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Recommended Citation

Arthur John Keeffe, John J. Kelly Jr., and Myron S. Lewis, *Sick Sixty A Proposed Revision of Section 60A of the Bankruptcy Act*, 33 Cornell L. Rev. 99 (1947)
Available at: <http://scholarship.law.cornell.edu/clr/vol33/iss1/5>

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SICK SIXTY

A Proposed Revision of Section 60A of the Bankruptcy Act.

ARTHUR JOHN KEEFFE, JOHN J. KELLY, JR., AND MYRON S. LEWIS

Think of the effect on business if the headlines of the Wall Street Journal this morning proclaimed: *Supreme Court Voids All Security Devices as Bankruptcy Preferences*. While such a catastrophe is not yet upon us, its probability has been foreshadowed by the wording of Section 60a¹ of the Bankruptcy Act and the logical implications of *Corn Exchange National Bank and Trust Co. v. Klaunder*.²

PRESENT PREFERENCE LAW

Section 60a of the Bankruptcy Act defines a preference as any transfer made for an antecedent debt within four months before the filing of a petition in bankruptcy which transfer enables a creditor to get a greater percentage of his debt than other creditors of this same class if the transfer is made while the debtor is insolvent.³ There is nothing new or startling in this definition of a preference. Much the same idea has obtained in preference definitions in earlier Anglo-American bankruptcy legislation.⁴

In the Chandler Act of 1938,⁵ this conventional definition was changed

¹52 STAT. 869 (1938), 11 U.S.C.A. § 96 (1943).

²318 U. S. 434, 63 Sup. Ct. 679 (1943). This is the only case thus far decided under Section 60a by the Supreme Court.

³52 STAT. 869(a) (1938), 11 U.S.C.A. § 96(a) (1943); (a) A preference is a transfer, as defined in this title, 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 in bankruptcy, or of the original petition under chapter 10, 11, 12 or 13 of this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class. For the purposes of subdivisions a and b of this section, a transfer shall be deemed to have been made at the time when it became so far perfected that no bona-fide purchaser from the debtor and no creditor could thereafter have acquired any rights in the property so transferred superior to the rights of the transferee therein, and, if such transfer is not perfected prior to the filing of the petition in bankruptcy or of the original petition under chapter 10, 11, 12 or 13 of this title, it shall be deemed to have been immediately before bankruptcy.

⁴The same general concept of a preference was used in the Act of July 1, 1898, c. 541 § 60, 30 STAT. 562 (1898). Today a preference holder is penalized by allowing the trustee in bankruptcy to recover back from the preferred creditor the amount of the preference; in England in earlier days the penalty was slightly more personal in that the bankrupt himself paid for the preference by the loss of one ear and exhibition in the local pillory for two hours. 3 COLLIER, BANKRUPTCY 60.04 (14th ed., Moore and Oglebay 1941).

⁵52 STAT. 840 (1938), 11 U.S.C.A. § 1 (Supp. 1946).

by adding a provision that a transfer is not made until it is perfected, and further that no transfer is perfected if a bona fide purchaser or any creditor can obtain an interest in the security superior to that of the transferee. If not so perfected against bona fide purchasers and creditors, the transfer shall be deemed perfected immediately before bankruptcy, and hence within the four months preference period. And unless such a transfer be so perfected more than four months before bankruptcy, it is voidable and recoverable back by the trustee in an action under Section 60(b)⁶ on a showing that at the time of the transfer the creditor had reasonable cause to believe the bankrupt insolvent.

Before 1943, there was much speculation as to the real meaning of these changes.⁷ Was the Act designed to settle controversies merely between *actual* subsequent bona fide purchasers or creditors, or did it intend to strike down as a preference any transfer where a *potential* bona fide purchaser or creditor (even though in fact none existed) could get superior rights in the security?

This speculation was set to rest by the Supreme Court in *Corn Exchange National Bank and Trust Co. v. Klaunder*,⁸ where the Court clearly adopted the view that, if a *potential* bona fide purchaser or creditor can obtain a superior right, the transfer is a voidable preference, saying:

"This is undoubtedly the effect of a literal reading of the Act. Its apparent command is to test the effectiveness of a transfer, as against the trustee, by the standards which applicable state law would enforce against a good-faith purchaser. Only when such a purchaser is precluded from obtaining superior rights is the trustee so precluded. So long as the transaction is left open to *possible intervening rights* to such a purchaser, it is vulnerable to the intervening bankruptcy."⁹ (Italics added.)

Under 60a, as thus interpreted, the practical difficulty is that the following credit devices become imperfect transfers and voidable preferences:

1. Trust receipts,¹⁰

⁶52 STAT. 870 (1938), 11 U.S.C.A. § 96(b) (1943).

⁷In 1940 the Fifth Circuit held that section 60(a) did not declare a transfer a preference if made for present consideration despite the possibility of a potential bona fide purchaser obtaining superior interests in the security. *Adams v. City Bank & Trust Co.*, 11 F. 2d 453 (C. C. A. 5th 1940), *cert. denied*, 312 U. S. 699, 61 Sup. Ct. 739 (1941). However, the Maryland District Court held in 1941 that the statute referred to a potential bona fide purchaser or a potential creditor. *In re Seim Construction Co.*, 37 F. Supp. 855 (D. Md. 1941); see also Mulder, *Ambiguities in the Chandler Act*, 89 U. of PA. L. REV. 10, 22 (1940); McLaughlin, *Aspects of the Chandler Bill to Amend the Bankruptcy Act*, 4 U. OF CHI. L. REV. 369, 389 (1936).

⁸318 U. S. 434, 63 Sup. Ct. 679 (1943).

⁹*Id.* at 436, 63 Sup. Ct. at 679.

¹⁰UNIFORM TRUST RECEIPTS ACT § 9, 9 U.L.A. 687, provides that a bona fide purchaser

2. Conditional sales for resale,¹¹
3. Factoring agreements,¹²
4. Blanket chattel mortgage arrangements,¹³
5. Assignment of accounts receivable in jurisdictions where notice to the principal debtor is necessary to perfect the assignment.¹⁴

Each is voidable in bankruptcy for one reason and one alone—that a bona fide purchaser acquires better title to the security than the lienor.¹⁵

For instance, as every business man knows, the automobile dealer gives a trust receipt to his banker on the distinct understanding that any bona fide purchaser of the car on his floor will obtain a better title to the car than the dealer derives from the trust receipt. This transaction is a preference under Section 60a.

A security device doomed to failure in bankruptcy is useless since the purpose of security is not so much to prevent dishonesty as it is to secure a preferred position in insolvency or bankruptcy proceedings. Because of its devastating effect on the above security devices, if for no other reason, the present preference section should be torn out by the roots.

In the *Klauder* case¹⁶ the Court made it equally clear that if either a purchaser or creditor can obtain higher rights than the security holder the transfer will be preferential.¹⁷

takes free of the security holder's lien. This act has been adopted in twenty-one American jurisdictions, including New York, California, Massachusetts, New Jersey, Pennsylvania, and Illinois. See also, Note, 26 CORNELL L. Q. 306 (1941).

¹¹UNIFORM CONDITIONAL SALES ACT § 9, 2 U.L.A. 15, provides that a bona fide purchaser may obtain a superior title to the security holder if goods are expressly or impliedly intended for resale. Twelve jurisdictions have adopted this act.

¹²N. Y. PERS. PROP. LAW § 43 provides that bona fide purchasers from a factor shall take title superior to the lienor. Much postwar financing, especially in the electrical field, has been done through the use of this credit device. Ireton, *Trust Receipts and Factors' Liens* (1945) Proc. Section of Corp. Banking and Mercantile Law A. B. A. 106.

¹³N. Y. LIEN LAW § 230-c provides for filing for doing a continuous chattel mortgage business in automobiles and § 230-c(6) provides that the bona fide purchaser shall take free of the mortgagee's interest.

¹⁴These states follow the English rule of *Dearle v. Hall*, 3 Russ. 1, 38 Eng. Rep. 475, 10 Eng. Rul. Cas. 478 (1823, 1827). For the most recent analysis of the state of the law in American jurisdictions see Kessler, *Assignment of Accounts Receivable*, 33 CALIF. L. REV. 40, 70 (1945); Kupfer and Livingston, *Corn Exchange National Bank & Trust Company v. Klauder Revisited*, 33 VA. L. REV. 1 (1947).

¹⁵The above are not the only credit devices that fall. Others also fall because creditors can obtain better title. In re Gruner, 295 N. Y. 510, 68 N.E. 2d 514 (1946); note, 32 CORNELL L. Q. 402 (1947).

¹⁶*Corn Exchange National Bank & Trust Co. v. Klauder*, 318 U. S. 434, 63 Sup. Ct. 679 (1943).

¹⁷*Id.* at 439, 63 Sup. Ct. at 682. Since the *Klauder* case, In re Vardaman Shoe Co., 52 F. Supp. 562 (E.D. Mo. 1943) extended the potential test to transfers occurring in jurisdictions where Section 173 of the Restatement of the Law of Contracts called the

In view of this literal interpretation, it is possible that the next *Klauder* case will hold all security devices voidable by the trustee in bankruptcy since *potential* creditors always obtain superior rights to those of a security holder.

If what 60a means is that any security transfer is voidable if any potential creditor can obtain an interest in the security superior to the transferee (whether he has done so or not), then what security can he safely taken?

Take X who makes a loan to the bankrupt and receives back an ordinary real estate mortgage five years before bankruptcy. The property of the bankrupt may always become subject to unpaid state real estate taxes. These taxes, though subsequent to the mortgage loan are by statute made prior to the lien of the mortgage even though the lien accrues only days before bankruptcy. Thus the state within the meaning of 60a is *potentially* a superior creditor and under the test of 60a the mortgage is a voidable preference since not perfected against this eventuality, and therefore deemed to be made immediately prior to bankruptcy.

In addition to the omnipresent state and federal tax lien priorities,¹⁸ there are in many jurisdictions artisans' liens¹⁹ and other statutory liens²⁰ which are accorded special priority superior to the rights of any security holder.

Thus, under the literal wording of 60a certain creditors can always get higher rights than any security holder, and therefore all security devices may be voidable preferences.

Though the above result is theoretically possible and logically compelling neither the authors nor a realistic reader, we are sure, will seriously contend that the Supreme Court should or would go so far. It would completely upset credit financing. But the fact remains that this is the clear command of the present statute and our point is that ambiguity of this sort is not de-

"four horseman" rule applies. However, the later Circuit Court case *In re Rosen*, 157 F. 2d 997 (C. C. A. 3d 1946), *cert. denied*, — U. S. —, 67 Sup. Ct. 972 (1947) refused to extend the potential bona fide purchaser test. For a detailed comparison of the two cases see Kupfer and Livingston, *Corn Exchange National Bank & Trust Company v. Klauder Revisited*, 32 VA. L. REV. 910 (1946), 33 VA. L. REV. 1 (1947).

¹⁸REV. STAT. § 466 (1875), 31 U.S.C.A. § 191 (1940). Note, 56 YALE L. J. 1258 (1947). But compare Clark, *Federal Tax Liens and Their Enforcement*, 33 VA. L. REV. 13 (1947). In accord with the writers position is *In re Read-York Inc.*, 152 F. 2d 313 (C. C. A. 7th 1945) where a federal statutory lien was given priority over a prior private lien. For analysis of theory and cases see Kupfer and Livingston, *op. cit. supra* note 17, 32 VA. L. REV. 910, 926 (1946).

¹⁹52 STAT. 876 (1938), 11 U.S.C.A. § 107 (b) (1943); Snedeker, *Security Devices as Preferences under the Bankruptcy Act*, 8 MO. L. REV. 85, 91-93, n. 23 (1943).

²⁰52 STAT. 876 (1938), 11 U.S.C.A. § 107 (b) (1943). See *Illinois v. Campbell*, 329 U. S. 362, 67 Sup. Ct. 340 (1946) involving ILLINOIS STAT. ANN. (Jones 1944) § 45.154 (e) which gives a lien to the state on "all the personal property" for state unemployment compensation taxes.

sirable in a statute such as 60a governing ordinary every day business transactions.

The drastic defects of the present section 60 have been exhaustively presented in recent legal periodicals.²¹ Our purpose is not to go into elaborate detail as to its deficiencies, but rather to analyze the bill to revise 60a which has been recently introduced into the House²² and Senate,²³ and to suggest improvements in the bill.

THE PROPOSED BILL TO AMEND 60A

In response to the dissatisfaction aroused by the *bona fide purchaser* test and its literal construction in the *Klauder* case²⁴ the American Bar Association, Section on Corporations, Banking and Mercantile Law appointed a committee²⁵ to draft a revision of Section 60a. The committee proposal, with slight alteration, is currently before Congress.²⁶

²¹McLaughlin, *Defining a Preference in Bankruptcy*, 60 HARV. L. REV. 233 (1946); Hanna, *Some Unsolved Problems under Section 60A of the Bankruptcy Act*, 43 COL. L. REV. 58 (1943); Ireton, *A Proposal to Amend Section 60A of the Bankruptcy Act*, A6 CORP. REORG. 257, 287 (1947); Snedeker, *Security Devices as Preferences under the Bankruptcy Act*, 8 MO. L. REV. 85 (1943); Oglebay, *Proposed Revision of Section 60A of the Bankruptcy Act: A Step Backward*, 21 J. N. A. REF. BANKR. 54 (1947); Mulder, *Ambiguities in the Chandler Act*, 89 U. OF PA. L. REV. 10 (1940); Kupfer and Livingston, *Corn Exchange National Bank & Trust Company v. Klauder Revisited*, 32 VA. L. REV. 910 (1946), 33 VA. L. REV. 1 (1947).

²²H.R. 2412, 80th Cong. 1st Sess. (1947). See Ireton, *A Proposal to Amend Section 60A of the Bankruptcy Act*, A6 CORP. REORG. 287 (1947).

²³S. 826, 80th Cong., 1st Sess. (1947); Ireton, *supra* note 22.

²⁴*Corn Exchange National Bank and Trust Co. v. Klauder*, 318 U. S. 434, 63 Sup. Ct. 679 (1943).

²⁵The special committee consisted of Messrs. Homer J. Livingston, Milton P. Kupfer, J. Francis Ireton, and Professors James A. McLaughlin and John Hanna. See Ireton, *A Proposal to Amend Section 60A of the Bankruptcy Act*, A6 CORP. REORG. 257 n. 2, 288 n. 2 (1947).

²⁶Ireton, *supra* note 25 at 287.

"a. (1) A preference is a transfer, as defined in this Act, 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 original 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: *Provided, however*, That this section shall have no application to proceedings under chapter IX of this Act.

"(2) For the purpose of subdivisions a and b of this section, and subject to the provisions of paragraph (3), a transfer shall be deemed to have been made or suffered at the time when it became so far perfected that no creditor obtaining under applicable law by legal or equitable proceedings on a simple contract a lien on such property without a special priority (whether or not such a creditor exists), could acquire, after such perfection, any rights in the property so transferred superior to the rights of the transferee therein, and if such transfer is not so perfected prior to the filing of the original petition initiating a proceeding under this Act, it shall be deemed to have been made immediately before the filing of such original petition: *Provided, however*, That where real property is transferred for or on account of an antecedent debt, the transfer

The new bill will correct many of the objectionable provisions in the present sixty and to the extent that it does so, the authors of the bill deserve the gratitude of the profession.

But the difficulty is that along with these beneficial changes there are certain dangerous and undesirable ones.

The chief purpose of this paper is to direct attention to these defects and ask their elimination.

Beneficial Changes

The outstanding change made by the Bill is the elimination of the *bona fide purchaser test*, and the substitution in its place of the *judgment creditor test*. In essence the judgment creditor test is this:—if a potential judgment could acquire interests in the security superior to those of the transferee, then the transfer is a preference voidable by the trustee in bankruptcy. Its chief advantage is that it saves desirable security devices such as trust receipts and others enumerated above which are preferences under the present statute since not perfected against bona fide purchasers. The draftsmen wisely inserted an express statement that the creditor test will be applied “whether or not such a creditor exists” thus avoiding possible misconstruction of their intention to provide a *potential judgment creditor test*.

shall be deemed to have been made at the time when it became so far perfected that no bona fide purchaser from the debtor could acquire, after such perfection, any rights in the property so transferred superior to the rights of the transferee therein.

“(3) A transfer, wholly or in part, for or on account of a new and contemporaneous consideration shall, to the extent of such consideration and interest thereon and the other obligations of the transferor connected therewith, be deemed to be made or suffered at the time of the transfer, unless the applicable law requires the transfer to be perfected by recording, delivery or otherwise, in order that no creditor described in paragraph (2) could acquire, after such perfection, any rights in the property so transferred superior to the rights of the transferee therein. A transfer to secure a future loan, if such loan is actually made, or a transfer which becomes security for a future loan, shall have the same effect as a transfer for or on account of a new and contemporaneous consideration. If any requirement specified in this paragraph (3) exists, the time of the transfer shall be determined by the following rules:

“I. Where (A) the applicable law specifies a stated period of time of not more than thirty days after the transfer within which recording, delivery, or some other act is required, and compliance therewith is had within such stated period of time or where such stated period of time is more than thirty days, and compliance therewith is had within thirty days after the transfer, the transfer shall be deemed to be made or suffered at the time of the transfer.

“II. Where compliance with the law applicable to the transfer is not had in accordance with the provisions of subparagraph I, the transfer shall be deemed to be made or suffered at the time of compliance therewith, and if such compliance is not had prior to the filing of the original petition initiating a proceeding under this Act, such transfer shall be deemed to have been made or suffered immediately before the filing of such original petition.”

The provisions in the statute that the test will be that of a judgment creditor's lien "without special priority" is excellent in that it effectively kills the possibility of any such horrendous calamity affecting the business world as that mentioned in our opening paragraphs. Thus the fictitious judgment creditor will not have the advantage of top priority statutory liens such as tax and artisans' liens with which to invalidate otherwise sound security devices.²⁷

As to real property transfers the new bill retains the *bona fide purchaser* test for the plain and sufficient reason that recording statutes universally provide for perfection of title against even good faith purchasers. Since real property transactions can be so easily perfected against bona fide purchasers, it was thought reasonable to require such perfection.

Another major improvement made by the new bill is to be found in subsection (3). Its effect is to save from the stigma of an antecedent debt for thirty days transfers for present and equivalent consideration whose perfection cannot be achieved simultaneously with the transfer.

For example, under the present statute if money is loaned today and a real property mortgage is executed and exchanged today to secure the loan but the recordation is delayed for so much as one day, perfection of the security transfer will take place tomorrow, and thus will be a security transfer for an antecedent debt (i.e. the antecedent debt being the loan made today). If the mortgagor should be adjudged bankrupt within four months of recordation, the mortgagee would hold but a voidable preference since the transfer was made (perfected) for an antecedent debt within four months of bankruptcy.

Under the new bill if the transaction is recorded within thirty days it will be saved from the antecedent debt ban and considered to have taken place at the time of the loan and actual security transfer,²⁸ provided state law allows thirty days or longer in which to record. Although this is in effect a "relation back" for a limited period of not to exceed thirty days, its usefulness is indicated by examples such as the above as well as by the practical impossibility in a complicated security transaction of perfecting the transfer simultaneously with the exchange of documents or actual transfer. This is not to be confused with the infamous "relation back" doctrine which will be discussed later in the paper.²⁹

²⁷*Id.* at 289. See also note 15 *supra*; *In re Gruner*, 295 N. Y. 510, 68 N. E. 2d 514 (1946) where other members of the New York Stock Exchange are given special priority and thus under present 60a would invalidate any loan on a member's seat; Note, 32 CORNELL L. Q. 402 (1947).

²⁸Ireton, *A Proposal to Amend 60A of the Bankruptcy Act*, A6 CORP. REORG. 287, 290.

²⁹*Sexton v. Kessler & Co.*, 225 U. S. 90, 32 Sup. Ct. 657 (1912); see note 39 *infra*.

Defects

There are two major defects in the proposed bill.

Defect One

The history of preference statutes until 1943 has been a series of frustrated attempts by the legislators to strike down secret equitable liens.³⁰ In holding that the *bona fide purchaser* test finally succeeded in emasculating secret liens, Mr. Justice Jackson writing for the Court said:

“. . . for thirty-five years Congress has consistently reached out to strike down secret transfers, and the courts have with equal consistence found its efforts faulty or insufficient to that end.”³¹

It is the contention of the writers that the proposed judgment creditor test is once again “faulty or insufficient to that end,”³² in that it revives with unimpaired vigor the inequities of the secret lien. The new bill fails to strike down secret equitable liens in all situations in which, under applicable state law, the equitable lienor acquires rights superior to those which a subsequent judgment creditor could obtain.

In the law of liens, equitable and secret liens are generally coextensive. Most equitable liens are secret, and most secret liens are equitable.³³ It is in their secrecy that the basic unfairness of equitable liens arises. The ordinary tradesman in his business transactions extends credit relying pretty much on appearances. He is not too concerned with the actual financial condition of his trade debtor so long as the debtor has sufficient visible assets, apparently unencumbered, such as a stock in trade or accounts receivable,

³⁰3 COLLIER, BANKRUPTCY § 60.48 (14th ed., Moore and Oglebay, 1941); Hanna, *Some Unsolved Problems under Section 60A of the Bankruptcy Act*, 43 COL. L. REV. 58 (1943); McLaughlin, *Aspects of the Chandler Bill to Amend the Bankruptcy Act*, 4 U. OF CHI. L. REV. 369 (1936); Neuhoff, *Assignment of Accounts Receivable as Affected by the Chandler Act*, 34 ILL. L. REV. 538 (1940); Mulder, *Ambiguities in the Chandler Act*, 89 U. OF PA. L. REV. 10 (1940); Hamilton, *The Effect of Section Sixty of the Bankruptcy Act upon Assignments of Accounts Receivable*, 26 VA. L. REV. 168 (1938).

³¹Corn Exchange National Bank & Trust Co. v. Klauder, 318 U.S. 434, 438, 63 Sup. Ct. 679, 682 (1943).

³²*Ibid.*

³³“The equitable lien is a dangerous and elusive enemy of the law of preferences. As applied to some bankruptcy cases it seems as well named as the Holy Roman Empire for it is neither equitable nor a lien.” McLaughlin, *Amendment of the Bankruptcy Act*, 40 HARV. L. REV. 341, 389 (1927).

Though equitable liens are usually secret this is not necessarily the case. Occasionally, a recordation of a legal lien will fail, for one reason or another, to establish the desired, legal lien. In such cases of failure of a legal lien, it is usually held that an equitable lien arises in its stead. In these cases, the lien is not necessarily secret, but still equitable.

out of which to satisfy his trade debt. Knowing that there are no recorded liens against the assets, he feels free to sell on the security of the debtor's assets. Does it not seem unjust to permit the holder of a secret lien, equitable in nature, to assert his lien in bankruptcy with rights superior to those of such a creditor? The injustice of such lien priority is aggravated when one realizes that the secrecy of such a lien is not accidental, but usually deliberate and closely guarded both by the favored creditor and the panicky debtor on the brink of insolvency.

During the past thirty years legislatures,³⁴ judges,³⁵ and writers³⁶ who have studied the equitable lien have almost unanimously concluded that it is an unfair preference of the most flagrant type.

To illustrate more graphically, consider *Sexton v. Kessler*³⁷ which so aroused the ire of the late Chief Justice Stone.³⁸

There stocks and bonds were placed in a vault in the bankrupt's place of business with a tag on them that they were to be security for a favorite creditor. The transfer was obviously imperfect because there was no actual delivery of the securities to the creditor until a few days before bankruptcy. Furthermore, there was a reservation of dominion in the bankrupt who reserved the right to go into the vault and substitute securities in the package as he desired.³⁹ The Supreme Court of the United States held that though the transfer was imperfect because of non-delivery of the securities, the creditor had a valid equitable lien good against creditors and the trustee in bankruptcy.

By statute New York has repealed the rule of this case as to stock and bonds only.⁴⁰

³⁴30 STAT. 562 (1898) and amendments. See also *Bankruptcy Act as Amended by the Chandler Act*, COLLIER-BENDER (Pamphlet Ed. 1938).

³⁵Corn Exchange National Bank & Trust Co. v. Klauder, 318 U. S. 434, 63 Sup. Ct. 679 (1943); Adams v. City Bank & Trust Co., 115 F. 2d 453 (C. C. A. 5th 1940), cert. denied, 312 U. S. 699, 61 Sup. Ct. 739 (1941).

³⁶*Ibid*; Mulder, *Ambiguities in the Chandler Act*, 89 U. OF PA. L. REV. 10 (1940); McLaughlin, *Aspects of Chandler Bill to Amend the Bankruptcy Act*, 4 U. OF CHI. L. REV. 369 (1936); Note, 34 YALE L. J. 891 (1925).

³⁷225 U. S. 90, 32 Sup. Ct. 657 (1912).

³⁸Stone, *The Equitable Mortgage in New York*, 20 COL. L. REV. 519 (1920).

³⁹In the case itself, the holding was that the transfer made a few days before bankruptcy "related back" to the date of the acquisition of the equitable lien that arose from the imperfect escrow. Thus, the transfer so "related back" was outside the four months period and the lien good in bankruptcy.

Proponents of the new bill contend that the obnoxious "relation back" doctrine has been struck down. It is admitted that "relation back" itself is not reinstated, but the same evil would obtain from the validation of equitable liens. The means would be different but the undesirable result the same.

⁴⁰N. Y. PERS. PROP. LAW § 230.

But in other states and in New York with respect to property other than stocks and bonds, the rule of *Sexton v. Kessler* will rise from the grave to plague the business world if we amend the present 60a by substituting the judgment creditor test of the proposed bill.

Secret equitable liens of the sort upheld in *Sexton v. Kessler* cannot be justified. Why should Congress in 1948 restore by statute the rule of *Sexton v. Kessler* that the late Chief Justice Stone so bitterly excoriated in 1920⁴¹ and which was, as the result of his efforts and the efforts of other scholars, was changed by the enactment of Section 60 in its present form in 1938?

Present Section 60 has faults but it does have the merit of destroying the rule of *Sexton v. Kessler* and no change in Section 60 can be considered that restores so rotten a rule.

Lest anyone suppose that the secret equitable lien is limited to a *Sexton v. Kessler* situation, let it be said that they are so numerous and of such infinite variety that great injustice will be done by any blanket recognition of their validity.⁴²

The prime evil of secret equitable liens is that they lead to a mad scramble for the insolvent debtor's assets, wholly uncontrolled by any just and reasonable pro rata distribution of the bankrupt's estate. Voidable preferences are established by statute to assist in formulating a fair and impartial balance between secured and unsecured creditors of a bankrupt.⁴³ If equitable liens are not included in the Bankruptcy Act as preferences, then much of the force and justice of the preference section is lost.

How to Cure Defect One

Our recommendation is that there be inserted in subsection (2) of the House and Senate Bills a proviso reading:

"For the purposes of this section such a creditor shall be deemed to have an interest superior to that of any equitable lienor."

This proposal retains the principal advantage of the present law in requir-

⁴¹Stone, *The Equitable Mortgage in New York*, 20 COL. L. REV. 519, 531 (1920).

⁴²In at least eighteen states today some form of equitable liens give the lienor rights superior to that which a judgment creditor may acquire. For analysis of jurisdictions where and situations in which equitable lienors prevail over judgment creditors see POMEROY, *EQUITY JURISPRUDENCE* § 721-23 (5th ed. 1941).

Recognition of the fact that a judgment creditor test would reinstate equitable liens may be found in *In re Seim Construction Co.*, 37 F. Supp. 855, 858 (D. Md. 1941).

⁴³McLaughlin, *Defining a Preference in Bankruptcy*, 60 HARV. L. REV. 233, 234 (1946); McLaughlin, *Amendment of the Bankruptcy Act*, 40 HARV. L. REV. 341, 390 (1927); see also note 21 *supra*.

ing an high degree of perfection of security devices, and cures its worst fault, the invalidation of many useful security devices.

The suggestion will undoubtedly be attacked on the ground that it will raise the trustee in bankruptcy to a preferred status in which he does not theoretically belong. The argument roughly is that since after the filing of the petition he has only the status of a simple judgment creditor, he should not have a preferred status as regards the four months period preceding bankruptcy.⁴⁴ This has also been one of the main points of attack on the *bona fide purchaser* test.⁴⁵ On the grounds of pure logic and consistency, the premises of this argument are indisputable. However, it is once again pointed out that the prime purpose of bankruptcy is to secure a fair and impartial distribution of assets among the insolvent's creditors.⁴⁶ It is submitted that even though the proposal departs from the formal logical parallelism of the "status" argument, it does effectuate the foremost consideration in bankruptcy—proportional participation among creditors of the same class. Even the draftsmen of the new bill recognize that departure from the status concept was necessary and desirable when they retained the *bona fide purchaser* test as to real property.⁴⁷

Defect Two and the Suggested Cure
Federal or State Law in the Determination of Preferences

The second criticism of the new statute relates to that part which ties Bankruptcy preferences to state law. The Constitution creates the bankruptcy power by providing that "The Congress shall have the power . . . to establish . . . uniform laws on the subject of bankruptcies throughout the United States."⁴⁸

Is the constitutional mandate met when bankruptcy preferences are tested not by one law, but by the varying and inconsistent laws of the forty-eight states?

As one of the members of the drafting committee has put it, "With the

⁴⁴Ireton, *A Proposal to Amend Section 60A of the Bankruptcy Act*, A6 CORP. REORG. 257, 260-1 (1947); Hanna, *Some Unsolved Problems under Section 60A of the Bankruptcy Act*, 43 COL. L. REV. 58, 59 (1943).

⁴⁵*Ibid.*

⁴⁶See notes 21 and 43 *supra*.

⁴⁷Ireton, *A Proposal to Amend Section 60A of the Bankruptcy Act*, A6 CORP. REORG. 257, 270 (1947).

In retaining the *bona fide purchaser* test as to real property transfers the draftsmen of the bill would kill equitable liens as to real property, but not as to any other property, tangible or intangible.

⁴⁸U. S. CONST. ART. I, § 8.

effect of the Section running across the lines of forty-eight states, with varying sovereign laws affecting a great variety of commercial transactions, the problem is not simple, nor can it be easily stated."⁴⁹ So long as the preference law is dependent on state law, the problem is indeed complex of solution.

For example, suppose *A* is a bankrupt in New York. *B* is one of *A*'s creditors. *A* owned two organ factories, one in New York and one in Oklahoma. Six months before bankruptcy *B* loaned money to *A* for which *A* gave mortgages purporting to include in the mortgage after acquired chattels. In New York any lien under the after acquired property clause is a preference under the present or either of the proposed statutes so long as the test is by local law,⁵⁰ because a creditor can acquire rights superior to that of the lienor. In Oklahoma, where the general law prevails, the transfer is not a preference since creditors cannot obtain higher rights than those of the lienor under an identical mortgage.⁵¹ Thus we have the ridiculous situation in which the same transaction is called a preference in one state but not in the other merely because of intervening state lines. This situation is impractical and illogical. The above example is not unique;⁵² it is merely set forth as typifying the unsatisfactory state of the present law.

Steps have been taken in other fields of the law to correct this defect. Uniform laws have been drafted and adopted⁵³ in increasing numbers of states, and a Federal Commercial Code⁵⁴ is presently being drafted. Is it not time then that bankruptcy preferences be tested uniformly in line with the constitutional command?

We propose that subsection (2) be amended by adding at the end thereof the following provision:

"Provided, further, that for the purposes of this section, applicable law shall be construed to mean the statutes of a state and the common law of a state providing such common law accords with general law."

This proposal would embody the rule of *Swift v. Tyson*⁵⁵ in the preference section of the Bankruptcy Act. The rule of the *Tyson* case was that in com-

⁴⁹Ireton, *A Proposal to Amend Section 60A of the Bankruptcy Act*, A6 CORP. REORG. 287, 291 (1947).

⁵⁰Zartman v. First National Bank, 189 N. Y. 267, 82 N. E. 127 (1907).

⁵¹OKLA. STAT. ANN. (1937) tit. 16, § 17 and tit. 42, § 8.

⁵²See note 42 *supra*.

⁵³Though it is recognized that the uniform laws become law only in states where adopted, they are a useful attempt to cut down the many differences in the law caused by the accident of state lines.

⁵⁴The draft of the code has not yet been completed, but its purpose is to apply one law to commercial transactions among the states.

⁵⁵16 Pet. 1 (U. S. 1842).

mercial transactions the law of the state would be followed only if in accord with general law, i.e. the better view in common law jurisdictions. It is to be noted that neither the *Tyson* case, nor our proposed amendment, attempts to override state law as set forth by statute.⁵⁶

The doctrine of *Swift v. Tyson* was overruled by *Erie v. Tompkins*⁵⁷ as applied to cases where jurisdiction in the federal courts was based on diversity of citizenship. Much has been written as to the application of the *Erie* case in fields other than diversity.⁵⁸ In *Prudence Realization Corporation v. Geist*,⁵⁹ subsequent to the *Erie* holding, the Supreme Court held that in the distribution of assets in bankruptcy the general law would be applied though directly contrary to the case law of New York, the state in which the transactions took place.

Still later than the *Prudence* case was *Corn Exchange National Bank and Trust Co. v. Klaunder*⁶⁰ holding that a preference would be tested by applicable state law. However, the *Klaunder* case involved exclusively the construction of Section 60a, and in no way is authoritative in limiting or delimiting the constitutional choice of general law in the bankruptcy cases or statutes. If the preference section were changed as suggested, there would be no constitutional difficulties and the *Klaunder* case would no longer be controlling.

Conclusion

Combining the suggested changes with subsection (2) of the new bill as introduced in Congress, the subsection would now read:

“(2) For the purpose of subdivisions a and b of this section, and subject to the provisions of paragraph (3), a transfer shall be deemed to have been made or suffered at the time when it became so far perfected that no creditor obtaining under applicable law by legal or equitable proceedings on a simple contract a lien on such property without a special priority (whether or not such a creditor exists), could acquire, after such perfection, any rights in the property so transferred superior to the rights of the transferee therein, and if such transfer is not so perfected prior to the filing of the original petition initiating a proceeding under this Act,

⁵⁶For discussion of the *Swift v. Tyson* rule, see Frankfurter, *Distribution of Judicial Power Between State and Federal Courts*, 13 CORNELL L. Q. 499 (1928); Sharp and Brennan, *The Application of the Doctrine of Swift v. Tyson since 1900*, 4 IND. L. J. 367 (1929); Clark, *State Law in the Federal Courts: The Brooding Omnipresence of Erie v. Tompkins*, 55 YALE L. J. 267 (1946).

⁵⁷304 U. S. 64, 65 Sup. Ct. 1466 (1938).

⁵⁸*Klaxon v. Stentor Electric Co.*, 313 U. S. 487, 61 Sup. Ct. 1020 (1941) (extending *Erie* doctrine to conflicts of law); *Prudence Realization Corp. v. Geist*, 316 U. S. 89, 62 Sup. Ct. 978 (1942) (refusing to apply *Erie* rule to bankruptcy).

⁵⁹316 U. S. 89, 62 Sup. Ct. 978 (1943).

⁶⁰318 U. S. 434, 63 Sup. Ct. 679 (1943).

it shall be deemed to have been made immediately before the filing of such original petition: *Provided, however, for the purposes of this section such a creditor shall be deemed to have an interest superior to that of any equitable lienor*, and: *Provided, further, however, that where real property is transferred for or on account of an antecedent debt, the transfer shall be deemed to have been made at the time when it became so far perfected that no bona fide purchaser from the debtor could acquire, after such perfection, any rights in the property, so transferred superior to the rights of the transferee therein. Provided, further, that for the purposes of this section, applicable law shall be construed to mean the statutes of a state and the common law of a state providing the common law is in accord with general law."*

Under the proposed statute, if any state wishes to recognize any equitable liens, it is free to raise them to the status of legal liens by statutory provision. It is felt that such remedy should be left to the states in the event that it decided as a matter of public policy or commercial necessity that certain liens, hitherto equitable, were desirable. By codifying the security device, a state can raise a lien to the status of a legal lien, thus bringing it outside the first proposal. The saving of the statutory exception under the second change enables a state to decide its public policy by statute, and make it binding, though contrary to the doctrines of general law.

It is not contended by the authors that there are no equitable liens that could be useful and satisfactory credit devices in a sound economy.

For example, the authors feel that instead of using the bulky, cumbersome corporate mortgage indentures the English and Canadian device of the "floating charge"⁶¹ could be well utilized by our large corporations and public utilities.⁶² Roughly, a "floating charge" is a security on all property of a corporation both present and after acquired. At common law, it is an equitable lien inferior to that of a prior levying judgment creditor. In American law, it is at present not generally recognized. Americans should utilize it and it could be created by statute and perfected against bankruptcy. To accomplish this purpose a statute could accord it a superior position to that of a judgment creditor. This is cited merely as a possible example of a desirable equitable lien. Undoubtedly, some others may seem equally desirable.⁶³

⁶¹N. Y. PERS. PROP. LAW § 45 provides in a limited way for a lien similar to a floating charge on merchandise consigned to factors.

⁶²In England and Canada, the device is much used in the public utility field and is essentially an equitable lien. The validity of a floating charge as a lien on all assets including after acquired property enables English and Canadian corporate indentures to be much simpler and more easily understood than our bulky American indentures.

⁶³For example, recorded after acquired property mortgages on chattels are desirable and could be made legal liens by statute; also the lien of members on stock exchange

With the statutory subordination of the equitable lien and the nationalization of the law by which a security is tested, the authors feel that the new bill would be desirable.

The first change was called for long ago by the late Chief Justice Stone and the second is called for by the constitutional mandate and the needs of present day business which day by day is beset with varying interpretations of the same transaction as it passes through each of our forty-eight states.

As thus changed the new bill ought to be just the right medicine for poor sick sixty.*

seats. See *In re Gruner*, 295 N. Y. 510, 68 N. E. 2d 514 (1946); Note, 32 CORNELL L. Q. 402 (1947).

*The writers wish to acknowledge that this article represents the synthesis of a term's study in the course entitled "Security Transactions" at Cornell Law School in the fall of 1946. All members of that class, now graduated or about to graduate, contributed greatly to the fire of classroom discussion by which we tested 60 and the proposed amendment and found them both sick. Many other suggestions for amendment to Section 60 were tested ranging all the way from retention of the present Section 60 with specific exceptions for named security devices to a suggestion for a statute detailing specifically each security device with federal recordation provided for perfection. These, likewise were found to be sick and ultimately discarded. Grateful acknowledgement is likewise made to Lawrence Bennett, Esq., of 15 Broad Street, New York, N. Y. for first suggesting to Professor Keeffe the possibilities of the floating charge, and for his many other contributions to the classroom analysis of why Section 60 is sick.