Washington Law Review

Volume 38
Number 2 *Washington Case Law—1962*

7-1-1963

Creditor's Rights—Bankruptcy—Section 70(c)—Actual Creditor Required

John S. Calvert

comes effective. The determination of the question again appears to lie in the purpose of the requirement. If it can be said that the purpose is only to give constructive notice to those who may be affected, then actual knowledge would certainly be a binding substitute. On the other hand, the scope of the requirement may be greater, necessitating filing as a final step in the rule making process. The express separation of the filing and publishing requirements lends support to such an argument.

The federal picture remains uncertain, but it is suggested that the *Aarons* case correctly interprets the filing and publication requirements under APA § 3(a)(3) and FRA § 5.[41] Further, it seems correct to say that APA § 4(a) requires publication of notice of proposed rule making as a prerequisite to the passing of a valid rule. Only future litigation can verify these conclusions but they are supported by the most logical interpretation of the purpose of these sections.

RALPH HAWKINS

CREDITOR'S RIGHTS

Bankruptcy—Section 70(c)—Actual Creditor Required. In *Pacific Finance Corp. v. Edwards*[1] the United States Court of Appeals for the Ninth Circuit interpreted § 70(c) of the Bankruptcy Act[2] to mean that the trustee acquires the status of a hypothetical lien creditor only if there is an actual creditor who could have acquired a lien on the date of the petition in bankruptcy.

The debtor purchased a Cadillac automobile on a conditional sale contract, after which the automobile title and the sale contract were immediately transferred to appellant Pacific Finance Corporation. The contract was filed with the county auditor two days after its execution, but through a mutual mistake the contract was dated October 10, 1959, instead of its real date of execution, November 10, 1959. On April 1,

[41] The *Hotch* case is still good law in the Ninth Circuit and there are indications that it has been accepted in the Fourth Circuit. See Graham v. Lawrimore, 185 F. Supp. 761 (1960), *aff'd on other grounds*, 287 F.2d 207 (1961). Another case contrary to the views expressed in the *Hotch* case is Eastern Airlines v. Union Trust Co., 221 F.2d 62 (1955) (cited by the *Aarons* court).

[1] 304 F.2d 224 (9th Cir. 1962).

[2] "The trustee, as to all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt could have obtained a lien by legal or equitable proceedings at the date of bankruptcy, shall be deemed vested as of such date with all the rights, remedies, and powers of a creditor then holding a lien thereon by such proceedings, whether or not such a creditor actually exists." 30 Stat. 565 (1898), 11 U.S.C. §110(c) (1952).

1960, adjudication in bankruptcy occurred. The court found that no one had extended credit to the bankrupt after the execution of the conditional sale contract for the Cadillac.

Under the Washington conditional sale contract recording statute,[3] the title of the conditional vendee is absolute as to all subsequent creditors unless the instrument is filed within twenty days after the vendee takes possession. The parties agreed that under Washington law the instrument could not be reformed.[4] Since late filing could not cure the defect and the lien of the conditional vendor under Washington law[5] was void as to those who extended credit after the late filing, the trustee contended that he obtained the status of a hypothetical creditor with a lien at the date of the filing of the petition in bankruptcy under § 70(c) of the Bankruptcy Act[6] and that, therefore, the lien of appellant was ineffective against the appellee trustee.

The court of appeals denied the right of the trustee to set aside the lien, saying that "creditor" as used in § 70(c) means "actual creditor" and "that the clause 'whether or not such a creditor actually exists' refers only to a 'creditor then holding a lien thereon.' "[7] The court then gave its interpretation of the effect of this construction:

> Under our construction of §70, sub. c the Trustee is empowered to exercise the powers given him even if no actual creditor has obtained a lien, but he cannot do so if no actual creditor could have obtained a lien. In that instant case . . . there was in existence at the date of bankruptcy no actual subsequent creditor of the bankrupt who could have obtained a lien on the Cadillac automobile at the date of bankruptcy.[8]

The court supported this construction by following the reasoning of the Supreme Court of the United States in *Lewis v. Manufacturers Nat'l Bank*.[9] Since no general creditor has been injured by the defect in filing there was no reason why the secured creditor should lose his

---

[3] RCW 63.12.010, as amended, Wash. Sess. Laws 1961, ch. 159, § 1, provides that, "all conditional sales of personal property . . . containing a conditional right to purchase, where the property is placed in the possession of the vendee, shall be absolute as to all . . . subsequent creditors, whether or not such creditors have or claim a lien upon such property, unless within twenty days after the taking of possession by the vendee, a memorandum of such sale, stating its terms and conditions, . . . shall be filed in the auditor's office of the county, wherein, at the date of the vendee's taking possession of the property, the vendee resides. . . ." The 1961 amendment changed the recordation period from ten to twenty days.

[4] Malott v. General Machinery Co., 19 Wn.2d 62, 141 P.2d 146 (1943).

[5] See statute cited note 3 *supra*.

[6] 30 Stat. 565 (1898), 11 U.S.C. §110(c) (1952).

[7] 304 F.2d at 228.

[8] *Ibid.*

[9] 364 U.S. 603 (1961).

preferred position merely because the debtor was an adjudicated bankrupt. Contrary "construction would enrich unsecured creditors at the expense of secured creditors, creating a windfall merely by reason of the happenstance of bankruptcy."[10]

Section 70(c) of the Bankruptcy Act has often been referred to as the "strong arm" provision of the Act.[11] The clause received its most liberal construction in *Constance v. Harvey*,[12] where the bankrupt executed to Constance a chattel mortgage which was not recorded within a reasonable time as required by state law. There were no creditors existing at the date of actual recordation. Over a year after the actual filing, the chattel mortgagor was adjudicated bankrupt. Since the right of a trustee in bankruptcy to set aside a security transaction depends on the laws of the state in which the bankrupt is located[13] and since in this case state law provided that a belated filing was good against creditors who became such after the belated filing but not before, the trustee could find no actual creditor who could have set aside the mortgagee's lien on the date of filing in bankruptcy. The court, however, concluded that the lien of the chattel mortgagee was ineffective against the right of the trustee, reasoning that § 70(c) gives the trustee the right "to be put in the position of an 'ideal' hypothetical creditor."[14] The trustee thereby acquired the rights and powers of a hypothetical creditor not only at the date of filing in bankruptcy, but also at any anterior point in time that would be of best advantage to him. This would enable the trustee to declare any security transaction void as to him "if he could conceive of a situation when a general

[10] *Id.* at 608-609.

[11] In 1910 the trustee was vested with the "rights, remedies, and powers of a creditor holding a lien by legal and equitable proceedings thereon; and also, as to all property not in the custody of the bankruptcy court, shall be deemed vested with all the rights, remedies, and powers of a judgment creditor holding an execution duly returned unsatisfied." 36 Stat. 840 (1910). This was, however, a part of § 47(a)(2). In 1938 the Chandler Act removed this "strong arm" provision from § 47(a)(2) to § 70, and in so doing made it clear that the trustee's rights, remedies, and powers were not dependent on any actual creditor with a lien or unsatisfied execution by adding the clause "whether or not such a creditor actually exists." 52 Stat. 881 (1938). In 64 Stat. 26 (1950), § 70(c) was amended to give the trustee the rights of a hypothetical creditor with a lien by legal or equitable proceedings as to all property "whether or not coming into possession or control of the court." Finally, Congress, by 66 Stat. 430 (1952), clarified this section to show that the lien of the trustee is meant to include property in which the bankrupt had an interest or to which the bankrupt may be vested with title, for the trustee already has title to all the bankrupt's property and therefore can't have a lien on his own property. 2 U.S. CODE CONGRESSIONAL AND ADMINISTRATIVE NEWS, 82d Cong., 2d Sess., 1976 (1952).

[12] 215 F.2d 571 (2d Cir. 1954).

[13] Myers v. Matley, 318 U.S. 622 (1943); Holt v. Crucible Steel Co. of America, 224 U.S. 262 (1912); 4 COLLIER, BANKRUPTCY 1411 (14th ed. 1940).

[14] 215 F.2d at 575.

creditor might have existed who could personally, as of the date of bankruptcy, claim rights superior to those of the secured creditor under state law. . . ."[15]

The *Constance* decision was criticized by many of the courts who were subsequently faced with the same problem.[16] Because of this difference among the circuits in the interpretation of § 70(c), the Supreme Court granted certiorari in *Lewis v. Manufacturers Nat'l Bank*.[17] Here the state law provided that the security instrument should be filed immediately or it would be ineffective against those who extended credit during the interval between execution of the instrument and its actual recordation. There were no such creditors, and after the recording of the instrument the debtor was adjudicated a bankrupt. The Supreme Court held that the trustee acquired his rights under § 70(c) at the date of bankruptcy, and that these rights were to be determined as of that date and not at any anterior point in time. The court reasoned that a construction like that of *Constance* would destroy the secured position of some creditors when the applicable state law had said that no general creditors had been injured. By holding that the trustee's rights were to be ascertained as of the date of filing in bankruptcy, the court was maintaining the "balance" intended between secured and unsecured creditors.

The Court, in making its point that the rights of the trustee were to be ascertained as of the date of bankruptcy, said that "the trustee acquires the status of a creditor as of the time when the petition in bankruptcy is filed. . . ."[18] This statement produces an apparent inconsistency between *Lewis* and *Pacific*. Literally, the trustee in *Pacific* would become a creditor who had extended credit as of the date of filing of the petition in bankruptcy. The Washington conditional sales filing statute states that a conditional sale contract not filed within twenty days is ineffective as to any subsequent creditors.[19] Therefore, the trustee could argue that since *Lewis* made him a creditor at the date of filing, he is a subsequent creditor within the terms of the Washington statute, and the lien of the conditional vendor is voidable by

[15] 49 ILL. B.J. 517 (1961).

[16] *In re* P.T.G. Grain Service, 185 F. Supp. 332 (D. Minn. 1960); *In re* Billings, 170 F. Supp. 253 (W.D. Mo. 1959); *In re* Gondola Associates, Inc., 132 F. Supp. 205 (E.D.N.Y. 1955). The *Gondola* case arose in the same circuit as *Constance* and the court felt compelled to follow *Constance* even though they did not agree with the result or the reasoning.

[17] 364 U.S. 603 (1961).

[18] *Id.* at 607.

[19] See statute cited at note 3 supra.

him. But did the Supreme Court intend the statement to be read literally? It would seem not.

First, the Supreme Court was concerned with reestablishing the protection to secured creditors removed by the *Constance* decision.[20] Unless the applicable state law determines that there is a general creditor who has been injured by the defect in filing, there is no reason to defeat the secured creditor's lien.[21] Such a literal construction of this passage would defeat one of the major objectives of the Bankruptcy Act, that of keeping in balance the interests of secured and unsecured creditors.[22] Under statutes similar to Washington's conditional sales filing statute[23] a secured creditor's preferred position would be lost even though no actual creditor has been injured.

Secondly, since the Court in *Lewis* was concerned with eliminating the unfair advantage that *Constance* gave to general creditors and with bringing the positions of the two classes of creditors back into balance, it is doubtful whether this statement, read in context, can be given an interpretation inconsistent with *Pacific*. The Court was intent upon overruling the interpretation expressed in *Constance,* which gave the trustee his rights as an ideal creditor at any ideal point in time. The paragraph under consideration was the one that disposed of this interpretation, and the Court was concerned with *when* the trustee acquired the rights of a creditor. It was not concerned with *making* him an actual creditor.[24]

However, it can be argued that the trustee is an actual creditor since in the course of his administration he accumulates expenses which must be paid out of the estate. But the trustee's status is not that of

[20] "That construction [in the *Constance* decision] would enrich unsecured creditors at the expense of secured creditors, creating a windfall merely by reason of the happenstance of bankruptcy." 364 U.S. at 608-609.

[21] "The rule pressed upon us would deprive a mortgagee of his rights in states like Michigan, if the mortgage had been executed months or even years previously and there had been a delay of a day or two in recording without any creditor having been injured during the period when the mortgage was unrecorded." *Id.* at 609-610.

[22] "The two basic principles of the Bankruptcy Act, to promote equality of distribution among creditors and to preserve security interests fairly acquired, are of course directly in conflict." Marsh, *Constance v. Harvey—The "Strong-Arm Clause" Re-Evaluated,* 43 CALIF. L. REV. 65, 68 (1955).

[23] See statute cited in note 3 *supra.*

[24] By reading the passage in context, it is evident that the court only had in mind the time at which the trustee acquired his rights of a hypothetical creditor. "We think that one consistent theory underlies the several versions of § 70, sub. c which we have set forth, *viz.,* that the rights of creditors—whether they are existing or hypothetical—to which the trustee succeeds are to be ascertained as of 'the date of bankruptcy,' not at an anterior point of time. That is to say, the trustee acquires the status of a creditor as of the time when the petition in bankruptcy is filed. We read the statutory words 'the rights * * * of a creditor [existing or hypothetical] then holding a lien' to refer to that date." 364 U.S. at 607.

a general creditor because his expenses have priority and are paid before general claims.[25] In addition, since these expenses are not really liabilities incurred by the bankrupt, it is difficult to see how the trustee can be considered one of the bankrupt's creditors.[26]

The effect of the *Pacific* decision can best be seen by a discussion of its import on a cross-section of Washington's recordation statutes.

Conditional Sale Contracts. As mentioned above,[27] the failure to file a conditional sale contract within twenty days after the property is placed in the possession of the vendee will make the vendee's title absolute as to all subsequent creditors, whether or not they have a lien. The construction given § 70(c) by some circuits would allow the trustee to void the lien of the vendor if the contract is not filed within the twenty day period, even though no credit has been extended during the interval between delivery of possession and the date of filing in bankruptcy.[28]

Pacific, however, holds that there must be an actual creditor who could have obtained a lien at the date of bankruptcy.[29] The construction in *Pacific* certainly appears to be more in line with the intent of *Lewis.* Since the chattel was not yet in the possession of the bankrupt, prior creditors would not have considered its value in determining whether to extend credit. Therefore, these creditors could not have been injured by a defective recordation, and there is no reason to give them a "windfall" just because the debtor has been forced into bankruptcy.

Chattel Mortgages. The Washington chattel mortgage filing statute makes any chattel mortgage of personal property void as to all prior and subsequent creditors, whether or not they have or claim a lien, if such mortgage is not filed within ten days of its execution.[30] The rule of the *Pacific* decision in requiring an actual creditor who could have obtained a lien will have no effect, for by force of the statute it makes no difference whether the creditor has a lien, and the mortgage is void as to both prior and subsequent creditors. Since the statute applies to

[25] 30 Stat. 563 (1898), 11 U.S.C. § 104(a) (1952).
[26] "On the one hand, the debt, demand or claim must involve a liability of the *bankrupt.*" 1 COLLIER, BANKRUPTCY 74-75 (14th ed. 1940). (Emphasis added.)
[27] See statute and amendment cited note 3 *supra.*
[28] *In re* Babcock Box Co., 200 F. Supp. 80 (D. Mass. 1961); *In re* Luckenbill, 156 F. Supp. 129 (E.D. Pa. 1957); National Oats Co. v. Long, 220 F.2d 745 (5th Cir. 1955); McKay v. Trusco Finance Co., 198 F.2d 431 (5th Cir. 1952).
[29] 304 F.2d at 228.
[30] RCW 61.04.020.

any possible creditor, and there has to be at least one creditor to have bankruptcy, § 70(c) would not be needed to give the trustee a lien. He could proceed to void the mortgagee's lien under § 70(e).[31]

The argument was made in *Pacific* that construing § 70(c) against the trustee would make it nugatory because it would be identical in operation with § 70(e).[32] This argument is certainly valid when applied to statutes similar to Washington's conditional sale and chattel mortgage statutes, where it is immaterial whether the creditor has a lien. If, however, either of these statutes protected only lien creditors, and there was a creditor at the date of filing in bankruptcy who could have obtained a lien but did not, the trustee could then proceed under § 70(c) and acquire the rights which such a creditor would have with a lien. But here the trustee could not proceed under § 70(e), for the trustee would acquire only the actual rights that the existing creditor had at the date of filing. This distinction clearly appears from the following discussion of the Washington bill of sale statute, a discussion which also demonstrates the practical application of both the *Lewis* and *Pacific* decisions.

Bill of Sale. The Washington bill of sale recordation statute protects existing creditors who obtain a lien between execution of the bill of sale and its recording, if such recording is not filed within ten days and the property is left in the possession of the vendor.[33]

Assume that a bill of sale is executed and the property is left in the possession of the vendor. The bill of sale is filed more than ten days after the sale, and a creditor who was owed a debt at the time of the sale does not acquire a lien prior to recordation. If a petition in bankruptcy is filed *after* the bill of sale is recorded, then the trustee is unable to defeat the sale under either § 70(c) or § 70(e). Section 70(e) is unavailable to the trustee because the intervening creditor failed to get a lien prior to recordation. Under the rule of the *Lewis* case, the trustee only acquires the rights of a lien creditor at the time

[31] Section 70(e) of the Bankruptcy Act, 30 Stat. 565 (1898), 11 U.S.C. §110(e) (1952), reads in part as follows: "(1) A transfer made or suffered or obligation incurred by a debtor adjudged a bankrupt under this title which, under any Federal or State law applicable thereto, is fraudulent as against or voidable for any other reason by any creditor of the debtor, having a claim provable under this title, shall be null and void as against the trustee of such debtor."

[32] 304 F.2d at 230.

[33] RCW 65.08.040. In Umbarger v. Berrian, 195 Wash. 348, 80 P.2d 818 (1938), the court construed "existing creditor," as used in the bill of sale statute to mean a creditor who had acquired intervening rights after its execution and before its recordation.

of bankruptcy, and by that date the bill of sale has been perfected so that no lien creditor can attack it.

However, if the example is altered so that at the date of filing in bankruptcy there has been no recordation of the bill of sale, then the outcome is substantially different. Section 70(e) is still unavailable to the trustee, for the actual creditor did not have a lien as required by Washington law. But the trustee is successful under section 70(c). Since there is an actual creditor in existence who could have obtained a lien at the date of the filing of the petition, the trustee will be clothed with the same rights which that creditor would have had at the date of bankruptcy if the creditor had by then acquired a lien. Therefore, since the bill of sale was not recorded at the date of filing in bankruptcy and under Washington law a lien creditor at that date can attack the bill of sale, the trustee will be able to successfully attack it.

Conclusion. Under the construction given to § 70 by some courts, the trustee, under the Washington recordation statutes, could set aside a defectively filed conditional sale contract or chattel mortgage in any situation.[34] However, since the *Pacific* decision requires that there be in existence at the date of filing in bankruptcy an actual creditor who could have acquired a lien, the conditional vendor will not be as vulnerable to attack as before, nor as vulnerable as the chattel mortgagee.

The decision of *Pacific* is believed to be the correct one, for unless there is a general creditor who has been injured by the secret lien, the secured creditor should be allowed to retain his preferred position. This position has support in other circuits.[35] The rule developed by *Pacific* is a needed refinement on the objective of the *Lewis* decision, namely, to reestablish the balance between the interests of secured and unsecured creditors in bankruptcy.

JOHN S. CALVERT

[34] *In re* Dumont-Airplane & Marine Instruments, Inc., 203 F. Supp. 511 (S.D. N.Y. 1962); *In re* Luckenbill, 156 F. Supp. 129 (E.D. Pa. 1957); McKay v. Trusco Finance Co., 198 F.2d 431 (5th Cir. 1952).

[35] *In re* P.T.G. Grain Service, 185 F. Supp. 332 (D. Minn. 1960); *In re* Billings, 170 F. Supp. 253 (W.D. Mo. 1959); *In re* Central Connecticut Screw Machine Co., 168 F. Supp. 718 (D. Conn. 1958). The *Billings* case was criticized in 57 MICH. L. REV. 1227, 1238 (1959), where the writer said, "Although the result of the *Billings* case is sound, it appears that the underlying reasoning is perhaps incorrect. To say that no hypothetical creditor on the date of bankruptcy could avoid the chattel mortgage because no rights of actual creditors intervened in the interim is to say that the trustee's rights under section 70c are derivative rights, dependent on the existence of actual creditors. This is clearly contrary to the statute."