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Edwin W. Hadley

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FRAUDULENT CONVEYANCE AS AN ACT OF BANKRUPTCY

FRAUDULENT conveyances are voidable transactions; they are also acts of bankruptcy; they also have other uses in bankruptcy proceedings. But for all these purposes, involving different parties and different social ends, are fraudulent conveyances always the same sort of thing? Human ideas, like human words, are prone to ambiguity and confusion. The ultimate problem of this article is: Can a transaction which is not voidable nevertheless be enough of a fraudulent conveyance to be an act of bankruptcy?

An essential element of an involuntary petition in bankruptcy is the allegation and proof of an "act of bankruptcy," committed by the debtor within four months of the date of filing the petition against him.¹ A debtor is to have his assets taken away from him for administration on behalf of his creditors only if there is evidence that it is unsafe to leave this task to the debtor himself. Acts of bankruptcy are listed in section 3a of the Bankruptcy Act; and first on the list is "conveyed, transferred, concealed, or removed, or permitted to be concealed or removed, any part of his property with intent to hinder, delay, or defraud his creditors, or any of them."² The statutory list of acts of bankruptcy

¹ Bankruptcy Act § 3b.

² Bankruptcy Act § 3a (1).

is strictly exclusive; the courts will not enlarge it, on principles of equity, to include conduct merely analogous to that listed.³

Suppose that we have proof of a clear conveyance or transfer of his property by the debtor, and we want to test it for use as the first act of bankruptcy just recited. The immediate question arises as to *what evidence* is sufficient to prove that the act was done with an *intent* to hinder, delay, or defraud creditors. On this the statute is silent. The federal courts might have worked out their own rules of proof, using decisions from other tribunals merely as persuasive authority. The usual rule, however, has been that on this matter of intent to delay or defraud, a federal court sitting in bankruptcy will look to and follow the law of the state wherein the transaction occurred.⁴

How do states come to have any law on this matter? At common law, a conveyance intended to delay or defraud one's creditors came to be held void as to creditors, although valid as between transferor and transferee. Creditors could attach the property as though it still belonged to the debtor-transferor, unless the transferee was a *bona fide* purchaser for value. This principle was codified in the famous *Stat. 13 Eliz. (1570) c. 5*, which also provided for punishment on a criminal basis. This process of ignoring the conveyance, however, involved some hazards to the creditor, such as a liability for conversion if it should turn out that the conveyance was not fraudulent or that the transferee was a *bona fide* purchaser for value. Therefore equity came to fill the inadequacy at law by giving relief on a bill, filed by a creditor, to have a fraudulent conveyance avoided or cancelled. Around these basic principles of common law and equity a considerable body of case-law grew up, concerned with the kinds of evidence which, as a matter of human

³ In re Empire Co., 98 Fed. 981 (1899); In re Ceballos Co., 161 Fed. 445 (1908).

⁴ Peters v. Bain, 133 U. S. 670 (1890).

experience, show that a debtor-transferor has an intent to hinder or defraud his creditors. These principles and cases were taken over by our states as part of the common law, with local variations and additions based on differences of theory and experience.

In all states it is agreed that, when a creditor seeks to ignore or avoid a conveyance, and the matter gets before a court of law or equity, the wrong done by the debtor-transferor to his creditor must be balanced against the acquired rights of the transferee. If the transferee is a purchaser for value, who took without knowledge of the intent of the transferor, it is unfair to take the property away from him. As between him and a creditor who gave credit without taking security in the property, the creditor may be deemed to have taken the chance of such a transfer, and the purchaser should be protected in his title. Therefore the English and American decisions on this matter have agreed that for a creditor to ignore or avoid a conveyance on the ground of fraud or delay *two distinct elements* of evidence must be proved. First, the evidence must show that the debtor-transferor had an intent, actual or constructive, to delay or defraud his creditors; second, it must show that the *transferee* participated in, knew of, or was fairly chargeable with the intent of his transferor.

Now, in the course of a federal bankruptcy proceeding, a fraudulent conveyance may have to be dealt with from several points of view. One aspect is the same as that which we have just discussed as evolved at common law. The trustee in bankruptcy represents the creditors, in part, and is empowered by the federal statute to avoid or ignore a fraudulent conveyance made within four months of the petition⁵ and to avoid any transfer which a creditor might have avoided.⁶ Thus, if the bankrupt debtor made a conveyance with

⁵ Bankruptcy Act § 67e.

⁶ Bankruptcy Act § 70e.

intent to delay or defraud his creditors, the trustee may ignore the conveyance and retain or attach the property, or he may bring a bill in equity for cancellation and restoration. On this matter the same double test of evidence is required as is necessary under state law. The intent of the debtor-transferor makes the transaction fraudulent; the intent or knowledge of the transferee make his title void or voidable. If the transferee took *bona fide* and for value, his title will prevail against the claims of the trustee in bankruptcy.

But suppose that a conveyance with intent to delay or defraud creditors is being used in a federal bankruptcy proceeding as an *act of bankruptcy*; should the same double evidentiary burden be required? An answer to this question depends upon an understanding of the reason why an "act of bankruptcy" is required to support an involuntary petition.

An act of bankruptcy is a "red flag," which gives warning that there is need, in fairness to creditors, to take over the assets of a debtor and put them *in custodia legis*. The various "acts" set out as acts of bankruptcy in our federal statute are occurrences which indicate that if the debtor is left in control of his property his creditors as a whole are very apt to suffer. These listed occurrences range from intentional crookedness to mere incompetency, giving warning that the assets are in a process of depletion. It is the management of his estate by the debtor which is the point of inquiry, the inquiry being put in motion by creditors who have seen cause to fear for their claims if the debtor continues to control his assets.

In view of this purpose, it is submitted that the conduct of the *debtor-transferor alone* is of importance in determining whether a "red flag" of warning has been raised in the form of a conveyance to hinder, delay, or defraud creditors. Knowledge of or chargeability with the debtor's fraudulent

purpose on the part of the transferee is quite beside the point, and no rights of the transferee are at issue in the point which is before the federal court, sitting in bankruptcy for adjudication. Some participation by the transferee is necessary in order to prove that it is fair and proper to take the property away from him, but it is not necessary in proving that the debtor-transferor has committed the first act of bankruptcy and ought to have *the remainder* of his assets taken away from *him*. The Bankruptcy Act itself says nothing about the transferee in connection with the first act of bankruptcy, merely specifying the intent of the debtor in the transfer.

It would seem that this distinction, between the evidence required to show a fraudulent conveyance as an act of bankruptcy and as a void or voidable transaction, is logical and clear. And yet the distinction has been ignored or confused in decisions, texts and casebooks.

Perhaps the confusion under the present Bankruptcy Act dates from the opinion of the District Court in New York in the case of *In re Gillette*.⁷ A special master had found and reported an act of bankruptcy by the debtor, in the form of a transfer with intent to hinder, delay, or defraud. The court, at the start of its opinion, says that it sustains "the report of the special master in reference to the acts of bankruptcy" on the ground that the *transferee knew* that the debtor-transferor was insolvent. Later in the opinion the court talks about the transfer as a preference, thus weakening its hint that both transferor and transferee must participate in the fraud in order to prove the first act of bankruptcy.⁸

⁷ 104 Fed. 769 (1900).

⁸ But if the transfer was a preference, the court was still wrong in requiring participation by the transferee. In making a preference an act of bankruptcy, the Bankruptcy Act, § 3a, merely specifies a transfer with intent by the debtor to prefer, although a later section allows the trustee to avoid a preference only when the creditor-transferee knew or had reasonable cause to believe that he was being preferred. This distinction has been noted in judicial decisions, which have de-

This hint was made the matter of a square decision in *Githens v. Shiffler*.⁹ An involuntary petition had been filed, using as its act of bankruptcy a sale for cash in which the debtor-vendor intended to hide out the cash and use it to pay certain creditors and delay others. The court dismissed the petition, on the ground that there had been no act of bankruptcy because the transferee paid full value and was innocent of the purpose of the debtor-transferor. In its scanty argument on this point, the court did not even recognize that there might be a distinction between fraud as an act of bankruptcy and fraud as a void or voidable transaction. Being familiar with the evidentiary rule of the common law and equity, requiring proof of a fraudulent intent in both parties, the court carelessly declared that the *same tests* must be fulfilled in finding a fraudulent conveyance as an act of bankruptcy, ignoring the fact that the parties and the social ends to be served are different in the two proceedings.

Many subsequent decisions, without seeming to see the problem, generally speak only about the intent of the debtor-transferor in testing a fraudulent conveyance as an act of bankruptcy.¹⁰ It is hard to tell whether they disagree with *Githens v. Shiffler*, for they frequently cite state or federal avoidance cases as to the sufficiency of certain evidence as proof of a badge of fraud. Many other subsequent decisions state loosely that the language of the federal statute which makes an act of bankruptcy out of conveyances to hinder, delay, or defraud means just the same as the common law

clared that the state of mind of the preferred creditor is unimportant when the preference is being used as an act of bankruptcy. In *re Rome Planing Mill*, 96 Fed. 812 (1899); In *re Ed. W. Wright Lumber Co.*, 114 Fed. 1011 (1902); In *re Truitt*, 203 Fed. 550 (1913).

⁹ 112 Fed. 505 (D. C. Pa., 1902).

¹⁰ *E.g.*, see *Brickell v. Bond Corp.*, 36 F. (2d) 865 (5th C. C. A., 1930); In *re George Lampros, Inc.*, 18 F. (2d) 633 (D. C. Mass., 1927); *Merchant's Nat. Bank v. Cole*, 149 Fed. 708 (6th C. C. A., 1907); *Bean-Chamberlain Co. v. Standard Spoke Co.*, 131 Fed. 215 (6th C. C. A., 1904); In *re McLoon*, 162 Fed. 575 (1908), in which *avoidance* cases are cited as though they were fully in point.

and the Statute of Elizabeth. An interesting example is *Johnson-Baillie Shoe Co. v. Bardsley*.¹¹ At page 765 the court says: "Did this mortgage in itself establish the intent of the mortgagors to hinder, delay and defraud . . . and hence the act of bankruptcy specified in section 3, subdivision 1, of the Bankruptcy Law?" At page 768 the court points out that there was no proof that "the mortgagors made this mortgage with any intent to hinder, delay or defraud." These statements seem interested only in the fraudulent intent of the debtor-mortgagor. But at page 767 the court says: "Section 3, subdivision 1, must have the same construction as the statute of Elizabeth," citing *Githens v. Shiffler*!

The decision in *Githens v. Shiffler* has been somewhat discredited in a marginal note to *Dean v. Davis*;¹² but the Supreme Court was there dealing with an avoidance action, not an act of bankruptcy. It criticizes the earlier decision as to the sufficiency of certain evidence, but says nothing about the problem of two (or more) different uses for fraudulent conveyances.

In *Coder v. Arts*¹³ the decision involved the voidability of a conveyance, and the court held that for this purpose "Congress, in enacting [§] 67e, and using the terms 'to hinder, delay or defraud creditors,' intended to adopt them in their well-known meaning" as developed at the common law. This is true enough. But the court goes on to say: "The same terms are used in § 3, subdivision 1, in which it is made an act of bankruptcy . . ." Does the court mean to hint that the words in section 3 must be given the same interpretation as those in section 67e, and hence that evidence that the transferee participated in the intent of the debtor-transferor is *always* required? The language is careless, but probably the court did not have our present problem in mind; it will

¹¹ 237 Fed. 763 (8th C. C. A., 1916) (In Remington's Cases on Bankruptcy the page is cited erroneously as 673.).

¹² 242 U. S. 438 (1917).

¹³ 213 U. S. 223 (1909).

take clearer language before we can say that the Supreme Court has adopted the unsound view of *Githens v. Shiffler*.

The nearest thing to a judicial recognition of our contention has been provided by the District Court in Illinois, in the case of *In re Smith*.¹⁴ A motion had been made to dismiss an involuntary petition, one of the grounds being that an allegation of the participation of the transferee in a fraudulent conveyance, which was the act of bankruptcy, was too hazy and on mere information and belief. The court denied the motion, holding that the haziness was unimportant because the allegation as to the transferee was mere surplusage "when we remember that this is not a suit against the transferee to recover the property conveyed."

The confusion which we have noted in the cases appears also in most of the text-books.

In speaking of fraud as an act of bankruptcy, Collier says loosely that the words of section 3 of the statute have the "same meaning, construction and effect" as have been attributed at common law and under the Statute of 13 Elizabeth.¹⁵ In Remington on Bankruptcy, in which the problem is at least partly recognized, the false rule of *Githens v. Shiffler* is stated as law; speaking of fraud as an act of bankruptcy, the text says: "Participation of the transferee in the fraudulent design must be shown, in accordance with the usual rules as to fraudulent transfers."¹⁶ Neither of these texts gives any discussion on the point. They do not support their statements by intelligible authorities; they show no realization that a petition in bankruptcy and an avoidance proceeding involve different parties and different social purposes; they do not remark on the fact that section 3 of the federal statute speaks only of the intent of the debtor-transferor.

¹⁴ 14 Fed. (2d) 464 (1926).

¹⁵ 1 Collier on Bankruptcy (13th ed., 1923) 128.

¹⁶ 1 Remington on Bankruptcy (3rd ed., 1923) 168. The same statement appears in the 2nd ed. (1915), at page 126.

Corpus Juris, citing *Githens v. Shiffler*, says: "The fraudulent nature of the conveyance or transaction is to be determined by the same tests as would determine whether it was voidable at common law."¹⁷ No reference is made to the lack of logic in this position.

This same confusion is carried over, indirectly, into most of the casebooks on Bankruptcy.

In Williston's Cases on Bankruptcy (2nd ed., 1915), under a chapter on acts of bankruptcy, thirty cases on conveyances to delay or defraud are given. Of these cases, nineteen are state actions to avoid or disregard the conveyance, two are similar federal-court actions, eight are similar proceedings in England, and one is an English criminal case. There is not a single case on fraudulent conveyance as an act of bankruptcy.

In the Cases on Bankruptcy by Holbrook and Aigler (2nd ed., 1927) thirty-one cases on fraudulent conveyances are printed under the heading of acts of bankruptcy, as part of the general topic of "Prerequisites to Adjudication." Of these cases, twenty are state actions to avoid or disregard, five are similar federal actions, four are similar actions in England, and one is an English criminal prosecution against the transferee; only *one case* is a federal proceeding in which fraud is passed upon as an act of bankruptcy.

In Remington's Cases on Bankruptcy (1926) fraudulent conveyances as acts of bankruptcy are printed under the adjudication problem; as void or voidable transactions they are printed under the administration problem. This severance, however, does not result in any recognition of our present problem. Under the first heading only two cases, one a short extract, are given. One of them is the opinion of the Eighth Circuit Court of Appeals, to which we have

¹⁷ 7 C. J. 50, Title "Bankruptcy."

referred, in which a dictum cites the proposition and authority of *Githens v. Shiffler*.¹⁸

The closest thing to recognition of the point of this paper appears in Britton's Cases on Bankruptcy (1928). At page 83 the author says: "The Bankruptcy Act makes various uses of fraudulent conveyances, but it does not always use the same fraudulent conveyances which it uses in other connections. . . . in the study of bankruptcy close attention must be paid to the question: Which particular type of fraudulent conveyance is involved in the matter then under discussion?" Professor Britton gives no cases under the adjudication problem, however, and later on under the administration problem all of his cases on fraudulent conveyances are concerned with them as void or voidable transactions in which the intent or knowledge of the transferee is important.

In conclusion, it may be noted that failure to make the distinction which we have been discussing may lead to two ill results.

First, it may cause involuntary petitions to be dismissed for lack of an act of bankruptcy when they really should be sustained. This result was reached consciously in *Githens v. Shiffler*. Perhaps it has occurred unconsciously, without leaving a trace in the record, in many other instances. Those who watch the bankruptcy decisions will have noted the decline in the use of conveyances to delay or defraud as an act of bankruptcy. This seems to be based on the difficulty of advancing sufficient proof to satisfy the court. May it be that the courts are demanding too much proof, because they think that a fraudulent conveyance is always the same sort of thing and do not wish to prejudice the right of the transferee to hold the property or the right of the bankrupt to receive a discharge? If they realized that fraud as an act of bankruptcy proves nothing as to the rights of the

¹⁸ Johnson-Baillie Co. v. Bardsley, 237 Fed. 763 (1916).

transferee, and may be different from the fraud which bars a discharge, they might feel more free in sustaining involuntary petitions. As an act of bankruptcy, or a danger signal, fraud should be treated as a generalization which includes constructive as well as actual intent. It seems reasonable to say that Congress intended the "intent to delay" to be just as important as the intent to defraud, as far as signs of danger to creditors are concerned, and that this was to be quite a different problem than that of discharge or avoidance.

Another danger which may flow from failure to make the distinction for which we have been contending is that when a conveyance has been found, as the first act of bankruptcy, this adjudication may be given improperly heavy weight in subsequent proceedings concerning the rights of the transferee or discharge of the bankrupt. If it is recognized that the parties, social ends, and elements of fraud are different in these various proceedings, then an adjudication of bankruptcy based on a conveyance to delay or defraud should be admitted in evidence in either of the other two proceedings only when it was expressly found to be actual fraud,—or perhaps not at all. If "delay or defraud" means two or more different things, then such conduct may be proved sufficiently for one purpose when the evidence would not prove it for some other purpose.

Edwin W. Hadley.

Northeastern University, Boston, Massachusetts.