankruptcy Act].
2. U.S. CONST. art. I, § 8, cl. 4.
3. International Shoe Co. v. Pinkus, 278 U.S. 261, 265 (1929).
4. *Id.*
5. *Id.*
6. U.S. CONST. art. VI, cl. 2.
7. *See* Perez v. Campbell, 402 U.S. 637 (1971).

latter focus is of more recent origin.[8] It provides creditors with a means to collect debts which might otherwise be totally uncollectible, and at the same time provides a vehicle for the honest debtor to obtain a fresh financial start.[9]

Precisely because the Bankruptcy Act allows otherwise valid contractual obligations to be avoided, it has been the object of strong criticism almost since its inception.[10] In 1971, the Brookings Institute issued a critical examination of bankruptcy proceedings,[11] adding to the already large body of opinion attacking the Bankruptcy Act. The Brookings Report recognized bankruptcy as a governmental institution and emphasized the shortcomings of that statutory creation. In large part due to the Brookings Report characterization of the bankruptcy system as "a dreary, costly, slow and unproductive process. . . . [that] is a shabby and indifferent effort,"[12] a congressional commission was authorized to review the bankruptcy law.[13] An outgrowth of the Commission's report was congressional introduction of a completely new Bankruptcy Act on January 4, 1977.[14] While the proposed legislation would

8. Prior to the Bankruptcy Act of 1841 only creditors were provided a remedy in bankruptcy. Bankruptcy Act, ch. 9, 5 Stat. 440 (1840) (current version at 11 U.S.C. §§ 1 to 1103 (1970 & Supp. V 1975)).

9. The Court's description in Local Loan Co. v. Hunt, 292 U.S. 234 (1934) of the Act's purpose as to debtors is illuminating:

> One of the primary purposes of the bankruptcy act is "to relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes." This purpose of the act . . . give[s] to the honest but unfortunate debtor who surrenders for distribution the property which he owns *at the time of bankruptcy*, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.

Id. at 244 (emphasis in original) (citations omitted).

10. *See* Nims, *Representing the Bankrupt*, in BANKRUPTCY AND THE CHAPTER PROCEEDINGS 1 (G. Holmes ed. 1976).

11. D. STANLEY & M. GIRTH, BANKRUPTCY: PROBLEMS, PROCESS, REFORM (1971) [hereinafter cited as BROOKINGS REPORT].

12. *Id.* at 197.

13. S.J. Res. 88, 84 Stat. 468 (1970). *See* REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, 93d Cong., 1st Sess., pt. I & II (1973).

14. H.R. 6, 95th Cong., 1st Sess. (1976), was substituted in the House Judiciary Committee by H.R. 8200, 95th Cong., 2d Sess. (1977). On July 19, 1977, H.R. 8200 was reported favorably to the House floor by the House Judiciary Committee. 95th Cong., 2d Sess., 95 CONG. REC. D1086 (1977). Unfortunately, no further action was taken prior to the conclusion of the 95th Congress. Nonetheless, H.R. 8200 provides an insight into likely Congressional action in the 96th Congress. The proposed Bankruptcy Act was designed to streamline bankruptcy proceedings. Among its major changes H.R. 8200 proposed: (1) establishment of a new court system, independent of its present status as an arm of the federal court system; (2) establishment of a system of United States trustees to perform the functions now referred to bankruptcy judges; (3)

have generally streamlined bankruptcy proceedings, congressional inaction on that legislation has left the conflict between the Bankruptcy Act and state statutes an area of serious dispute. There are three primary areas where state and federal bankruptcy conflicts arise: (1) between the definition of the property the trustee in bankruptcy takes under Section 70(a)[15] of the Bankruptcy Act and state attempts to define such property; (2) between the Bankruptcy Act and provisions of the Uniform Commercial Code;[16] and (3) between state statutes and the Bankruptcy Act's policy to allow the bankrupt a fresh start.[17]

This article will focus on the decisional law in these three areas to illustrate the problems encountered by the courts in attempting to reconcile the conflicts between state statutory schemes and the Bankruptcy Act.

II. Developmental Decisions

The focus of much bankruptcy litigation in recent years has been the scope of the constitutionally based federal authority. Early decisions had suggested that where state legislation did not have the purpose, but only the effect, of being inconsistent with federal law, the state legislation would control. In *Reitz v. Mealey*,[18] the Supreme Court examined New York's motor vehicle financial responsibility law, which had the effect of frustrating the Federal Bankruptcy Act policy of totally discharging the debtor's obligations. The *Reitz* Court found that the statute constituted a permissible state interference with the effect of bankruptcy proceedings, insofar as the New York law was an enforceable state policy designed to promote highway safety.[19]

Similarly, in *Kesler v. Department of Public Safety*,[20] the majority found that a Utah financial responsibility law was not designed to aid in the collection of debts but to enforce a policy against irresponsible driving.[21] Thus, the *Kesler* Court was satisfied that the dictates of the

encouragement of consumer repayment plans; (4) enhanced consumer effectiveness; (5) redefinition of both consumer and commercial creditors' rights; and (6) facilitation of business reorganization mechanisms. The bill, if enacted, would have become effective on October 1, 1978. H.R. 8200, 95th Cong., 2d Sess. § 402(a) (1977).

15. 11 U.S.C. § 110(a) (1970). *See* notes 28-80 *infra* and accompanying text.

16. *See* notes 81-140 *infra* and accompanying text.

17. *See* notes 141-173 *infra* and accompanying text.

18. 314 U.S. 33 (1941).

19. *Id.* at 37.

20. 369 U.S. 153 (1962).

21. *Id.* at 174.

Bankruptcy Act and the Constitution were served as long as the *purpose* of the state statute was not violative of the supremacy clause.

However, in 1971 the Supreme Court reexamined its position with respect to state motor vehicle financial responsibility laws and their impact on the Bankruptcy Act, and overturned both *Reitz* and *Kesler* in a decision having broad ramifications. *Perez v. Campbell*[22] invalidated an Arizona statute which authorized the suspension of an individual's driver's license and vehicle registration for non-payment of a liability resulting from an automobile accident, even when that debt had been discharged in a bankruptcy proceeding. Adopting language from *Hines v. Davidowitz*,[23] the Supreme Court declared that: "our function is to determine whether a challenged state statute 'stands as an obstacle to the accomplishment and execution of the full purpose and objectives of Congress'."[24]

In rendering its landmark decision in the *Perez* case, the Court found: "*Kesler* and *Reitz* can have no authoritative effect to the extent they are inconsistent with the controlling principle that any state legislation which frustrates the full effectiveness of federal law is rendered invalid by the Supremacy Clause."[25]

The reach of *Perez* is reflected in *Grimes v. Hoschler*[26] where the California Supreme Court held that sections of the state's Business and Professions Code permitting suspension of a contractor's license until debts incurred as a contractor were paid in full, notwithstanding a discharge in bankruptcy, were invalid under the supremacy clause. The court correctly observed

> that the controlling principle is whether a state statute interferes with and frustrates a federal statute and not merely whether the former is designed for some conceivable state purpose. In other words, the existence *vel non* of a conflict depends on the *effect* of the state statute and cannot be determined by a consideration of the *purpose*.[27]

Since the *Perez* decision clearly establishes the pre-eminence of the Bankruptcy Act, courts rendering decisions which involve provisions of the Bankruptcy Act and provisions of state statutes must first determine whether or not there is, in fact, a conflict. The practical effect of the state law must control. It is not necessary that the state statute have

22. 402 U.S. 637 (1971).
23. 312 U.S. 52 (1941).
24. 402 U.S. at 649 (quoting Hines v. Davidowitz, 312 U.S. 52, 67 (1941)).
25. *Id.* at 652. *See* notes 3-7 *supra* and accompanying text.
26. 12 Cal. 3d 305, 525 P.2d 65, 115 Cal. Rptr. 625 (1974), *cert. denied*, 420 U.S. 973 (1975).
27. *Id.* at 310, 525 P.2d 65, 67-68, 115 Cal. Rptr. 625, 627-28 (emphasis in original).

a specific purpose to circumvent the provisions of the Bankruptcy Act. Therefore, when courts are analyzing the facts of a particular case to determine whether or not a conflict exists between the provisions of the state statute and the Bankruptcy Act, they must look to the ultimate effect of the state statute and not the state's purpose in enacting the specific legislation.

III. SECTION 70(a) OF THE BANKRUPTCY ACT AND STATE STATUTES

Section 70(a)[28] of the Bankruptcy Act provides that the trustee in bankruptcy is vested with title to the property of the bankrupt as of the date of bankruptcy (the date the petition is filed). Claims against such property are first granted to claimants entitled to a priority under a scheme set forth in section 64[29] of the Act, and then on a pro-rata basis to non-priority unsecured creditors. It is impossible in a limited discussion to set forth all of the assets which will belong to the trustee; however, the examination of one such asset effectively illustrates the conflict between section 70(a) of the Bankruptcy Act and state statutes. Liquor licenses, and the distribution of the assets arising from their sale, have been the subject of several cases in both the California courts and the Ninth Circuit Court of Appeals.[30]

In *In re Professional Bar Co., Inc.*,[31] the Ninth Circuit upheld the provisions of section 24049 of the California Business and Professions Code (B.P.C.)[32] which authorized the Department of Alcoholic Beverage Control (ABC) to refuse to transfer a state-created liquor license as long as certain state taxes remained unpaid. The court held that no conflict arose between the B.P.C. and federal bankruptcy law insofar as

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28. 11 U.S.C. § 110(a) (1970). *But see* Bankruptcy Act § 6, 11 U.S.C. § 24 (1970), which exempts certain property.

29. 11 U.S.C. § 104 (1970).

30. *See In re* Professional Bar Co., Inc., 537 F.2d 339 (9th Cir. 1976); Meyer v. Bass, 281 F.2d 728 (9th Cir. 1960); United States v. California, 281 F.2d 726 (9th Cir. 1960); Gough v. Finale, 39 Cal. App. 3d 777, 114 Cal. Rptr. 562 (1974).

31. 537 F.2d 339 (9th Cir. 1976).

32. CAL. BUS. & PROF. CODE § 24049 (West Supp. 1977) provides in relevant part:

> The department [Alcoholic Beverage Control] may refuse to transfer any license whom [*sic*] the applicant is delinquent in the payment of any taxes due under the Alcoholic Beverage Tax Law, the Sales and Use Tax Law, or on unsecured property . . . , when such tax liability arises in full or in part out of the exercise of the privilege of an alcoholic beverage license, or any amount due under the Unemployment Insurance Code when such liability arises out of the conduct of a business licensed by the Department of Alcoholic Beverage Control.

Id.

states are entitled to make such licenses conditional and impose transfer restrictions thereon.

On August 7, 1972, Professional Bar Co., Inc. filed a Chapter XI proceeding pursuant to section 322 of the Bankruptcy Act.[33] Attempts at an arrangement were unsuccessful and on December 15, 1973, the corporation was adjudicated a bankrupt. Among the assets of the bankrupt were four on-sale general liquor licenses which had been issued by the state. Pursuant to an order of the bankruptcy judge, these licenses were sold. Outstanding were approximately sixty-one labor claims for wages which were filed against the bankruptcy estate and which were owed to former employees of the bankrupt.

Following the dictates of B.P.C. section 24049, the ABC refused to transfer the liquor licenses until all of the bankrupt's delinquent state taxes were paid. The trustee, having no other choice, paid the amount of the state taxes owed by the bankrupt and it was only after doing so that the ABC transferred the liquor licenses to their purchasers.

The trustee argued that under both federal and state law qualified wage claims against a bankrupt estate are entitled to priority over tax claims of the state. The Ninth Circuit in its decision agreed that this was true as a general principle.[34] However, the court indicated that the difficulty centered on defining the nature of the bankrupt's property to which the claims attached. In upholding the ABC's authority to withhold the transfer of the licenses, the court relied on its earlier decisions in *United States v. California*[35] and *Meyer v. Bass*[36] for the proposition that California was entitled to place a limitation on the value of a liquor license which it created.[37]

The trustee in bankruptcy had alleged that the state statute not only conflicted with his status under section 70(a), but that it was in conflict

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33. 11 U.S.C. § 722 (1970). The section provides that "[i]f no bankruptcy proceeding is pending, a debtor may file an original petition under this chapter with the court which would have jurisdiction of a petition for adjudication." *Id.*

34. 537 F.2d at 340 n.1. The court refers to Bankruptcy Act § 64, 11 U.S.C. § 104 (1970), and several California statutory provisions in support of this proposition. *See, e.g.*, CAL. CIV. PROC. CODE § 1204 (West 1972); CAL. LAB. CODE § 1702 (West 1972); CAL. REV. & TAX CODE § 6756 (West 1972).

35. 281 F.2d 726 (9th Cir. 1960).

36. 281 F.2d 728 (9th Cir. 1960).

37. The court observed that:

> Because the state creates and controls its liquor licenses, the terms of any transfer of a license necessarily remain the prerogative of the state. If the state chooses to create conditions which make the transfer value of a license a net value after the state's claims are satisfied, that residual value is all that the trustee may look to.

537 F.2d at 340.

with the provisions of section 64 of the Bankruptcy Act which establishes priority of payment to various classes of creditors in connection with the distribution of the assets of the bankruptcy estate. The trustee unsuccessfully urged that since under section 64 of the Bankruptcy Act wage claims have a higher priority than state taxes, said wage claims should be paid ahead of any taxes that may have been owed by the bankrupt to the state.[38] Obviously, the provisions of section 24049 of the B.P.C. and section 64 of the Bankruptcy Act are in conflict with one another. Thus, the court had to pursue some line of analysis under which the state tax claims could be excused from the provisions of the Bankruptcy Act. It did so by defining what constitutes section 70(a) property in such a fashion as to remove the state creditor from the operation of the priority scheme set forth in section 64 of the Act.

Section 24049 of the B.P.C. was clearly designed to permit California to be paid any taxes owed in connection with the transfer of an asset (the liquor license) which it had created. It was argued successfully by the state that since it had created the property which the trustee took under section 70(a), it had the right to impose any conditions it chose on the transfer of that asset; notwithstanding the fact that the value of the asset was lessened as a result.[39]

However, as noted previously,[40] the important consideration is not the intention of the state legislature in enacting a particular statute but the effect of that statute when it conflicts with a provision of the Bankruptcy Act. *Professional Bar* makes clear the effect of the California statute. It creates a priority for the state over the wage claims of the former employees of the bankrupt. The provisions of section 64 of the Bankruptcy Act give a higher priority to wage claims than to state taxes. Therefore, the state B.P.C. provision frustrates the full effectiveness of the Bankruptcy Act and should have been declared invalid by the court under the *Perez* rationale.[41] The court's reasoning in *Professional Bar* is painfully clear. The claims of the State of California for unpaid taxes shall take precedence over the unpaid wage claims owed by the bankrupt. The state, in the court's apparent view, has the legitimate right

38. Section 64 establishes that the first priority shall be for the expenses of the administration of the bankruptcy estate; the second and third priorities are awarded to wage and wage related claims; taxes are relegated to fourth and fifth priority status. 11 U.S.C. § 104 (1970).

39. 537 F.2d at 340.

40. *See* text accompanying notes 22-27 *supra*.

41. *Id.*

to pay itself first for an asset which it creates, even though this effectively establishes a priority for the state which conflicts with provisions of the Bankruptcy Act.

The better view is stated by Judge Smith in his dissent.[42] In analyzing the facts of the case he determined that there was a clear conflict between the provisions of section 24049 of the B.P.C. and section 64 of the Bankruptcy Act and, accordingly, when such a conflict exists the Bankruptcy Act should govern. Judge Smith recognized the manifestly inconsistent results of the majority's disregard of *Perez*.[43]

Section 64 of the Bankruptcy Act mandates that wage earners be paid first, and section 24049 of the B.P.C. requires that the state should be paid ahead of all creditors. As Judge Smith stated: "The liquor license is no more a state created property which the state may regulate and control without regard to the bankruptcy laws then was the driver's license in *Perez*."[44]

It is illustrative to contrast the *Professional Bar* decision with a California appellate court's decision in *Gough v. Finale*.[45] The *Gough* court wrestled with the problem created when a licensee enters into an escrow arrangement with a purchaser and subsequently files a bankruptcy petition resulting in insufficient assets in the estate to pay all of the bankrupt's creditors. Given the conflicting priority systems established under section 24074 of the B.P.C. and section 64 of the Bankruptcy Act, *Gough* held that the distribution of a bankrupt's assets was governed by the Bankruptcy Act, thereby invalidating the priority system established by state law. Obviously, it was the state's intention in *Gough*, pursuant to its exercise of police powers, to regulate the manner in which creditors of a liquor licensee may be protected in the collection of their debts from the proceeds of the sale of a liquor license. There can be no argument that this is a viable state objective. It is nonetheless violative of the Bankruptcy Act.

It can be argued that *Gough* is distinguishable from *Professional Bar* on the grounds that the state was not a creditor of the bankrupt for unpaid taxes and, therefore, *Gough* did not address the question of the state imposing restrictions affecting the nature of property which

42. 537 F.2d at 340-41.

43. *Id.* at 341.

44. *Id.*

45. 39 Cal. App. 3d 777, 114 Cal. Rptr. 562 (1974). *Gough* focused on B.P.C. § 24074 provisions which set forth a priority system among creditors of a selling liquor licensee. CAL. BUS. & PROF. CODE § 24074 (West Supp. 1977).

it created. As applied in *Gough*, the priority system established by section 24074 was to protect creditors other than the state creditors; citizen-creditors who did not create the asset involved. The effect of *Gough* is to direct that citizen-creditors must yield to similarly situated creditors who have a superior priority under the Bankruptcy Act. Such an asserted distinction is insufficient, however, as the *effect* of the California statute providing for payment of state taxes ahead of all claimants is to create a system of priorities contrary to those established by the Bankruptcy Act. It makes no difference that the state desires to collect its taxes in one case and in the other to protect citizen-creditors.

Another key case dealing with state statutory restrictions on the transfer of a liquor license in a bankruptcy proceeding is *State Board of Equalization v. Stodd.*[46] This case involved various California agencies which had filed tax claims in a bankruptcy proceeding during the pendency of which penalties and post bankruptcy petition interest had accrued. The issue raised was whether or not these state agencies could apply any of the funds paid by the trustee for pre-petition taxes toward the payment of penalties and post-petition interest on the delinquent taxes. The Ninth Circuit held in the negative.[47] The trustee had paid the pre-petition taxes as a necessary condition to the sale and transfer of the license.

The state agencies conceded that penalties and post-petition interest are claims which generally cannot be asserted in a bankruptcy proceeding. However, they argued that the taxes received from the trustee for pre-petition tax debts to permit the liquor license transfer were paid wholly outside the bankruptcy proceedings. Therefore, application of such funds by the agencies to post-petition penalties and interest was not within the jurisdiction of the bankruptcy court.[48]

The Court of Appeals dismissed this argument, stating that:

> the liquor license and proceeds from its sale were a part of the bankrupt's estate, to which title passes to the trusteee under Section 70(a)(5) of the Bankruptcy Act.
>
> Once funds are part of the bankrupt's estate, they may not be used to pay penalties and post-petition interest under § 57(j).[49]

46. 500 F.2d 1208 (9th Cir. 1974).
47. *Id.* at 1210.
48. *Id.* at 1209-10.
49. *Id.* at 1210.

While the court was not squarely faced with the question raised in *Professional Bar*[50] regarding the conflict between the priorities established by state statute and the Bankruptcy Act, by refusing to permit the state to collect penalties and post-petition interest, the court in effect restricted the ability of the state to collect all of the taxes which it claimed. This result permitted the trustee to transfer the license without full payment of obligations owed to the state. The *Stodd* court seems to recognize the state's right to refuse to transfer a liquor license, yet upholds the right of the bankruptcy court to determine how the assets of a bankruptcy estate are to be distributed to the creditors of that estate.[51] The result in *Stodd* has thereby narrowed the scope of the decision in *Professional Bar.*

A. Liens v. Priorities

Before further exploring the section 70(a) property conflict, it is important to recognize the distinction between liens or security interests and priorities,[52] since this difference serves as the lynch pin of numerous state/federal conflicts in bankruptcy cases. Moreover, the difference is essential to the definition of bankruptcy property taken by the trustee under section 70(a)[53] and often arises in situations involving liquor licenses.

"[A] priority is merely a right to earlier payment or better treatment in the administration of an unencumbered estate."[54] It does not consist of a property interest in particular property, but instead is merely a right to be given an advantage in the distribution of an insolvent estate. A lien creditor, on the other hand, is totally outside the purview of the Bankruptcy Act and therefore the reach of the trustee. While it is sometimes necessary for a bankruptcy court to determine the priority among several different liens, the Bankruptcy Act only deals with lien priorities incidentally and to a very limited extent.

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50. *See* note 38 *supra* and accompanying text.

51. The court attempts to distinguish *Professional Bar* by observing that "[t]he state may refuse to transfer the liquor license, but it cannot determine how the assets of the bankrupt estate should be distributed." 500 F.2d at 1210.

52. *See* Kennedy, *Priorities and Liens*, in BANKRUPTCY AND THE CHAPTER PROCEEDINGS 163 (G. Holmes ed. 1976) [hereinafter cited as Kennedy].

53. Section 70(a) of the Bankruptcy Act, 11 U.S.C. § 110(a) (1970), provides in pertinent part:

> The trustee of the estate of a bankrupt . . . shall . . . be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this title, except insofar as it is to property which is held to be exempt, to . . . [certain specified] kinds of property wherever located . . . .

54. Kennedy, *supra* note 52, at 167.

The difference between liens and priorities is illustrated in the 1975 Ninth Circuit decision of *In re Leslie*.[55] In *Leslie*, a tavern owner sold his business, including his liquor license. California law requires any seller of a business of that kind to place the proceeds of the sale in escrow pending consideration of the application for transfer by the ABC.[56] If the ABC approves the transfer, the proceeds are to be distributed according to a set pattern of distribution.[57] In *Leslie*, after the sale had been approved by the ABC, the seller went into bankruptcy. The trustee in bankruptcy attempted to claim the proceeds that had been placed in escrow. The applicable statute gave the sellers of merchandise to the tavern owner a *priority* over other general unsecured creditors.[58] The supplier-creditors argued that they had a *lien* on the proceeds, were entitled to assert their statutorily-created advantage,[59] and were exempt from the provisions of section 64 of the Bankruptcy Act. The trustee said they had no more than a priority under state law and could only share pro rata with other unsecured creditors.[60] As in *Professional Bar* the *Leslie* court looked to section 64[61] and agreed with the trustee—rejecting the lien-exception argument. The court reasoned that the federal priority scheme pre-empts distribution in bankruptcy and that priorities prescribed by state law do not apply, except for the limited priority afforded a landlord by section 64(a)(5).[62] The supplier-creditors in *Leslie* were thus not treated as secured (lien) creditors, and their priority position under state law was not deferred to under the Bankruptcy Act.[63]

In reaching this result, the court distinguished an earlier Ninth Circuit case, *United States v. California*.[64] There, after the sale of a liquor license, both the federal and state governments asserted tax *liens*

55. 520 F.2d 761 (9th Cir. 1975).

56. CAL. BUS. & PROF. CODE § 24074 (West Supp. 1977).

57. *Id.*

58. *Id.* Section 24074 of the B.C.P. accords a priority to "claims for goods sold and delivered to the transferor for resale at his licensed premises and . . . claims for services rendered, performed, or supplied in connection with the operation of the licensed business."

59. *See* note 56 *supra*.

60. 520 F.2d at 762.

61. 11 U.S.C. § 104 (1970).

62. Section 64(a)(5) gives a priority to "rent owing to a landlord who is entitled to priority by applicable State law. . . ." but restricts the priority to rent presently owing which has accrued within three months before the date of the bankruptcy. 11 U.S.C. § 104(a)(5) (1970).

63. 520 F.2d at 762.

64. 281 F.2d 726 (9th Cir. 1960).

against the license. The court of appeals ruled that the state tax creditors had effective liens against the licensee, reasoning that the limitations on the value of the license which had been set by the state limited the property which became part of the bankrupt estate.[65] This lien theory approach to section 70(a) property is similar to the analysis of the Ninth Circuit in *Professional Bar*, and consequently, suffers from the same defects in reasoning.

The *Leslie* court, shifting as it was its prior analysis, also sought to distinguish the Supreme Court's decision in *Chicago Board of Trade v. Johnson.*[66] That case is primarily significant for its holding that a seat on a board of an exchange is not property which passes to the trustee in bankruptcy.[67] The bankrupt in that case owned a seat on the Chicago Board of Trade. Under the Board rules, if a member owed money to other members, the Board could prohibit the transfer of that member's seat to a third person. The trustee in bankruptcy claimed that he had title to the seat by operation of section 70(a)(5) of the Bankruptcy Act. Although recognizing that a seat on the Board is normally property which passes to the trustee in bankruptcy, the court held that the Board rules gave the member-creditors a secured interest (lien) in the seat and that title therefore could not pass to the trustee for distribution to the general creditors of the bankrupt estate.[68] It is noteworthy that unlike the other cases finding such a lien analysis applicable, *Chicago Board of Trade* did not involve a governmental agency, but rather a pseudo-governmental creditor. *Leslie* seems to look to this distinction in its holding; allowing such pseudo-governmental and governmental agencies the right to define section 70(a) property, but withholding that right from private creditors.[69]

In order to reconcile these cases, it is essential to examine more closely the fundamental distinction between a lien and a priority. A

65. The court upheld the state's claim for delinquent taxes in these terms:

> [T]he conditions [on licensing] . . . constitute a limitation on the right of the applicant and upon the property which that right constitutes and upon the values which attach to that property. Those values and no greater values became a part of the bankrupt estate and fell within the reach of the United States.

Id. at 728.

66. 264 U.S. 1 (1924).

67. *Id.* at 8, 12.

68. *Id.* at 15.

69. *See* text accompanying note 54 *supra.* Secured creditors, however, are not without limitations in a bankruptcy proceeding. As Justice Douglas stated in Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 219 (1941), "[t]he theme of the Bankruptcy Act is equality of distribution." By contrast, the secured creditors in a bankruptcy proceeding seek "to avoid that very result." Kennedy, *supra* note 52, at 170.

creditor who can assert a lien, clearly has a better chance of recovering what is owed him out of the proceeds of the estate. Despite this apparent basis for distinguishing the aforementioned cases, it is submitted that neither the creditors in *United States v. California* nor those in *Chicago Board of Trade v. Johnson* actually had valid security interests in the property claimed by the trustee in bankruptcy. Both courts used the rationale that since they had created the property rights in the first place, the creditors claiming superior status over the trustee in each case could impose reasonable restrictions on the transfer of the property.[70] Such an analysis ignores the threshold rule that when a bankruptcy takes place and a conflict develops, the court must look to federal law. By misidentifying the nature of the property, and therefore misidentifying the asserted claims, both the Ninth Circuit and the Supreme Court frustrated the purpose and effectiveness of the Bankruptcy Act in that the cases stand in derrogation of the system of priorities created by section 64.

In concluding this analysis of the necessity for a clearer distinction between liens and priorities in determining what property the trustee takes under section 70(a), three interesting cases in which a state attempted to create a lien upon the filing of a petition in bankruptcy should be noted. The courts in these cases held that the assets involved were free and clear of any asserted liens and would be distributed to the general creditors of the bankrupt estate.

N.W. Day Supply Company v. Valenti[71] reflects the better view. There, a Massachusetts statute caused a lien to arise in favor of materialmen upon adjudication in bankruptcy of certain contractors. The *Valenti* court stated that "[w]hatever may be the purpose of this statute, or its effect in other circumstances, it is plainly not within the

70. In *Chicago Bd. of Trade*, the Court noted that the lien was "inherent in the property in its creation, . . ." 264 U.S. at 15. Similarly, in *United States v. California*, the Ninth Circuit expressed its rationale as follows:

> Here the license existed because the state had issued it. If the licensee acquired something of value, it was because the state had bestowed it upon him. Whatever value the license, as property, may have had to a purchaser depended upon its transferability. If it was transferable, it was because the state had made it so. If the state had seen fit to impose conditions upon issuance or upon transfer of property it has wholly created, that is the state's prerogative so long as its demands are not arbitrary or discriminatory. The federal government has no power to command the state in this area. It has no power to direct that property be created by the state for purposes of federal seizure.

281 F.2d at 728. This analysis dovetails with the Ninth Circuit's analysis in *Professional Bar*. See notes 38 & 39 *supra* and accompanying text.

71. 343 F.2d 756 (1st Cir. 1965).

exceptions permitted to a state to control the distribution of assets in the hands of the Bankruptcy court."[72]

The court recognized that the state was attempting to create a lien for a certain class of creditors (materialmen) so that they would have a priority over the general creditors of the bankrupt estate. However, the court looked to the effect of the statute when a bankruptcy was initiated and correctly determined that the assets of the bankrupt should be distributed in accordance with the priority scheme of the Bankruptcy Act.

In re Crosstown Motors, Inc.[73] involved another state attempt to create a lien on the assets of a bankrupt estate in favor of a particular class of creditors. The issue was whether Illinois law gave an entrustor a lien on the general assets of a bankrupt, or a priority in payment for the value of proceeds received from trust sales which were expended for operating expenses prior to bankruptcy.[74]

In examining the statute, the court noted that it should consider "not only the language used but the evil to be remedied and the object to be attained."[75] The court found that it was the intent of the Illinois legislature to provide for only a priority or preference upon distribution. Therefore, the claimant was properly denied the status of a lien creditor, and the priorities set forth in section 64 of the Bankruptcy Act prevailed.[76] *Crosstown Motors* thus reemphasizes that the Bankruptcy Act is superior to any state statute and that a state attempt to create a priority in favor of a specific class of creditors is invalid when it conflicts with the priority provisions enumerated in section 64.

Elliot v. Bumb[77] synthesizes the key issues involved in the establishment of liens and priorities by states. It is perhaps the most illustrative case to deal with the question of which property rights pass to the trustee in bankruptcy pursuant to the provisions of section 70(a).

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72. *Id.* at 757.

73. 272 F.2d 224 (7th Cir. 1959).

74. The statute in question provides, in part, that if the proceeds of sales were received by the trustee within ten days prior to the filing of a petition in bankruptcy by the trustee, or the demand made by the entrustor for prompt accounting, said entrustor would be entitled to a priority to the amount of such proceeds or the value thereof. ILL. REV. STAT. ch. 121½ § 175 (1957) (current version at ILL. ANN. STAT. ch. 26, § 9306 (Smith- Hurd 1974)).

75. 272 F.2d at 226 (citing Inter-State Water Co. v. City of Danville, 39 N.E.2d 356, 358 (Ill. 1942)).

76. In so deciding, the court noted that the 1938 Bankruptcy Act had eliminated recognition of state-created priorities, with an exception created for rent. *Id.* at 227. *See* note 79 *supra* and accompanying text.

77. 356 F.2d 749 (9th Cir. 1966).

The *Elliott* case dealt with a California statute providing that a seller of money orders to the public was required to retain the proceeds of money order sales in a special account and that a "trust" would be impressed on these proceeds (as opposed to a lien). Moreover, upon insolvency of the seller of such money orders, the proceeds of the trust would go to the issuer of the money order rather than the trustee of the seller's bankrupt estate.[78] The Ninth Circuit held that the state statute did not control, stating:

> Congress has made even clearer its intent that state law shall not be permitted to confer preference on one class of the creditors of one adjudged a bankrupt under federal law, even though the state may have the highest public purpose in attempting to do so. So it is that section 64 of the Bankruptcy Act eliminates all state-created priorities save one (rent). And statutory liens not accompanied by "possession of" or by "levy upon" the property subject to lien before the filing of the petition in bankruptcy are invalidated by section 67c(2) of the Bankruptcy Act.[79]

The court thus accurately identified the "trust" as a state-created priority under a different label[80] and refused to allow it to thwart the distributive provisions of section 64. It is implicit from the *Elliott* court's disposition of the conflict that even the highest public purpose on the part of the state would not justify allowing a state-created preference to override the federal scheme.

B. *Summary*

Thus, relevant cases in this area reveal, under the correct analysis, that property owned by the bankrupt prior to bankruptcy passes to the bankrupt's trustee pursuant to the provisions of section 70(a) of the Bankruptcy Act. Further, the property of the bankrupt estate must be distributed according to the priorities established by the Bankruptcy Act under section 64 and not according to priorities established by specific state statutes which conflict with the Bankruptcy Act's system of priorities. Nonetheless, pseudo-governmental and governmental

78. CAL. FIN. CODE § 12300.3 (West Supp. 1977).

79. *Id.* at 754-55 (citations omitted). Section 67(c)(2) interrelates with § 64 in that § 67(c)(2) directs that certain liens may, by order of the court, be preserved for the benefit of the estate and pass to the trustee, or be invalidated. The section provides: "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 . . . section 64 of this Act, even though not otherwise granted a priority." 11 U.S.C. § 107(c)(2) (1970).

80. 356 F.2d at 755.

entities may be able to successfully remove themselves from the scope of the Act through the expedient mechanism of asserting a right to define the nature of such property.

IV. The Bankruptcy Act and the Uniform Commercial Code

A frequently litigated issue in bankruptcy proceedings is the conflict between the Bankruptcy Act and the Uniform Commercial Code (U.C.C.).[81] There are two primary instances when this conflict arises: (1) when section 9-306 of the U.C.C. conflicts with section 60 of the Bankruptcy Act; and (2) when section 2-702(2) of the U.C.C. conflicts with section 67 of the Bankruptcy Act.

A. Section 9-306 of the U.C.C.

Before we can commence a discussion of this conflict a brief explanation of the so-called "avoiding powers" of a trustee in bankruptcy is useful. The trustee is endowed by Congress with certain powers as a public officer and as an officer of the court.[82] The avoiding powers of the bankruptcy trustee are the powers to "avoid" transactions between the bankrupt and another person which were effected before the filing of a petition by or against the bankrupt under the Bankruptcy Act. This discussion will focus on the trustee's powers to avoid, nullify, or otherwise invalidate the bankrupt's pre-bankruptcy transfer of property or attempt to prefer one creditor over another by the grant of a security interest under Article 9 of the U.C.C.

The trustee in bankruptcy is charged by statute to collect as much as he can for the benefit of the unsecured creditors in a bankruptcy proceeding.[83] The extent of the trustee's powers can, depending on the case, exceed the powers of the bankrupt and of actual creditors.[84]

Section 60[85] of the Bankruptcy Act enables the trustee to avoid certain transfers which would otherwise be perfectly valid. As one commentator has noted, "[t]he basic purpose of section 60 is to cut off the creditors' race of diligence some four months before bankruptcy,

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81. UNIFORM COMMERCIAL CODE [hereinafter referred to as U.C.C.]. All citations to the U.C.C. are to the 1972 Official Text.
82. Callaghan v. Reconstruction Fin. Corp., 297 U.S. 464, 468 (1936).
83. Bankruptcy Act § 47, 11 U.S.C. § 75 (1970).
84. *See* note 86 *infra* and accompanying text.
85. 11 U.S.C. § 96 (1970).

and to place all creditors on an equal level as of that earlier date."[86]

Section 60(a)(1) defines a preference as:

> a transfer, . . . 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.[87]

In other words, it is a transfer by the debtor to pay or secure a previously incurred debt. By its terms, section 60 excludes from the definition of preference such simultaneous transactions as purchases for cash or security interests given in connection with simultaneous loans.[88] However, even a very brief interval between the time the debt was incurred and the time the debt was secured or paid will suffice to establish a non-simultaneous transaction.[89]

Under Section 60(b), a trustee may avoid a preference if, at the time the property was received, the creditor had "reasonable cause to believe that the debtor . . . [was] insolvent."[90]

Section 9-306(2)[91] of the U.C.C. sets forth the secured party's interests in "proceeds." Proceeds are defined in section 9-306(1) as "whatever is received when collateral or proceeds is sold, exchanged, collected or otherwise disposed of." That section further defines proceeds in terms of "cash" and "noncash proceeds." "Cash proceeds" include money, checks and deposit accounts; "non-cash proceeds" include all other proceeds. Generally, a perfected security interest in collateral continues in any proceeds received in exchange for the collateral.[92] However, this general rule is not applicable in the case of an insolvent debtor as provided by section 9-306(4)(d) of the U.C.C. This section purports to give the secured party an interest in commingled proceeds which may or may not have been traceable as proceeds of the collateral. Thus, this section precludes any claim based

86. Weingarten, *The Avoiding Powers of a Trustee in Bankruptcy* in BANKRUPTCY AND THE CHAPTER PROCEEDINGS 129, 151 (G. Holmes ed. 1976) [hereinafter cited as Weingarten].

87. 11 U.S.C. § 96(a)(1) (1970).

88. Weingarten, *supra* note 86, at 152.

89. *Id.*

90. 11 U.S.C. § 96(b) (1970).

91. U.C.C. § 9-306(2). *See generally* Note, *Secured Transactions in Personal Property-Operation of the U.C.C. § 9-304(d) in Bankruptcy*, 10 LOY. L.A.L. REV. 508 (1977).

92. U.C.C. § 9-306(3).

on tracing even if a secured creditor could trace more than is given to him under the provisions of section 9-306(4)(d) of the U.C.C. It places a maximum on the sum that can be collected by a secured party which would be equal to the amount of cash proceeds received in the ten day period prior to the initiation of a bankruptcy proceeding. The phrase "proceeds" in section 9-306(4)(d), as recently defined by the Ninth Circuit, means all cash receipts from any source received by the debtor in the ten day period prior to bankruptcy.[93]

In a recent decision, *In re Gibson Products*,[94] the Ninth Circuit was faced with determining the proper relationship between section 60 of the Bankruptcy Act and section 9-306(4)(d) of the U.C.C. The court held the operation of section 9-306(4)(d) created a voidable preference under section 60 of the Bankruptcy Act,[95] thereby according the federal law the priority which the supremacy clause requires.

The *Gibson* court explicitly rejected the interpretation of the phrase "any cash proceeds" which had been given in *Fitzpatrick v. Philco Finance Corp.*[96] There, the Seventh Circuit interpreted the phrase in conjunction with the definition of proceeds in section 9-306(1) and limited it to "cash proceeds from the sale of collateral in which the creditor had a security interest."[97] Instead, the court in *Gibson* interpreted the phrase "any cash proceeds" as provided for in section 9-306(4)(d) of the U.C.C. to mean all cash receipts from any

93. Arizona Wholesale Supply Co. v. Itule, 543 F.2d 652, 656 (9th Cir. 1976), *cert. denied*, 97 S. Ct. 1583 (1977) [hereinafter referred to as *In re* Gibson Products].

94. *Id.* The facts of the case are as follows: Gibson Products of Arizona was indebted to Arizona Wholesale Supply Co. in the amount of $28,860 for household appliances which Wholesale had sold to Gibson. Wholesale had a perfected security interest in these appliances.

Gibson filed a petition in bankruptcy on January 13, 1972. In the ten-day period prior to the filing Gibson deposited $19,505.27 in its bank account, only $10.00 of which was derived from the sale of an appliance in which Wholesale had a perfected security interest. Wholesale claimed the entire $19,505.27 under § 9-306(4)(d) of the U.C.C. in opposition to the claim of the bankruptcy trustee. The bankruptcy court awarded judgment to Wholesale. The district court affirmed, and the trustee in bankruptcy appealed. *Id.* at 654-55.

95. The Ninth Circuit held that Wholesale's interest in the fund, and its priority position over later creditors, did not arise until some part of Wholesale's proceeds were deposited with other cash in Gibson's bank account in the ten days prior to Gibson's filing the bankruptcy proceeding. Therefore, the transfer on account of an antecedent debt was received by Wholesale and it could not qualify for the relief provided by § 9-306(4). The transfer of the excess proceeds, over and above the amount of proceeds belonging to Wholesale, was declared by the court as a preference which was avoidable by the bankruptcy trustee. *Id.* at 657.

96. 491 F.2d 1288 (7th Cir. 1974).

97. *Id.* at 1292.

source received by the debtor in the ten day period prior to the filing of bankruptcy.

Referring to the statute, the court stated that "proceeds" was divided into two categories, "identifiable and non-identifiable." Non-identifiable proceeds essentially referred to proceeds that were commingled with other proceeds. The extent of the security interest in the "proceeds" depended upon the category in which they fell. Section 9-306(4)(d) dealt only with non-identifiable cash proceeds. If the cash proceeds could be identified, meaning they were not commingled, the secured party would have a perfected security interest in the whole fund under section 9-306(4)(b) without any of the limitations imposed by section 9-306(4)(d). U.C.C. section 9-306(4)(d) gives a secured creditor a security interest even when he cannot identify his proceeds in the commingled fund, as long as he can show that some of his proceeds were among those in the fund.[98] This approach was found objectionable by the court, since it gave such a creditor a preference under section 60 of the Bankruptcy Act which was otherwise avoidable by the bankruptcy trustee.[99]

The court in *Gibson* observed that the collision between the U.C.C. and the Bankruptcy Act can be avoided if: "(1) [the creditor's] interest was initially perfected in the collateral more than four months before bankruptcy, and (2) he can identify the proceeds to which his security

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98. The court stated as follows:

> The proceeds section of the Code generally follows the pre-Code law that a security interest continues in any identifiable proceeds received by the debtor from the sale or other disposition of the collateral. The Code's new twist is extending the creditor's security interest to commingled funds without specifically tracing the creditor's proceeds into the fund, when the debtor has become insolvent.

543 F.2d at 655.

99. The Ninth Circuit discussed the conflict between the preference sections of the Bankruptcy Act and the provisions of § 9-306 of the U.C.C. as follows:

> The effect of Section 9-306(4) is thus to transfer to Wholesale a security interest in the cash in Gibson's bank account which does not derive from the sale of its collateral. In this situation, the act that gives Wholesale priority and the events that attach the security interest to the questioned asset occur at the same time. The transfer cannot occur earlier than ten days before the institution of bankruptcy. The transfer of the excess, above the wholesaler's proceeds, is a preference unless we can say that the transfer was neither for nor on account of an antecedent debt. We cannot avoid the conclusion that the transfer was on account of an antecedent debt. Wholesale could not qualify for Section 9-306(4) treatment absent the antecedent debt; moreover, the transfer does not happen unless the debt owed exceeds the payments made to the creditor during the ten-day period before the bankruptcy petition has been filed.
>
> The result is that Wholesale cannot successfully assert its claim under U.C.C. Section 9-306(4)(d) to thwart the trustee's power to set that interest aside as a preference.

Id. at 657.

interest has attached."[100] The fulfillment of those two predicates will, in the court's view, entitle that creditor to a priority over later creditors which "relates back to this initial perfection."[101] As seen in *Gibson*, the problem arises in these situations involving section 9-306(4)(d) "because that subsection gives the secured creditor a perfected security interest in the entire amount deposited by the debtor within ten days before bankruptcy without limiting the interest to the amount that can be identified as the proceeds from the sale of the creditor's collateral."[102] Under U.C.C. section 9-306(4)(d), a creditor's security interest in these non-identifiable proceeds arises when the bankruptcy action is begun and when proceeds from his collateral become commingled with the debtor's other cash proceeds. Pursuant to section 9-306(4)(d), the creditor's security interest is held to an "amount not greater than the amount of any cash proceeds received by the debtor within ten (10) days before institution of the insolvency proceedings."[103]

Gibson stands for the proposition that the rights provided a secured creditor by U.C.C. section 9-306(4)(d) will necessarily fall when they conflict with the "avoiding powers"[104] given to a trustee by section 60 of the Bankruptcy Act.[105]

One interesting sidelight of the Ninth Circuit's decision in the *Gibson* case is its effect on a prior case, *DuBay v. Williams*.[106] *DuBay* dealt with a conflict between section 60 of the Bankruptcy Act and section 9-108 of the U.C.C. Relying on the state law definition of "antecedent debt" as indicated in U.C.C. section 9-108, the Ninth Circuit in *DuBay* held that the acquisition of new collateral pursuant to an after-acquired property clause (property acquired within four months of bankruptcy) was not a preference.[107] This outcome was ill-advised in that the Ninth Circuit failed to acknowledge the obvious conflict between state and federal law. While *Gibson* does not specifically overrule *DuBay*, it does significantly limit that case's applicability. *Gibson* therefore provides a much-needed corrective to the tendency

100. *Id.* at 655.
101. *Id.* *Cf.* DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1969) (when additional post-petition collateral constitutes accounts receivable and the creditor has fulfilled U.C.C. filing requirements, a subsequent lien creditor will not gain a priority).
102. 543 F.2d at 655.
103. *Id.* at 655 (citing U.C.C. § 9-306(4)(d) (1972 version)).
104. *See* text accompanying notes 82-90 *supra*.
105. *See* note 99 *supra*.
106. 417 F.2d 1277 (9th Cir. 1969).
107. *Id.* at 1289.

on the part of many courts to minimize or ignore the state-federal conflict and thereby frustrate the operation of provisions of the Bankruptcy Act.

B. *Section 2-702 of the U.C.C.*

Another dispute arises when section 2-702(2)[108] of the U.C.C. is pitted against the transfer provisions of section 67[109] of the Bankruptcy Act. It is an area in which numerous commentators have disagreed.[110] The U.C.C. was enacted by several states to pre-empt and reorganize state commercial law and therefore obviously supersedes preexisting law. The new law has been of great benefit to those engaged in commercial activity. Article 9 has removed from the courts the many disputes involving secured creditors. In this context, it seems highly inappropriate to attempt to interpret the U.C.C. in general, and resolve disputes arising under section 2-702(2)[111] in particular, by way of pre-Code statutory and common law as was recently done by the Sixth[112] and Ninth Circuits.[113]

How a seller's rights to reclamation of property under U.C.C. section 2-702 are applicable in a bankruptcy proceeding is of significant importance. The historical development of the Bankruptcy Act as it impacts the U.C.C. reclamation provisions provides an insight to the conflict. Section 64 of the Bankruptcy Act of 1898[114] provided a scheme of priori-

108. U.C.C. § 2-702(2).

109. 11 U.S.C. § 107 (1970).

110. Professor Vern Countryman of Harvard strongly supports the position that U.C.C. § 2-702 is in conflict with the Bankruptcy Act and is therefore invalid. Countryman, *Buyers and Sellers of Goods in Bankruptcy*, 1 N.M.L. REV. 435 (1971). Professor Lawrence P. King of New York University and one of the editors of COLLIER ON BANKRUPTCY with Countryman, 1-15 COLLIER ON BANKRUPTCY (14 ed. 1976), supports the position of the reclaiming seller. King, *Reclamation Petition Granted: In Defense of Defrauded Sellers*, 44 J. NAT'L CONF. OF REFEREES IN BANKRUPTCY 81 (1970). Finally, Professor Frank R. Kennedy of Michigan University, and also a COLLIER editor, whose position may be classified as one of moderation, is a strong supporter of the U.C.C.; but he appears to recognize that the 1966 amendments of § 67(c) of the Bankruptcy Act have seriously limited U.C.C. § 2-702. *See* Kennedy, *The Interest of a Reclaiming Seller Under Article 2 of the Code*, 30 BUS. LAW. 833 (1975).

111. U.C.C. § 2-702(2) provides for the reclamation of property by a seller by stating:

> Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency had been made to the particular seller within three months before delivery the ten-day limitation does not apply.

Id.

112. *See* note 123 *infra* and accompanying text.

113. *See* note 128 *infra* and accompanying text.

114. Bankruptcy Act, ch. 541, § 64, 30 Stat. 544 (1898) (current version at 11 U.S.C. § 104 (1970)).

ties in disbursing the assets of a bankruptcy estate. Included in the list of priorities were: "debts owing to any person, . . . who by the laws of the States . . . in [sic] entitled to priority, . . ."[115] During the ensuing thirty years, the passage of many state priority statutes created serious problems with the scheme of distribution provided by the Bankruptcy Act.

The Chandler Act of 1938 made substantial amendments to the Bankruptcy Act of 1898, including an amendment to section 64.[116] The amendment deleted all state created priorities except as to a landlord who by state statute was entitled to a priority for rent. Sections 67(c)(1)(A)[117] and 67(c)(1)(B)[118] of the Bankruptcy Act also impact the rights of a reclaiming seller by establishing the trustee's priority over liens arising out of insolvency and fraudulent transfers.[119]

Congressional action in 1966 repealed the prior explicit recognition of statutory liens, the House Judiciary Committee finding that such state created priorities effectively frustrated the distribution provisions of the Bankruptcy Act.[120]

Congress also enacted a definition of "statutory lien" which provided that:

> 'statutory lien' shall mean 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.[121]

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115. *Id.* § 64(b)(7).

116. Chandler Act, ch. 575, 52 Stat. 840 (1938) (current version at 11 U.S.C. § 104 (1970)).

117. 11 U.S.C. § 107(c)(1)(A) (1970).

118. *Id.* § 107(c)(1)(B).

119. These sections, as amended in 1966, provide in relevant part:

> (c)(1) The following liens shall be invalid against the trustee:
> (A) every statutory lien which first becomes effective upon the insolvency of a debtor . . . ;
> (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. . . .

Pub. L. No. 89-495, 80 Stat. 268-69 (1966) (current version at 11 U.S.C. § 104 (1970)).

120. *Id.* *See also* S. REP. No. 1159, 89th Cong., 2d Sess, *reprinted in* [1966] U.S. CODE CONG. & AD. NEWS 2456.

121. Pub. L. No. 89-495, 80 Stat. 268 (1966) (current version at Bankruptcy Act § 1(29a), 11 U.S.C. § 1(29a) (1970)). Moreover, § 70(c) of the Act, 11 U.S.C. § 110(c) (1970), sets forth a priority for the trustee in providing:

> The trustee shall have as of the date of bankruptcy the rights and powers of:

Thus, the backdrop is set for the question: Is the state-created right of reclamation, provided by U.C.C. section 2-702 which prefers certain creditors over all others, invalid in bankruptcy? The answer, based on a threefold analysis, must be in the affirmative. First, the state-created right of reclamation plainly contemplates a state-created priority to be paid in advance of dividends to creditors, and thus is contrary to the scheme of priorities set forth in section 64 of the Bankruptcy Act. Second, the state-created right of reclamation works as a state-created lien which first becomes effective upon insolvency, and thus is invalid in bankruptcy pursuant to section 67(c)(1)(A) of the Bankruptcy Act. Third, the state-created right of reclamation has the effect of a state-created 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, and thus is invalid in bankruptcy pursuant to section 67(c)(1)(B).

In re Federal's[122] presents a thorough documentation of both the U.C.C. and Bankruptcy Act reclamation provisions. In denying reclamation, Judge Brody found that U.C.C. section 2-702, as adopted by Michigan, conflicted with the Bankruptcy Act. However, on appeal the Sixth Circuit reversed Judge Brody.[123] Looking erroneously to pre-Code state law, the appeals court found that section 2-702 did not violate the provisions of Bankruptcy Act section 67(c)(1)(A), nor was the right of reclamation a state-created priority in conflict with section 64 of the Act.[124]

In *In re Good Deal Supermarkets, Inc.*,[125] the district court, after an examination of the legislative history,[126] affirmed the ruling of the bankruptcy judge denying reclamation pursuant to section 2-702. Like the district court in *In re Federal's*, the *Good Deal Supermarkets* court found that the seller's right to reclamation established by 2-702 was a

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(1) a creditor who obtained a judgment against the bankrupt upon the date of bankruptcy, whether or not such a creditor exists, (2) a creditor who upon the date of bankruptcy obtained an execution return unsatisfied against the bankrupt, whether or not such a creditor exists, and (3) a creditor who upon the date of bankruptcy obtained a lien by legal or equitable proceedings upon all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt upon a simple contract could have obtained such a lien, whether or not such a creditor exists.

11 U.S.C. § 110(c) (1970).

122. 12 U.C.C. REP. SERV. 1142 (E.D. Mich. 1973), *affirmed,* 17 U.C.C. REP. SERV. 407 (E.D. Mich. 1975).

123. III CORP. REORG. REP. No. 5, *Bankruptcy Court Decisions* at 264 (1977).

124. *Id.* at 272.

125. 384 F. Supp. 887 (D. N.J. 1974).

126. *Id.* at 888.

state-created statutory lien in conflict with the statutory lien created under section 67(c)(1)(A) of the Bankruptcy Act.[127]

It is clear, despite the misguided view of the Sixth Circuit, that the provisions of U.C.C. section 2-702 conflict with the provisions of the Bankruptcy Act as they create a disguised state priority in derrogation of section 67(c)(1) of the Act. Notwithstanding this seemingly obvious conclusion, *In re Federal's* was not the first decision to uphold the rights of the reclaiming seller against the bankruptcy trustee when the provisions of U.C.C. section 2-702 and the Bankruptcy Act came into conflict.

Perhaps the best illustration can be found in *In re Telemart Enterprises, Inc.*[128] Critical analysis reveals the fallacious basis of *Telemart.* There is, as reflected in *In re Federal's,* a clear conflict between section 67 of the Bankruptcy Act and section 2-702 of the U.C.C. When such a conflict exists the provisions of the Bankruptcy Act must govern.[129]

In *Telemart,* the seller, Alfred M. Lewis, Inc., sold frozen foods and groceries on credit to Telemart Enterprises. Lewis had delivered this merchandise throughout the period from August 27 to September 25, 1970. On September 30, having learned of Telemart's Chapter XI bankruptcy petition, Lewis demanded return of the delivered goods pursuant to section 2-702 of the U.C.C. The referee in bankruptcy and the district court refused to permit Lewis to reclaim his goods and were reversed by the Ninth Circuit.[130]

The trustee argued that U.C.C. section 2-702(2) was invalid against him because it was a statutory lien which first became effective upon the insolvency of the debtor and therefore was invalid pursuant to section 67(c)(1)(A) of the Bankruptcy Act.

The Ninth Circuit held that the right of a seller, under the U.C.C., to reclaim goods received by the buyer on credit *while* insolvent, does not have the same effect as a statutory lien first becoming effective *upon* the buyer's insolvency.[131]

The court stated that the Bankruptcy Act does not prohibit a state

127. *Id. See* note 122 *supra* and accompanying text.

128. 524 F.2d 761 (9th Cir. 1975), *cert. denied,* 96 S. Ct. 1466 (1976). [hereinafter cited as *Telemart*].

129. *See* notes 3-7 *supra* and accompanying text.

130. 524 F.2d at 766.

131. *Id.* at 763-64.

from providing for statutory rescission for grounds in addition to those common law actions such as fraud and misrepresentation. The court found:

> Section 67c is . . . a remedial trimming-back of the special exemption conferred on statutory liens by section 67b. It was not intended to serve as a new tool by which the trustee could cut down provisions of state law obviously not entitled to the benefits of section 67(b). . . . The sale thus is defective from its inception.[132]

Therefore, even though the court recognized that there was a conflict between provisions of the Bankruptcy Act and section 2-702 of the California Commercial Code, it upheld the right of a reclaiming seller against the bankruptcy trustee. Such a position is erroneous, ignoring as it does the entire thrust of the supremacy clause, the application of which was illustrated in *Perez v. Campbell*.[133]

The court in *Telemart* attempted to utilize a theory of voidable title in its interpretation of U.C.C. section 2-702. Such reliance on the title theory was misplaced by the court. To a great extent the passage of title which was so important in determining the rights of the parties under pre-U.C.C. statutes has been abandoned. Indeed, the Official Comment to U.C.C. section 2-101 expressly rejects the title passage theory.[134] The issue of title is not involved under the U.C.C. and therefore should not have been relied upon by the Ninth Circuit in its decision in the *Telemart* case.

The proposed revision of the Bankruptcy Act considered by the last Congress[135] contained a provision which dealt specifically with the

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132. *Id.* at 764. The court also noted that its holding allows states to multiply grounds for rescission, thereby evading § 64:

> This loophole is a necessary result of Congress' attempt to promote simultaneously two conflicting interests: equal distribution of the bankrupt's estate among all general creditors and recognition of property interests created by the state. Section 67c was a result of congressional desire to restrict the state in creation of liens: only analogous legislation could effect a similar limitation on creation of grounds for rescission.

Id. at 766.

133. 402 U.S. 637 (1971); *see* notes 148-156 *infra* and accompanying text.

134. The arrangement of the present article is in terms of contract for sale and the various steps of its performance. The legal consequences are stated as following directly from the contract and action taken under it without resorting to the idea of when property or title passed or was to pass as being the determining factor. The purpose is to avoid making practical issues between practical men turn upon the location of an intangible something, the passing of which no man can prove by evidence and to substitute for such obstructions proof of words and actions of a tangible character.

U.C.C. § 2-101, Comment.

135. *See* note 14 *supra*.

limitation on the various avoiding powers of the bankruptcy trustee and might have resolved the U.C.C. section 2-702 conflict by adopting much of the language of the U.C.C. reclamation provision.[136] However, it should be noted that during Committee consideration of H.R. 8200[137] a new provision, section 549 of the bill, was added which provided for discretionary judicial authority to deny reclamation and grant the same priority as is presently mandated by section 64 of the Bankruptcy Act.[138]

Notwithstanding this potential relief from the above described statutory conflict, it is evident that under existing law the right created by a state in enacting U.C.C. 2-702 is a lien that only becomes effective upon the insolvency of the debtor. Such a right or lien is in clear conflict with sections 1(29a), 67c(1)(A), and 67c(1)(B) of the present Bankruptcy Act, and any state legislation which frustrates the full effectiveness of the Bankruptcy Act should be rendered invalid.

This view was most recently espoused in *Samuels & Co., Inc.*[139] While the bankruptcy trustee was not involved in the action, *Samuels* affirms the superiority of the Bankruptcy Act over U.C.C. section 2-702 creditors. *Samuels* involved a conflict between U.C.C. Article 9 and Article 2 creditors asserting rights to the same goods in bankruptcy. In finding the perfected security interest of the Article 9 creditor superior to the creditor claiming under 2-702, the court analogized the Article 9 creditor's rights to the priority afforded the bankruptcy trustee under section 70(c) of the Bankruptcy Act. Thus, *Samuels* would appear to place the Fifth Circuit with *Good Deal Supermarkets* in upholding the superiority of the Bankruptcy Act, referring to the bankruptcy trustee as having the "status of a hypothetical lien creditor" under section 70(c).[140]

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136. H.R. 8200 § 546(b) provided:

> The rights and powers of the trustee under . . . this title are subject to any statutory right or common-law right of a seller, in the ordinary course of such seller's business, of goods to the debtor to reclaim such goods if the debtor has received such goods on credit while insolvent, but—(1) such a seller may not reclaim any such goods unless such seller demands reclamation of such goods within ten days after receipt of such goods by the debtor; . . .

137. *See* note 14 *supra*.

138. H.R. 8200 § 549(a)(2)(B) provided that the trustee may avoid a transfer of the property of the bankrupt estate which "is not [otherwise] authorized . . . by the court."

This provisión may well have been added to cover the situation where the debtor sold the goods to another within the ten day reclamation period, or to allow for court intervention dependent upon the nature of the goods.

139. 526 F.2d 1238 (5th Cir. 1976).

140. *Id.* at 1248.

V. THE BANKRUPTCY ACT'S POLICY TO ALLOW THE BANKRUPT A FRESH START

The significant impetus to seek relief through a voluntary petition in bankruptcy is the availability of a discharge from the bankrupt's obligations. Absent such a discharge bankruptcy proceedings are meaningless to the debtor. A discharge in bankruptcy essentially means that any monetary obligations owed by the bankrupt to a particular creditor are no longer enforceable, thus enabling the bankrupt to start with a "clean slate." Therefore, if an individual contemplates filing bankruptcy, it must be determined whether or not he will be entitled to a discharge and what debts, if any, will not be affected by the discharge.[141]

Such a determination is facilitated by a study of sections 14(c)(1) through 14(c)(8)[142] of the Bankruptcy Act which set forth the basis for the refusal of a discharge.[143] In addition, an examination of section 17[144] reveals that certain obligations such as federal or state taxes incurred three years prior to bankruptcy and claims based upon fraudulent conduct, are not dischargeable in bankruptcy even though the bankrupt may obtain a general discharge.

Prior to 1971, the bankrupt was faced with a problem of obtaining a "fresh start" despite his having obtained a discharge in bankruptcy, when he had judgments outstanding against him that arose out of an automobile accident case. Although such judgments were theoretically dischargeable in bankruptcy, many states had so-called "financial responsibility laws" which provided that a bankrupt's driver's license could be suspended for failure to pay certain debts.[145] The states justified the enactment of such legislation on the ground that it was necessary to protect their citizens by permitting only financially responsible

141. *See* Brody, *Discharge, Debts Excepted from Discharge and Related Problems,* in BANKRUPTCY AND THE CHAPTER PROCEEDINGS 95 (G. Holmes ed. 1976) [hereinafter cited as Brody].

142. 11 U.S.C. §§ 32(c)(1)-32(c)(8) (1970).

143. *See* Brody, *supra* note 141, at 95-96 for a succinct summary of the grounds for denial of a discharge in bankruptcy.

144. 11 U.S.C. § 35 (1970).

145. *See, e.g.,* Uniform Motor Vehicle Safety Responsibility Act, ARIZ. REV. STAT. § 28-1163 (1976); CAL. VEH. CODE § 16372 (West 1971); Safety Responsibility Law, ILL. REV. STAT. ch. 7, §§ 7-100 to -503 (Smith & Hurd 1971); N.J. REV. STAT. §§ 39:6-23 to -104 (1973); Financial Security Act, N.Y. VEH. & TRAF. LAW §§ 310 to 321 (1970); Motor Vehicle Financial Responsibility Act, OHIO REV. CODE ANN. §§ 4509.01 to .78 (Anderson 1973).

persons to drive.[146] Prior to 1971, the Supreme Court had held that such legislation was not in conflict with the Bankruptcy Act.[147] In the landmark case of *Perez v. Campbell*,[148] however, the Supreme Court overruled prior cases permitting the states to enforce such legislation and held that the suspension of a driver's license for failure to pay a discharged debt frustrated the purpose of the Bankruptcy Act.[149] *Perez* provides an excellent dissertation on the ability of a bankrupt to obtain a "fresh start" when he files a petition in bankruptcy, and also sets forth the general position of the Court with regard to the conflict between provisions of a state statute and the Bankruptcy Act. Significantly, *Perez* holds that *any* state law that frustrates the purposes and full effectiveness of the Bankruptcy Act is unenforceable.[150]

The factual context of *Perez* warrants examination. Perez was an uninsured motorist involved in an automobile accident. He was sued in an Arizona state court for personal injuries and property damage sustained in the accident. A judgment for over $2,400 was entered against him.[151] Subsequently, Perez filed a petition in bankruptcy listing that judgment among his debts; thereupon, the bankruptcy court entered a discharge from all of his debts, including the auto accident judgment. Under Arizona's Motor Vehicle Safety Responsibility statute, the fact that a judgment against a motorist remained unsatisfied for sixty days was a ground for suspending the motorist's license and registration, even if the motorist received a discharge in bankruptcy following such judgment.[152] Pursuant to these statutory provisions, Perez's registration and license were suspended. In support of his complaint, the bankrupt filed an affidavit stating that the suspension of the registration and license worked both a physical and financial hardship upon him and his children.

Relying upon *Kesler*[153] and *Reitz*,[154] the Ninth Circuit affirmed

146. *See* Reitz v. Mealey, 314 U.S. 33 (1941) and discussion accompanying note 18 *supra*.

147. *See* notes 18-22 *supra* and accompanying text.

148. 402 U.S. 637 (1971).

149. The same rationale provided the basis for the decision in Rutledge v. Shreveport, 1 Bankr. Ct. Dec. 477 (W.D. La. 1975), wherein the court held that a police officer could not be dismissed for filing a petition in bankruptcy. Similarly, in *In re* Weitzen, 3 F. Supp. 698 (S.D.N.Y. 1933), the court held that an agreement to waive the benefits of the Bankruptcy Act is unenforceable.

150. 402 U.S. at 652.

151. *Id.* at 638.

152. ARIZ. REV. STAT. § 28-1163 (1976).

153. *See* notes 18-22 *supra* and accompanying text.

154. *Id.*

the district court's rejection of the contention that the Arizona statute was in conflict with the Bankruptcy Act.[155] On certiorari, the Supreme Court reversed, holding that the statute had the effect and purpose of frustrating federal law under the Bankruptcy Act and was thus invalid under the supremacy clause.[156]

This Supreme Court decision illustrates the analysis required to determine whether a state statute conflicts with a federal statute, stating: "Deciding whether a state statute is in conflict with a federal statute and hence invalid under the Supremacy Clause is essentially a two-step process of first ascertaining the construction of the two statutes and then determining the constitutional question whether they are in conflict."[157]

The Arizona statute was designed to protect automobile users from faultless loss occasioned by financially irresponsible motorists. Its purpose was to provide "leverage for the collection of damages"[158] from such motorists. Conversely, the Bankruptcy Act was designed to provide debtors "a new opportunity in life and a clear field for future effort, . . ."[159] In juxtaposing these two purposes the *Perez* Court found that the scope of the Bankruptcy Act included "preexisting tort judgments."[160] Consequently, the Arizona statute fell as having an effect which violated the superior federal purpose. *Perez* mandates the examination of the effect, as well as the purpose of the statute when the bankrupt asserts the defense of a state conflict with the Bankruptcy Act. No matter how otherwise laudatory the state's intention, its legislative efforts will be invalidated if such statutes run contrary in their effect to the Bankruptcy Act's purpose of providing debtors a fresh start.[161]

The Ninth Circuit decision in *In re Kanter*[162] is instructive of the problems encountered in the clash between the Bankruptcy Act's fresh start policy and state statutes. In *Kanter* the Ninth Circuit was

155. 421 F.2d 619 (1970).
156. 402 U.S. 637 (1971).
157. *Id.* at 644.
158. *Id.* at 646.
159. *Id.* at 644 (quoting Local Loan Co. v. Hunt, 292 U.S. 234 (1934)).
160. *Id.*
161. *See also* Grimes v. Hoschler, 12 Cal. 3d 305, 525 P.2d 65, 115 Cal. Rptr. 625 (1974), discussed at text accompanying notes 26-27 *supra*, which follows the *Perez* analysis. *Grimes* overrules the prior California case of Tracy v. Contractors' State License Bd., 63 Cal. 2d 598, 407 P.2d 865, 47 Cal. Rptr. 561 (1965).
162. 505 F.2d 228 (9th Cir. 1974).

faced with what seemingly were two conflicting purposes of the Bankruptcy Act. The first being the Act's objective to give a bankrupt a fresh start once he has obtained his discharge in bankruptcy; the second being the policy of equal distribution of assets to all creditors by enabling the trustee to take title to the bankrupt's property pursuant to the provisions of section 70(a)(5).[163]

The question before the court was whether section 688.1(b)[164] of the California Code of Civil Procedure so frustrated the full effectiveness of section 70(a)(5) and section 70(c)[165] of the Bankruptcy Act that it was rendered invalid. The Ninth Circuit found that the California law conflicted with the Bankruptcy Act and declared the state provision unconstitutional.[166]

Kanter sustained injuries in an automobile accident in March of 1970. In March of 1971 he filed suit for damages in the state court and two weeks later filed a bankruptcy petition. The trustee asserted that the personal injury lawsuit was an asset of the bankruptcy estate and sought a determination to that effect by the bankruptcy judge. The bankruptcy judge concluded that title to the personal injury action vested in the trustee regardless of the California provision and his decision was affirmed by the district court.[167]

The enactment of section 688.1 followed the Ninth Circuit's decision in *Carmona v. Robinson*,[168] wherein it was held that the predecessor to section 688.1 permitted a trustee in bankruptcy to include a personal injury action of the bankrupt among the assets of the bankruptcy estate

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163. 11 U.S.C. § 110(a)(5) (1970). Section 70(a) of the Act provides in relevant part:

> The trustee . . . shall in turn be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this Act, except insofar as it is to property which is held to be exempt, to all of the following kinds of property wherever located . . . (5) property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded, or sequestered: *Provided*, That rights of action ex delicto for . . . injuries to the person of the bankrupt . . . shall not vest in the trustee unless by the law of the State, such rights of action are subject to attachment, execution, garnishment, sequestration, or other judicial process. . . .

164. CAL. CIV. PROC. CODE § 688.1(b) (West Supp. 1977), *as amended by* Law of Sept. 19, 1970, ch. 1523, § 7.5 (1970) Cal. Stat. 3069, provides in relevant part: "Nothing in this section shall be construed to permit an assignee by operation of law of a party to a personal injury action to acquire any interest in or lien rights upon money recovered by such party for general damages."

165. 11 U.S.C. § 110(c) (1970).

166. 505 F.2d at 231.

167. 345 F. Supp. 1151 (C.D. Cal. 1972).

168. 336 F.2d 518 (9th Cir. 1964).

pursuant to section 70(a)(5) of the Bankruptcy Act. Subsequent to *Carmona* the California legislature amended the law in an attempt to deny this right to the bankruptcy trustee, by adding subsection b to former section 688.1.[169]

In *Kanter*, the Ninth Circuit discussed section 6[170] of the Bankruptcy Act which, in essence, states that the estate of the bankrupt does not include property which is exempt under state law. The section also permits a state to amend its law to expand the classes of property which are exempt from the claims of creditors in conformity with the fresh start policy of the Bankruptcy Act. If a state desired to expand its exemption provisions, this would remove the exempted property from the reach of the trustee in bankruptcy. Consequently, certain property will not pass to the trustee by operation of law under section 70(a) insofar as section 6 of the Act recognizes specific property which may be exempted by the state. However, the Ninth Circuit held that California's section 688.1(b) was not an exemption statute, pointing out that it was not Congress' intent to "provide the states with a free hand to circumscribe the powers of the bankruptcy trustee."[171]

The court then reviewed the *Perez* decision, specifically emphasizing the Supreme Court's two-step analysis for determining whether a state statute conflicts with the Bankruptcy Act. The court reflected upon the fact that one of the purposes of the Bankruptcy Act is "to bring about a ratable distribution among creditors of a bankrupt's assets; to protect the creditors from one another"[172] and to secure the assets of the estate for such creditors.

In examining section 688.1(b) the Ninth Circuit found it "an obstacle"[173] to the full enforcement of congressional purposes, since its effect is to deny certain assets of the bankruptcy estate to the trustee which would otherwise be included.

The *Kanter* case sets out the interplay of various provisions of the Bankruptcy Act, and their application in the context of a bankruptcy

169. *See* note 164 *supra.*

170. 11 U.S.C. § 24 (1970).

171. 505 F.2d at 230. The *Kanter* court found that § 688.1(b) was not "a general exemption provision"' of the kind envisioned by the Congress in enacting § 6 of the Bankruptcy Act, but rather "specifically permits judgment creditors to obtain a lien on a debtor's cause of action, and only limits the power of an 'assignee by operation of law,' a term intended to reach the trustee in bankruptcy. Hence it cannot be an exemption provision within the meaning of § 6 and 70, sub. a." *Id.* at 230-31.

172. *Id.* at 231.

173. *Id.*

proceeding involving a conflicting state statute. The California legislature was trying to do indirectly what it could not do directly. It clearly objected to personal injury judgments passing to the trustee in bankruptcy pursuant to section 70(a)(5) of the Bankruptcy Act, and therefore enacted section 688.1(b) of the Civil Procedure Code. The Ninth Circuit simply would not permit such an attempt to circumvent the purposes of the Bankruptcy Act under the guise of implementing the fresh start policy of the federal statute.

VI. CONCLUSION

We have examined three of the primary areas involving conflicts between the Bankruptcy Act and state statutes: (1) the conflict between the definition of property the bankruptcy trustee takes pursuant to section 70(a) of the Bankruptcy Act and state attempts to define such property;[174] (2) the conflict between the Bankruptcy Act and some provisions of the Uniform Commercial Code;[175] and (3) the conflict between state statutes and the Bankruptcy Act's policy to allow the bankrupt a fresh start.[176] The common theme running through all three areas is that the paramount consideration is the *effect* a specific state statute has on the purposes of the Bankruptcy Act. If that effect conflicts with the purposes of the Bankruptcy Act, the provisions of the Act will and should govern, whether the conflict arises in the context of specific definitional constructs or in the more general application of collateral statutes. Problems arise not from any dispute as to this basic principle, but from the sometimes confused analysis utilized by the courts in defining and distinguishing specific types of creditors. This results in the failure to recognize inherent conflicts between state definitional statutes and the Bankruptcy Act. Particularly with respect to the Uniform Commercial Code, absent federal statutory reform, it may well be left to the Supreme Court to provide the direction necessary to resolve these conflicts.

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174. *See* notes 28-80 *supra* and accompanying text.
175. *See* notes 81-140 *supra* and accompanying text.
176. *See* notes 141-173 *supra* and accompanying text.