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Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens

C.Robert Morris Jr.

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Students in my bankruptcy course do not readily understand the status of unperfected transfers in bankruptcy. Until it is spelled out for them, they do not understand that a mortgage given at the time of the secured debt and which would not be a preference if seasonably recorded becomes a preference if it is withheld from record or is recorded too late and less than four months before the mortgagor's petition in bankruptcy. I have always enjoyed teaching this subject because here was clearly a teaching task which I could accomplish. I could show them how, under section 60 of the Bankruptcy Act,[1] such a transaction is voidable as a preference.

I have come to the conclusion, however, that my students' initial intuition is correct. The law is wrong. Such a transaction is not factually a preference and the law of preferences is not the appropriate vehicle for handling secret liens in bankruptcy. The fiction whereby section 60 transforms secret liens into preferences has long been a source of mischief. This mischief could be abated by a new provision directed at the avoidance of secret transfers and by the rewriting of section 60 so that it governs only preferences in fact. Finally, a further change in the law of preferences would solve some of the problems that arise in trying to distinguish routine transactions from preferences and would put to rest a number of problems, including the status of floating liens in bankruptcy. Before proposing amendments to the Bankruptcy Act, however, this article will discuss true preferences and the reason for their avoidance, relate how the preference provision was expanded to include unperfected transfers, and review some of the problems that have resulted from confusing unperfected transfers with preferences.

I. HISTORY AND SUBSTANCE OF APPLICABLE BANKRUPTCY LAW PROVISIONS

A. True Preferences and the Rationale for Their Avoidance

It is said that section 60 voids some preferences made by the

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1. 11 U.S.C. § 1 *et seq.* (1964), *as amended,* (Supp. IV, 1969) [hereinafter cited as Act, with section references from the Statutes at Large, rather than the U.S.C.].

bankrupt in the four month period prior to bankruptcy because "the theme of the Bankruptcy Act is equality of distribution."[2] Any observer must admit, however, that the theme of equality is undermined by liens and priorities. Secured creditors are paid to the extent of their security, provided their security can withstand the onslaughts of the trustee's avoidance powers. Anything left over is used first to pay the costs of administration and then to pay in order four different classes of creditors with statutory priorities.[3] Usually nothing remains for the general creditors. Sometimes there is a pittance.

Nevertheless, the orchestration of the various themes of the Bankruptcy Act must be respected. A particular pattern of distribution has been ordained, and a failing debtor should not be permitted to subvert this pattern by making disbursements on the eve of bankruptcy. Thus, should the debtor allocate his dwindling resources among some of his creditors to the disadvantage of his other creditors, these assets may in certain circumstances be recaptured by the trustee in bankruptcy and reallocated according to the established pattern of distribution. One can wonder whether it is worth all the trouble, since often the reclaimed preference will be used merely to pay creditors who enjoy a statutory priority. Taking from Preferred Peter to pay Priority Paul does not smack of the equality which is equity.

Some of the equities in favor of leaving matters untouched are recognized by section 60. After all, the parties to a preference have usually done nothing dishonorable. The debtor paid a debt; the creditor accepted his due. An attempt to undo all such transactions of the previous four months would give bankruptcy courts more funds to allocate according to the ordained pattern, but it would be a mammoth task. Recovering all of the routine payments made during insolvency and the preceding four month period merely to reallocate these funds between the original recipients and the bankrupt's other creditors would simply not be worth the cost. Section 60(b) therefore permits avoidance of preferences only if the recipient, at the time of the payment, has "reasonable cause to believe that the debtor is insolvent." Thus, the great mass of preferences are not voided. The innocent creditor who accepts what appears to be a routine payment will normally be permitted to keep it.

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2. 3 W. COLLIER, BANKRUPTCY ¶ 60.01, at 743 (14th ed. 1969), and cases cited therein.

3. ACT, *supra* note 1, § 64(a).

The bad preference, the one which bankruptcy administration has sought to void, is one which involves some element of culpability. The elements of this malefaction have never been clearly defined. A debtor's attempt to distribute his estate among his creditors according to a plan different from that required in bankruptcy, with an eye to going into bankruptcy later, was considered by Lord Mansfield to be a fraudulent transfer. He did not, however, condemn payments in the ordinary course of business, even though on the eve of bankruptcy.[4] The key question therefore was whether the debtor intended to substitute his own pattern of distribution for that of bankruptcy. The early American bankruptcy acts did not materially depart from this English view; but the courts found it difficult to distinguish intentional preferences from payments in the ordinary course of business because they gave credence to the ancient dictum that every man intends the probable consequences of his own acts. Thus, routine payments by an insolvent were deemed voidable preferences.[5]

The Act of 1898, rather than focusing on the debtor's actual or presumed intent, considered the matter from the creditor's viewpoint. In an avoidance proceeding, the trustee had to prove that the preferred creditor "had reasonable cause to believe that it was intended to give a preference. . . ."[6] This language has since been amended twice. A 1910 amendment completely removed the debtor's intent from the determination, and instead established as the test whether the creditor had reasonable cause to believe that the transfer "would effect a preference."[7] Under this test, preferences were voidable only if the creditor had cause to believe that bankruptcy was imminent. In 1938, the Chandler Act deleted any implied reference to the creditor's expectation of bankruptcy,[8] so that today all that must be proved is that the creditor had reasonable cause to believe the debtor was insolvent.

These changes seem to have been dictated by problems of proof. Although a guilty intent is practically impossible to prove, the presumption that the actor intends the probable consequences of his act assured a finding that the transaction was

4. Alderson v. Temple, 4 Borrow 2235, 98 Eng. Rep. 165 (K.B. 1768).
5. 3 W. COLLIER, *supra* note 2, ¶ 60.05[1].
6. Act of July 1, 1898, ch. 541, § 60, 30 Stat. 562.
7. Act of June 25, 1910, ch. 412, § 11, 36 Stat. 842.
8. Act of June 22, 1938, ch. 575, § 60, 52 Stat. 870.

a preference. This presumption was eliminated by the 1898 version which stated the issue in terms of the creditor's state of mind. This test went too far, however, and the subsequent amendments were attempts to reduce the trustee's burden by framing an issue more susceptible of proof. The present test is not stated in terms of culpability, but it does include culpable creditors—those who are privy to the debtor's plan to supersede the bankruptcy scheme of distribution. There is, however, a bit of overkill in it. Some creditors who accept unsolicited payments from a debtor known to be insolvent will suffer. In practice, there is also some underkill in it. Some creditors may secretly connive with their debtors to defeat the bankruptcy scheme of distribution; if the secret is well kept, the trustee will not be able to prove that the creditor had reasonable cause to believe that the debtor was insolvent. Nevertheless, the test does protect many creditors who receive routine payments on the eve of bankruptcy, while reaching many who connive with their debtors.

B. Expansion of the Preference Provision to Include Unperfected Transfers

As considered thus far, the law of preferences has little to do with the law of secured transactions. Of course, a preference can be made by way of a lien, just as it can be made by way of a transfer of complete title. If a debtor gives his creditor a lien to secure an antecedent debt under circumstances in which payment of the debt would give rise to a voidable preference, then that lien will also be voidable as a preference. As originally enacted in 1898, section 60 went no further. Voidable preferences were voidable without regard to the form of transfer, and nonpreferential transactions were not within the reach of the section. Subsequent amendments, however, have extended the provision of section 60 to condemn certain unrecorded transactions regardless of whether they were, in fact, preferences. These amendments were part of Congress' attack on secret liens.

As enacted in 1898, the Bankruptcy Act appeared to condemn secret liens, but its provisions proved inadequate to accomplish such a task. Congress had seen only part of the problem and the sections which dealt with that part were poorly drafted. The main source of the trustee's title was then, as it is now, section 70(a)(5) which made him the bankrupt's successor, with title to the bankrupt's assets subject to all the liens and encumbrances which had attached before bankruptcy.[9] Section 67(a), however, provided that "[c]laims which for want of record . . . would not have been valid liens as against the claims of the creditors of the bankrupt shall not be liens against his estate."[10] Congress had not had sufficient experience with the secret lien problem to realize the two shortcomings of this provision. First, unrecorded liens would be "valid liens as against the claims of the creditors of the bankrupt" if the particular recording act gave no protection to general creditors but protected instead only those creditors who had obtained a judicial lien. Second, recorded liens might be just as pernicious as unrecorded ones if they had been withheld from record until shortly before bankruptcy. A belatedly recorded lien would surprise those who had extended credit. If bankruptcy quickly ensued, they would be injured as much as if an unrecorded lien had been honored in bankruptcy.

Furthermore, the preference provisions of the 1898 act aggrevated the problem of the belatedly recorded lien. Then, as now, preferences were both an act of bankruptcy under section 3(a) and voidable under section 60. And, as is still true, involuntary petitions in bankruptcy had to be filed within four months of the alleged act of bankruptcy. To deal with the danger that preferences might be withheld from record, section 3(b) provided that the period for filing an involuntary petition would not expire "until four months after . . . the date of recording or registering is required or permitted . . . ."[11] However, section

9. 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 bankruptcy] . . . to all . . . property 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 . . . .

Act of July 1, 1898, ch. 541, §70(a)(5), 30 Stat. 564-65 (codified as ACT, *supra* note 1, § 70(a)(5)). Language in the bracketed phrase and that omitted has been changed over the years by various amendments. The above quoted language, which contains the major substance of the subsection, has, however, remained the same since enactment.

Some cases have given the trustee better title than the bankrupt had in spite of the apparent limitation of his title to that of the bankrupt as of the date of bankruptcy. *See* 4A W. COLLIER, *supra* note 2, ¶ 70.48[1].

10. Act of July 1, 1898, ch. 541, § 67(a), 30 Stat. 564. Section 67(d) stated the converse of this proposition: "Liens given or accepted in good faith and not in contemplation of or in fraud upon this Act, and for a present consideration, which have been recorded according to law, if record thereof was necessary in order to impart notice, shall not be affected by this act."

11. *Id.* § 3(a), 30 Stat. at 546. The section continued:

60, which avoided preferences made within four months of bankruptcy, had no such provision. Thus a preferential transfer could be secretly made and withheld from record for at least four months. Upon recording it would be an act of bankruptcy but it would be too old to be voidable. The statute, therefore, encouraged the belated recording of preferential transactions.

In 1903, Congress attempted to remedy this matter. The House of Representatives added the above quoted language of section 3(b) to section 60.[12] The Senate, however, deleted the words "or permitted . . . ." The legislative history gives no hint of the reason for the deletion.[13] As finally enacted, the amendment added a sentence to the end of section 60(a): "Where the preference consists in a transfer, such period of four months shall not expire until four months after the date of the recording or registering of the transfer, if by law such recording or registering is required."[14] Contemporary legislative materials make it clear that Congress was only attempting to make voidable actual preferences which were also acts of bankruptcy. There is no evidence that Congress intended to make voidable unrecorded transfers which were not preferential in fact.[15] Con-

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> or, if [recording is not required or permitted], from the date when the beneficiary takes notorious, exclusive, or continuous possession of the property unless the petitioning creditors have received actual notice of such transfer or assignment.

12. 35 CONG. REC. 6938 (1902). The proposed amendment included the language quoted in note 11 *supra*.

13. 36 CONG. REC. 1036 (1903). The language quoted in note 11 *supra*, was also deleted. This change was recommended by the Senate Judiciary Committee, but the Committee made no written report and no reasons were advanced on the Senate floor.

14. Act of Feb. 5, 1903, ch. 487, § 13, 32 Stat. 799-800.

15. The House Judiciary Committee, in its analysis of the bill, stated:

> Section 60 . . . is amended . . . by adding . . . a clause which shall be equivalent to that found in section 3b(1). It seems that as section 60 . . . now stands, a preferential mortgage may be given, and the creditor preferred by withholding it from record four months be able [*sic*] to dismiss the trustee's suit to recover the same, though the paper was actually recorded within the four months' period. (*See* [*I*]*n re* Wright (Ga.), 96 Fed. 187; [*I*]*n re* Mersman (N.Y.), 7 Am. B.R., 46.)

H.R. REP. No. 1698, 57th Cong., 1st Sess. 8-9 (1902).

There is some subsequent evidence to the contrary. The proponents of the 1910 amendment to section 60 introduced their report by saying, "The object of this amendment is further to protect against the evil of secret liens, against which evils this same section was amended in 1903, but in such an unfortunate way as not effectually to prevent such liens." H.R. REP. No. 511, 61st Cong., 2d Sess. 7 (1910); *see also* S. REP. No. 691, 61st Cong., 2d Sess. (1910). *See* further quotations from these same reports in the text accompanying note 31 *infra*. It seems gress appeared unaware of the problems arising from nonpreferential liens which were kept secret by withholding them from record.

In actual bankruptcy administration, however, the secret lien problem was obvious. Trustees relied on section 67(a) to avoid liens never recorded and turned to the 1903 amendment to avoid liens kept secret for a time but recorded within four months of bankruptcy. Their leading case was *First National Bank v. Connett*.[16] There, an insolvent debtor gave his bank a mortgage to secure an antecedent debt, thereby effecting a preference. The bank, however, had no reason to know of his insolvency at the time. Ten months later, when the bank learned that the debtor was insolvent and planning to wind up his affairs, it recorded the mortgage. Bankruptcy ensued a month later. Though the mortgage was a preference in fact, before the 1903 amendment it would clearly have been too stale at the time of bankruptcy. The bank contended that even after the amendment, the transaction was too stale because recordation was not "required" but was merely permissible under local law. The court commented that such a holding would make the amendment a nullity and held that unrecorded mortgages were void to such a wide variety of persons that, as a matter of Missouri law, the transaction was not accomplished until the date of recordation.[17] The bank also defended on the ground that at the time of the transaction it had no reason to believe a preference was intended. But the court answered that the bank did have reason to so believe at the date of recording, which was the crucial date. The court stated:

> While the situation is somewhat anomalous, we believe it is within the spirit of the amended act, and that the voidable element is established by the knowledge of the bank when its

likely that these statements were merely attempts to sweeten the pill of the 1910 amendment and that they do not reflect any legislative intent behind the 1903 amendment.

16. 142 F. 33 (8th Cir. 1905).

17. *Id.* at 36. On this issue, the court expressly refused to follow the Fifth Circuit, which had ruled against the trustee in Meyer Bros. Drug Co. v. Pipkin Drug Co., 136 F. 396 (5th Cir. 1905). In that case the court, observing that the Texas recording act did not void unrecorded chattel mortgages as between the parties, held that recording was not "required" within the meaning of the 1903 amendment. Though this holding might have given meaning to the Senate's deletion of any reference to permissive recordation, it deprived the 1903 statute of all meaning, since most recording acts leave unrecorded transfers effective between the parties.

mortgages were recorded that the mortgagor was insolvent and contemplated a disposition of his property.[18]

Trustees whose estates were burdened with secret liens used the theory of the *Connett* case to attack such liens even when they were not originally granted as preferences. For instance, *In Re Reynolds*[19] involved an unrecorded mortgage given for a contemporaneous loan. The mortgagee, however, went into possession 10 months later. There was no evidence that the debtor had been insolvent at the time of the mortgage, but his insolvency was manifest at the time the mortgagee took possession. In spite of the fact that the mortgage was not given to secure an antecedent debt and thereby to prefer a general creditor, the court held it to be a voidable preference.

> [T]he amendment of 1903 was intended to remedy the evil resulting from secret instruments of transfer of the bankrupt's property, the withholding them from record until shortly before the institution of bankruptcy proceedings, and the then [*sic*] assertion of them as of the prior date of their execution and delivery. And this was accomplished by making the rights of a creditor thus favored determinable by the conditions existing when he caused the transfer to him to be [perfected] rather than by those existing at the time he secured it.[20]

By the time of perfection, the debt was an antecedent debt. Thus, by fictitiously postdating the security, the court converted a contemporaneous transaction into a preference.[21]

This fiction, however, was not accepted by some courts. In *Claridge v. Evans*,[22] the Supreme Court of Wisconsin refused to avoid a mortgage to secure future advances which, through a lawyer's oversight, was not recorded for two years, even though the mortgagee knew the debtor was insolvent at the

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18. 142 F. at 37.
19. 153 F. 295 (W.D. Ark. 1907).
20. *Id.* at 300.
21. The fictitious aspect of this theory was not recognized by some of the courts at the time:

> There can be no question as to these conveyances working a preference . . . . The defendant . . . got $6,000 of security from the bankrupt, as against $7,000 of indebtedness . . . ; whereas, to pay other creditors, by whom claims have been proved to the extent of over $42,000, there are perhaps $2,000 or $3,000 of available assets in sight.

English v. Ross, 140 F. 630, 632 (M.D. Pa. 1905) (mortgages to secure future advances not recorded until after the loans had been advanced). Of course, this would have been true had the mortgages been timely recorded. A secured creditor's position is preferable (in the sense of "nicer"), but he does not thereby enjoy a preference in the bankruptcy sense.
22. 137 Wis. 218, 118 N.W. 198 (1908).

time of the mortgage and at all times thereafter. The court stated:

> The fundamental difficulty with the trustee's contention is that the sections deal with preferences alone, not with all business transactions, and the giving of a mortgage or other security to secure prepayment of a present loan, or a loan to be made in the future, is not a preference. In order to constitute a preference there must be an existing antecedent debt, upon which a payment is made, or for which security is given . . . . The very word "preference" means that one person is favored above others, who, before the favor was shown, stood on an equal footing. . . . [P]robably there would have been no attack on the mortgage were it not for the concluding clause of section 60a, which, in effect, declares that if the local law requires the recording of the transfer, the four-month period during which preferences are inhibited shall not expire until four months after the date of the recording. But this clause does not define a preference, nor purport to make a preference out of a transaction which was not a preference before. It only applies where the transfer itself constitutes a preference . . . .[23]

Meanwhile, the trustees' attacks upon liens never recorded met serious obstacles. They had relied upon section 67(a), which voided all liens which were invalid against any creditor of the bankrupt for want of record.[24] They had also constructed some ingenious arguments based on other parts of the act.[25] The trustees enjoyed some success, but in *York Manufacturing Company v. Cassell*[26] they suffered a serious defeat. The Supreme Court upheld an unrecorded conditional sale because the Ohio recording act protected only creditors who acquired a judicial lien on the encumbered property, and none of the creditors whom the trustee represented had acquired such a lien. Since many recording acts are similarly limited and since most bankruptcies involve only creditors without such liens, the trustees' power to avoid secret liens which were never recorded was severely limited by the decision.

In 1910, Congress enacted two amendments in an attempt to solve the secret lien problem. From the report of the House

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23. *Id.* at 224-27, 118 N.W. at 200-01.

24. *See* text accompanying note 10 *supra*.

25. Relying upon section 70(a)(5), which gives the trustee title to property the bankrupt could have sold or which could have been levied on by his creditors, the trustees argued that they had the title such purchasers or levying creditors would have. A number of lower courts ruled in their favor and the Supreme Court tended that way in Security Warehousing Co. v. Hand, 206 U.S. 415 (1907) (undelivered pledge) and in Knapp v. Milwaukee Trust Co., 216 U.S. 545 (1910) (unrecorded chattel mortgage).

26. 201 U.S. 344 (1906). This case was not overruled by the later cases cited in note 25 *supra*.

Judiciary Committee,[27] it seems clear that the draftsmen of these amendments recognized that there was only a single problem—the problem of secret liens. However, there were two holdings which had to be overruled: the *York Manufacturing* case which preserved unrecorded liens and the *Claridge* line of cases which upheld liens recorded shortly before bankruptcy. The amendments, therefore, adopted a two-fold approach to secret liens.[28]

York Manufacturing was negated by the "strong arm" clause which gave the trustee the powers of a levying creditor.[29] This was responsive to the theory of *York*, which had held that the trustee could avoid certain unrecorded liens only if he represented an actual levying creditor who himself had rights superior to the lien under local law. The amendment gave the trustee the powers of such a creditor in all cases, whether or not such a creditor actually existed.

The other amendment negated the *Claridge* case by adopting the theory expressly repudiated by that case. It reworded section 60 so that all the elements of a preference would be tested as of the time of recording, thereby postdating many such transfers to within four months of bankruptcy and transforming transfers for contemporaneous value into transfers on account of antecedent debts.[30] By this fiction, belatedly recorded liens be-

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27. H.R. REP. No. 511, 61st Cong., 2d Sess. 7 (1910).

28. Act of June 25, 1910, ch. 412, §§ 8, 11, 36 Stat. 840, 842.

29. The amendment added the following provision to section 47(a):

> [T]rustees, as to all property in the custody or coming into the custody of the bankruptcy court, shall be deemed vested with all the rights, remedies, and powers of a creditor holding a lien by legal or 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.

Id. § 8, 36 Stat. 840. This provision was left unchanged until the major rewriting of the Bankruptcy Act by the Chandler Act of 1938, when it was placed in section 70(c). The Chandler Act reworded the section, and it has since been reworded three times, but without changing its substance. The current version states:

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

ACT, *supra* note 1, § 70(c).

30. The amendment rewrote section 60(b) to read:

came preferences in law whether or not they were preferences in fact. In arguing for this change, the House Judiciary Committee said:

> The real trouble it seems is this: There are, in reality two times of "transfer" in such cases: as between the transferror and transferee obviously the time of transfer is the time of the original execution and delivery of the instrument to the grantee or transferee, regardless of its registration, but as to other creditors and the rest of the outer world, the "transfer" is, by the state statute, not a complete "transfer" at all until recording, until delivery to the public recorder—then and not until then the debtor signifying to outside parties, to all others who might become interested in his assets, the effectual separation of the liened property from the rest of his assets. This, it must be conceded, is the bottom principle upon which rest the recording statutes of all our states. It is also the bottom principle of the right to legislate against secret liens. Thus, in our bankruptcy preference statute, the great object likewise should be to make clear that the "transfer," so far as outside parties becoming interested in the estate are concerned, is not complete or perhaps is not even to be considered a "transfer" at all (in cases where state law requires recording as against creditors) until delivery of the instrument to the recorder for registration.
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> Creditors, then, by these state Supreme Court decisions [like the *Claridge* case] construing the preference provisions of the present bankruptcy act, must be able to prove that at the time of the "transfer," perhaps several years beforehand, the debtor was then insolvent, the debt was then a past, a preexisting, debt, etc.—a practical impossibility; indeed an unreasonable requirement, since it is the present insolvent fund of the debtor that is rightly involved and not some ancient fund existing years beforehand.
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> The proposed amendment squarely and clearly makes the date of the recording . . . the date at which the creditor [trustee?] is to prove the existence of all the elements of a preference . . . . It brings forward to the date of recording the proof of the insolvency and all the other operative facts of the preference and makes the section conform to the real and actual intentions of the framers of the amendment of 1903.[31]

> If a bankrupt shall . . . have made a transfer of any of his property, and if, at the time of the transfer . . . or of the recording or registering of the transfer if by law recording or registering thereof is required, and being within four months before the filing of the petition in bankruptcy . . . , the bankrupt be insolvent and the . . . transfer then operate as a preference, and the person receiving it . . . shall then have reasonable cause to believe that the . . . transfer would effect a preference, it shall be voidable by the trustee and he may recover the property or its value from such person.

Act of June 25, 1910, ch. 412, § 11, 36 Stat. 842.

31. H.R. REP. No. 511, 61st Cong., 2d Sess. 8-9 (1910), S. REP. No. 691, 61st Cong., 2d Sess. 8-9 (1910). The Senate report continued:

> Indeed, it is perhaps merely declaratory of the law as it exists today, as laid down in the following cases, to wit, Bank v. Connett, 143 F. 35. . . . But there are contrary holdings. The

Thus, by the amendment of 1910, Congress attempted to make secret transfers not recorded until the eve of bankruptcy voidable as though they were preferences, whether or not they were preferences in fact. The section was so unartfully drawn, however, that it failed in accomplishing its purpose. First, not all security arrangements came within its purview.[32] Second, the Senate's deletion in 1903 of any reference to permitted (as contrasted with required) recording was continued, and ultimately the Supreme Court gave meaning to that deletion by holding the section inapplicable in cases where the particular recording act did not protect creditors actually participating in the bankruptcy.[33] Thus, where a recording act protected only levying creditors, the holder of a secret lien would lose his security if he failed to record it because the strong arm clause would give the trustee the powers of a levying creditor. But if he recorded on the eve of bankruptcy, he would not only be immune from the trustee's strong arm powers, he would usually be able to withstand an attack under section 60 because the recording would not be "required" within the meaning of that section. Finally, the holder of an "equitable lien" (an enforceable promise by the debtor to grant a lien in the future) enjoyed a similar position. His right to such a lien would fall in the face of the trustee's strong arm powers, but if he should be granted a "legal" lien on the eve of bankruptcy and promptly record it, that lien would, as a matter of common law, be held to relate back to the date of the enforceable promise. This date was usually more than four months before bankruptcy and often contemporaneous with the loan involved.[34]

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question is continually arising, and is a frequent source of litigation. It is of such importance that it should be set at rest.

Id. at 9.

32. Belatedly recorded conditional sales were held not to come within the section because the retention of security title was not a transfer from the debtor which depleted his estate. Bailey v. Baker Ice Mach. Co., 239 U.S. 268 (1915).

33. Carey v. Donohue, 240 U.S. 430 (1916); Martin v. Commercial Nat'l Bank, 245 U.S. 513 (1918). This problem had divided the circuits shortly after the 1903 amendment was adopted. *See* note 17 *supra*. However, Congress appears not to have been aware of the problem when it enacted the 1910 amendment. An amendment in 1926 added the words "or permitted" to section 60 in an attempt to cure this problem. Act of May 27, 1926, ch. 406, § 14, 44 Stat. 666. The words were, however, inserted in the wrong place and the courts continued to follow *Carey* and *Martin*. *See* Hirschfeld v. Nogle, 5 F. Supp. 234, 237 (E.D. Ill. 1933).

34. *See* Sexton v. Kessler & Co., 225 U.S. 90 (1912).

Twenty-eight years later the Chandler Act[35] overcame these difficulties by shunning any explicit mention of recording and stating the test instead in terms of the result recording achieves under local law. Before, all transfers were deemed to have been made at the time of any "required" recording. Now they were deemed to have been made when they had been so perfected that, under local law, no bona fide purchaser and no creditor of the transferor could thereafter acquire rights superior to the transferee; in the absence of any such perfection, all transfers were deemed to have been made immediately before bankruptcy.[36] This simple and short provision seemed to meet all the problems. For most transactions, of course, it timed the transfer when it was, in fact, made. A payment in money or the delivery of personal property to a creditor was deemed to occur when it had actually happened, so that if such transactions were preferential and occurred within four months of bankruptcy, they were voidable. However, in recordable transactions, the idea that recordation might be merely permissive but not required was put to rest. Where local law required recording to protect either purchasers or creditors, delay or failure to record would postdate the transaction and transform it into a preference as of the date of the recording or, in the absence of any record, as of the instant before bankruptcy.[37] This provision also solved the difficult equitable lien problem. Since latent equities are inferior to the rights of bona fide purchasers without notice, secret equitable liens would not be recognized under the bona fide purchaser test. The creditor's right to an encumbrance of the assets could have been defeated by a sale of those assets to a bona fide purchaser any time prior to the actual grant of the promised lien. Thus, the final lien could not be deemed to relate back to any

35. Act of June 22, 1938, ch. 575, 52 Stat. 840.

36. 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 so perfected prior to the filing of the petition . . . it shall be deemed to have been made immediately before bankruptcy.

Id. § 60, 52 Stat. at 869-70.

37. This was also intended to bring unrecorded conditional sales within the section. *See* note 32 *supra*. Recording acts generally protect purchasers or creditors from the vendor's interest under an unrecorded conditional sale contract. In 1952, to further clarify this matter, the definition of transfer in section 1(30) was amended to include "the retention of a security title to property delivered to a debtor." Act of July 7, 1952, ch. 579, § 1, 66 Stat. 420.

earlier date.

Prior to the Chandler Act, most commentary concerning section 60 pointed out the inadequacies resulting from the failure of the 1910 amendments to accomplish their purpose. When the Chandler Act overcame those difficulties, a new line of criticism appeared. Section 60 now seemed to do much more than had been intended. The criticism was triggered by *Corn Exchange National Bank & Trust Company v. Klauder*,[38] which struck down assignments of accounts receivable even though local law made no provision for their recording or publication, and thus illustrated that section 60 could void some transactions which were neither preferences nor unduly secret. Under the law of many jurisdictions, a second assignee of accounts receivable would prevail over the first assignee unless the account obligor had been informed of the first assignment. The rule had been adopted merely as a method of resolving disputes between competing assignees of the same account, not to notify the community of creditors that an account had been assigned. Indeed, informing the account obligor would not necessarily make the information a matter of common knowledge. But this rule made voidable in bankruptcy any lien on accounts receivable unless each account obligor was informed of the lien, since prior to such notice the lien was not perfected as against a hypothetical bona fide purchaser of the account.

Following *Klauder* fears were voiced concerning other kinds of secured transactions. For example, some creditors and purchasers have a kind of super-priority such that recording a lien will not protect it from their claims. For instance, South Carolina had a statute giving a judgment for personal injuries arising out of an automobile accident priority over all liens on the vehicle involved (other than tax liens), whether recorded or not.[39] A similar problem arises in connection with liens on inventory. The instruments creating such liens provide that the liens will not follow the goods into the hands of the borrower's customers.[40] Thus, recording does not protect all liens against all

38. 318 U.S. 434 (1943).

39. S.C. CODE § 8792 (1942), since repealed.

40. UNIFORM TRUST RECEIPTS ACT § 9(2)(a)(i) provided that "[a buyer in the ordinary course of trade] takes free of the entruster's security interest in the goods so sold, and no filing shall constitute notice of the entruster's security interest to such a buyer." Factors lien acts had similar provision. For example, ch. 590, § 5 [1947] Minn. Laws 1021 provided that "[P]urchasers for value in the ordinary course of the business of the borrower shall take the merchandise free and clear of

creditors and all purchasers. It was feared that courts after *Klauder* would hold these liens unperfected and hence deemed to have been given just prior to bankruptcy when they would be preferential. Finally, it was suggested that the normal mortgage might be deemed a preference even though given to secure contemporaneous credit. In practice, recording is accomplished shortly after the loan is made. Courts could construe this as a continuing transaction; but should they focus on events instant by instant, they would detect a gap between loan and recording and could deem the mortgage as given at the instant of recording and hence to secure an antecedent debt.[41]

It should be noted that at the time these fears were first broached they had no concrete basis. The accounts receivable problem was being corrected by state statutes which nullified the rights of second assignees of accounts, thereby making the reasoning of *Klauder* inapplicable. The other dangers had been, primarily, abstract suppositions of what courts might do in the absence of much evidence of what they would do. However, secured creditors, as a class, are anxious to limit their risks, and their spokesmen were urging change.[42] Then three cases gave

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the factor's lien provided for herein, whether or not they have knowledge of the existence of such lien." The UNIFORM CONDITIONAL SALES ACT § 9, provided that

> [W]hen goods are delivered under a conditional sale contract and the seller expressly or impliedly consents that the buyer may resell them prior to performance of the condition, the reservation of property shall be void against purchasers from the buyer in the ordinary course of business, and as to them the buyer shall be deemed the owner of the goods, even though the contract or a copy thereof shall be filed according to the provisions of this act.

Some states enacted similar provisions concerning chattel mortgages. *See, e.g.*, ch. 842, § 6, [1941] N.Y. Laws. All of these provisions have been superseded by the Uniform Commercial Code, which also gives buyers in the ordinary course of business priority over a perfected security interest. UNIFORM COMMERCIAL CODE § 9-307 [hereinafter cited as U.C.C.].

41. In the few cases which faced this issue, the mortgages were generally held not preferential. *In re* Metropolitan Dairy Co., 224 F. 444 (2d Cir. 1915) (resolution authorizing mortgage on June 14, loan advanced June 17, mortgage executed June 23 and filed June 26); *In re* E. H. Webb Grocery Co., 32 F. Supp. 3 (M.D. Tenn. 1940) (mortgage filed the day after the loan). But one case held a mortgage recorded two days after execution to be preferential. Local law only permitted a reasonable delay, and where the mortgage was executed within a mile of the recorder's office a delay of more than a few hours would be unreasonable. *In re* Coombs, 37 F. Supp. 495 (W.D. Mo. 1940).

42. The alarm was sounded in the following articles: Hanna, *Preferences in Bankruptcy*, 15 U. CHI. L. REV. 311 (1948); Keefe, Kelly & Lewis, *Sick Sixty: A Proposed Revision of Section 60a of the Bank-*

some reality to the fear that inventory financing could not withstand the super-priority of a hypothetical buyer in the ordinary course of business,[43] and in 1950 the section was amended to its present form.[44]

The new provision was built in layers. Since the bona fide purchaser test had caused some of the problems, if that test were excluded and the creditor test retained, those problems would be solved. But no such amendment was practical in the real property field, because many state recording acts protect only subsequent purchasers of realty. Therefore, the purchaser test was retained as to realty, and the creditor test was used for all other assets. But, to eliminate the problem of the special creditor with super-priority under local law, "creditor" was defined as a simple contract creditor. The switch to a creditor test might have revived the equitable lien problem, since the purchaser test had been included to invoke the well established rule that such equities would not be good against a purchaser without notice; so section 60(a)(6) was inserted to bring back the purchaser test in such cases. But then, to prevent the reintroduced purchaser test from knocking out inventory financing schemes, an exception was made to exclude the purchaser in the ordinary course of trade. Finally, section 60(a)(7) added a grace period of no more than 21 days so that recording would not postdate a transfer if the record was made within that grace period. Thus, from a simple, one sentence provision, section 60(a) has been expanded to a cumbersome, eight paragraph provision, with some paragraphs practically incomprehensible.

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ruptcy Act, 33 CORNELL L.Q. 99 (1947); Kupfer, *Progress in the Amendment of Section 60a of the Bankruptcy Act*, 13 LAW & CONTEMP. PROB. 624 (1948); Kupfer & Livingston, *Corn Exchange National Bank & Trust Co. v. Klauder Revisited: The Aftermath of Its Implications*, 32 VA. L. REV. 910 (1946); McLaughlin, *Defining a Preference in Bankruptcy*, 60 HARV. L. REV. 233 (1946).

Others were not so worried: Martin, *Substantive Regulation of Security Devices Under the Bankruptcy Power*, 48 COLUM. L. REV. 62 (1948); Moore & Tone, *Proposed Bankruptcy Amendments: Improvement or Retrogression?* 57 YALE L.J. 683 (1948); Oglebay, *Proposed Revision of Section 60a of the Bankruptcy Act: A Step Backward*, 51 COM. L.J. 263 (1946).

43. *In re* Harvey Distrib. Co., 88 F. Supp. 466 (E.D. Va. 1950) (trust receipt); *In re* Baltimore Casting Corp., Bkcy No. 10,000 (D. Md. 1949); *In re* Liberty Motors & Eng'r Corp., Bkcy No. 10,012 (D. Md. 1949). The last two cases are referee's opinions involving factor's liens cited in Countryman, *The Secured Transactions Article of the Commercial Code and Section 60 of the Bankruptcy Act*, 16 LAW & CONTEMP. PROB. 76, 86 n.61 (1951).

44. Act of Mar. 16, 1950, ch. 70, 64 Stat. 24.

C. Problems Resulting from Confusing Unperfected Transfers With Preferences

Are there still troubles? Of course there are. For a while, the equitable lien came back to haunt us, because the meaning of section 60(a)(6) was so obscure. It was not clear when the court should shift from the creditor test to the purchaser test, and at least one court failed to make the shift when it should have.[45] The equitable lien problem has finally been put to rest—not by any reform of bankruptcy law, but by the expunging of such liens from the local law through the adoption of the Uniform Commercial Code.[46] But the U.C.C. has also changed the kind of legal liens available under local law. It has regularized the floating lien, and the fate of these liens in the face of section 60 is currently the object of considerable scholarly comment.

The objective of the floating lienor is to perfect a lien upon a shifting quantum of goods or accounts or both. Inventories and receivables are the major assets of many businesses. If those firms are to give substantial security to their major sources of funds, these assets must be encumbered. Yet the mass of these assets is always shifting. Before the adoption of the U.C.C., a number of techniques had been devised to encumber such assets: trust recipients, statutory factor's liens, field warehousing and assignments of accounts receivable. These techniques usually involved rituals whereby agents of the lender "policed" the sequence of liens by making sure that no encumbered asset was released until a new asset was encumbered.

These rituals can serve important business purposes. They help assure the lender that his borrower will not spirit away the collateral. They also assure continuity of collateral since the policing agents will not allow old collateral to be released until new collateral is forthcoming. But in some cases, the lender does not fear that the borrower will convert the collateral and the particular business is such that there is little risk of serious gaps in the stream of collateral. Nevertheless, the lender in such a situation was not privileged, under the old rules, to waive policing requirements. Policing was necessary to avoid the rule of *Benedict v. Ratner*,[47] which deemed fraudulent as a matter of law

45. Porter v. Searle, 228 F.2d 748 (10th Cir. 1955).
46. U.C.C. § 9-203. But *caveat*, the equitable lien is alive and well in Michigan. Warren Tool Co. v. Stevenson, 11 Mich. App. 274, 161 N.W.2d 133 (1968). Also, it still can attach to real property, but the purchaser test of section 60(a)(2) prevents any subsequent real mortgage from relating back.
47. 268 U.S. 353 (1925).

transactions where the borrower retained "dominion" over the collateral. Moreover, this deliberate matching of old liens on items withdrawn from the collateral with liens on new items added to the collateral saved the new liens from the bite of section 60. Each new lien was in consideration of the contemporaneous release of an old one, so it was not a preference. In the cases where policing served no business purpose, the law's pervasive policing requirements merely added to the cost of credit. Finally, these rules were a source of worry and concern to lenders. If their agents made a slip in the ritual, the entire transaction might be vulnerable to attack under section 60 and under *Benedict.*

Article nine of the U.C.C. put this requirement to rest. The *Benedict* rule was eliminated.[48] Liens on after-acquired property were validated, with some minor exceptions.[49] Provision was made for the lifting of liens from encumbered property sold to the borrower's customers[50] and for the transferring of such liens to the proceeds of the sales should the parties so specify.[51] The danger that other creditors might be misled by the debtor's apparent dominion over the assets was removed by requiring notice filing of the particular arrangement in order to protect the lien.[52] Thereafter the lender would have a lien on all the items specified in the arrangement and his lien would be superior to those of any subsequent levying creditors.

With the lender's agents gone, and nothing being done to assure the immediate replacement of expired liens with new ones, a preference problem can arise. If the floating lien embraces all assets of a given kind, such as accounts receivable, each sale from inventory which creates a new account gives the lender additional security for his antecedent debt. If he is already completely secured, the new security is of no additional value to him, so he has not been preferred. But if he is only partially secured before this new lien attaches, it will improve his position vis-a-vis the general unsecured creditors of his

48. U.C.C. § 9-205.

49. U.C.C. § 9-204(3). Two exceptions were made for future crops and consumer goods. U.C.C. § 9-204(4).

50. U.C.C. §§ 9-307 to 9-309.

51. U.C.C. § 9-306. If the parties have not so specified, the lien continues in the proceeds but is subject to attack by other creditors after 10 days. Thus policing to segregate the proceeds and continue the lien for more than 10 days might be desirable, but failure to police does not put the entire transaction in jeopardy.

52. U.C.C. § 9-304. In the alternative, the lender may take possession of the collateral. *Id.* at § 9-305.

debtor, and he will receive a preference. This can happen even though in the long run the creditor's position is unchanged. Assume a debt which is partially secured by a pledge of accounts. Each morning, the debtor opens his mail and finds both new orders and payments on old accounts. He deposits the checks before noon and fills the orders at the close of the day. By noon the amount of the creditor's security has been decreased by the liquidation of the paid accounts.[53] But at the end of the day, the amount is increased by virtue of the new sales; he is as secure as he was before the morning mail came. The next day his security will again decrease in the middle of the day, only to increase again when the day's orders are filled. It should be kept in mind that these transactions involve no secret lien problem. The notice filing provision of the U.C.C. permits all other creditors to know what is going on. If these new liens are preferences, they are typical preferences—transfers to a creditor on account of an antecedent debt.

The draftsmen of the U.C.C. could easily solve the problem of *Benedict*, since it was a matter of state law and could be repealed. They could also avoid any problem of secret liens by requiring notice filing or delivery. But it is not clear that they could do anything about the problem of preferences in bankruptcy. They tried to do so, however, by enacting a fiction that new liens arising under a floating lien agreement are deemed to have been given for new value.[54] Since contemporaneous value prevents a transfer from being a preference, this fiction, if accepted, would have solved the problem.[55] There is in fact no contemporaneous value in the above example, since the value

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53. This is a simplification, because U.C.C. § 9-306 preserves a lien on the "proceeds," in this case the bank deposit, for 10 days. If the debtor's bank account is kept large enough to include all deposits made within the last 10 days, the creditor's security is not decreased by the conversion of accounts receivable into bank deposits, but he loses a perfected security interest in the bank account 10 days later. Each noon, then, his security is decreased by the amount deposited 10 days previously as his lien on those proceeds goes stale. Of course, if the debtor constantly depletes his bank account to pay current expenses the creditor's lien on proceeds is meaningless. There will be no identifiable proceeds for it to encumber.

54. U.C.C. § 9-108.

55. This provision is a bold-faced attempt to amend the Bankruptcy Act by means of state law, and has been the object of scholarly comment and scorn. Much of the largely critical scholarly comment on U.C.C. § 9-105 is gathered in Healy, *The Floating Lien Controversy in the Courts: Judicial Response to the Preference Problem*, 10 B.C. IND. & COM. L. REV. 265 nn.3 & 4 (1969).

given in return for each evening's new liens is the release of liens on accounts that morning. There may be recent value, but there is no new value. And at times, where the cycle is a long one, there is not even recent value. For example, a contractor building a series of large structures may have a cycle of several years. Or there may be no cycle at all, the amount of assets encumbered increasing steadily.

The terms in which bankruptcy scholars argue these cases have been amply discussed elsewhere[56] and need only be alluded to here. They fall into two classes. There is the distant view, whereby the individual members of the encumbered class seem insignificant and the gaps between liens on successive members of the class are overlooked. Additions to the class, whereby security is increased, appear to be merely a growth of what was already encumbered. From such a viewpoint, floating liens create no preferences. On the other hand, there is the myopic view where each individual member of the class looms large. Gaps between successive members of the class become material. Additions to the class create new liens. Under this view, floating liens create preferences if, at any time, the lienor was not fully secured and the debtor was insolvent. But neither point of view looks to the underlying issue, namely, whether the ordained scheme of distribution in bankruptcy has been unduly thwarted by transactions on the eve of bankruptcy. Of course, the lienor is claiming more than his pro rata share of the debtor's assets, but the theme of bankruptcy distribution is not equality at the expense of lienors. These arguments shed no light on the question of whether there was a lien given as a preference.

And yet, floating liens present a unique opportunity to effect preferences. A debt which is partially secured by such a lien can be preferred by feeding the lien. For instance, a lien on accounts receivable can be fed by reducing prices, thus increasing sales on account and the value of encumbered receivables. A debtor who has the necessary cash or credit can feed an inventory lien by increasing inventory. In all cases thus far reported, there seems to have been no feeding. The value of the collateral has declined as bankruptcy came near. This is to be expected. Yet the case will certainly arise where a debtor in failing circumstances will intentionally feed a lien to curry favor with his major source of credit in the hope of obtaining credit

56. *See* Hogan, *Games Lawyers Play with the Bankruptcy Preference Challenge to Accounts and Inventory Financing*, 53 CORNELL L.Q. 553 (1968).

for some future venture.

The fiction in section 60, however, makes impossible any attempt to avoid such feeding. That section fictitiously dates all transfers, deeming them to have been made at the date of perfection. The original purpose of this fiction was to postdate transfers so that belatedly perfected transactions could be deemed preferential whether or not they actually were. But there is no "One Way" sign in section 60. It can predate transfers also, deeming all liens under a properly filed financing arrangement to have been made at the date of filing, usually before the credit to be secured was extended.[57] This theory has found judicial favor.[58] Let a failing debtor manipulate his business to favor the holder of a floating lien. The creditor will assert under section 60 that all liens are deemed to have been given at the date of the filing of the notice—usually long before the four month period and before any credit was actually extended. The lien is then deemed to be one to secure future advances so it cannot be a preference; and in any event, it is too old.

II. PROPOSED CHANGES IN THE BANKRUPTCY ACT

This history of section 60 and the difficulties which we have encountered with it seem to indicate that a wrong turn was made in 1910 when the fictitious dating of transfers was first enacted. The real difficulty with that fiction was not immediately apparent because the 1910 version was riddled with loopholes; but since 1938, when the loopholes were finally filled, most of the section 60 troubles are traceable to that fiction. It voids transactions which ought not to be avoided and threatens to preserve transactions which ought not to be preserved.

Not only does this fiction regularly surprise us with unforeseen consequences; like many legal fictions it falls just a bit wide of the mark. By definition, fictions equate things which are in fact different. By transforming the secret lienor into a preferred creditor, section 60 has accorded the lienor all the

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57. *See* King, *Some Thoughts on Article 9 of the Uniform Commercial Code and the Bankruptcy Act*, 72 COM. L.J. 203, 206 (1967). King, *Section 9-108 of the Uniform Commercial Code: Does It Insulate the Security Interest from Attack by a Trustee in Bankruptcy?* 114 U. PA. L. REV. 1117, 1132-33 (1966).

58. *See* DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1969), Grain Merchants v. Union Bank & Sav. Co., 408 F.2d 209, 212-13 (7th Cir. 1969), *cert. denied sub nom.*, France v. Union Bank & Sav. Co., 396 U.S. 827 (1969); Rosenberg v. Rudnick, 262 F. Supp. 635, 638 (D. Mass. 1967).

immunities of such a creditor. The casually preferred creditor, having no reasonable cause to believe his debtor was in financial difficulty is perhaps worthy of protection and in fact is protected under section 60(b). The secret lienor is not equally worthy. Unlike the casually preferred creditor, who has behaved according to accepted business norms and has not connived with his debtor, the secret lienor has breached accepted norms and laid a trap for his fellow creditors. He has misrepresented the financial condition of his debtor; the degree of his culpability will vary from instances of intentional misrepresentation to mere oversight. However, he will never be completely innocent unless he lifts the veil of secrecy by recording in time for other creditors to protect themselves before bankruptcy. If bankruptcy comes too soon, and the lien ought to be avoided, the lienor's state of mind at the time of perfection is completely irrelevant to the issue. Whether or not other creditors were misled depends upon their state of mind, not his; yet section 60(b) requires proof that he had reasonable cause to believe the debtor insolvent at the time of perfection.

As further proof of the inappropriateness of this requirement in secret lien cases, the lienor's state of mind is not material where the trustee invokes the strong arm clause of section 70(c). This results in an anomaly when cases of liens belatedly perfected are compared with cases of liens never perfected. Both are now preferences under section 60. The former are deemed to have been given at the time of perfection, the latter immediately before the petition, but both are deemed to have been given for antecedent debts within four months of bankruptcy to creditors who were theretofore unsecured. In attacking a totally unperfected lien; the trustee would rarely use section 60; he would prefer to use section 70(c), since he would only have to show that a hypothetical levying creditor could have superseded the secret lienor at the time of the petition. In attacking the belatedly perfected lien, however, the trustee could not make such a showing and would have to proceed under section 60(b), thereby assuming the burden of proving that the lienor had reasonable cause to believe the debtor insolvent at the date of perfection. The trustee will normally win his 70(c) action but will sometimes lose his 60(b) suit, though in neither case does the creditor deserve to keep his lien.

In attacking liens on real property, however, the trustee might be forced to use section 60 even against liens never perfected. Though most recording acts protect creditors as well as purchasers, many in the field of real property protect only purchasers. Hence the trustee may be unable to show that a hypothetical levying creditor could supercede an unrecorded real mortgage on the date of the petition. This leads to another anomaly when the fate of an unrecorded mortgage on real property is compared to that of an unrecorded lien on personalty. As to the latter, the trustee could use the strong arm clause, but he would be relegated to section 60 in attacking the real estate mortgage. The lien on personalty would be avoided, while the real property mortgage might stand unless it could be shown that the mortgagee had reasonable cause to believe the debtor insolvent on the day of the petition.[59] But both transferees are equally blameworthy; there is no reason to treat them differently.[60]

A. A New Provision for Secret Liens and Modification of the Preference Provision

This suggests that what is needed now, and what was needed in 1910, is a special provision to handle the secret lien problem without fictions that transform such liens into other voidable transactions—a provision which makes no distinction between liens kept secret until shortly before bankruptcy and liens kept secret until after bankruptcy. Congress, in enacting the strong arm clause in 1910, recognized that a new section was needed, but its point of view was narrowed by the precedents it sought to correct; seeing two lines of precedent, it enacted two different provisions. There is no reason to continue this two-pronged approach. The strong arm clause now requires perfection of transfers as of the date of bankruptcy, using a judicial lien test of perfection. A similar provision which voids

59. Under section 60(a)(2) the fictional date of the mortgage would be the date of the petition in bankruptcy, usually a time when the debtor's insolvency is extreme and patent. Thus the trustee will lose few of these cases. He will usually be able to show reasonable cause as of the date of the petition, but there will be an occasional case where such proof is wanting. A mortgagee from a distant community who has received all of his payments on schedule may have no reason to know his debtor is insolvent.

60. It could be argued that this anomaly is one of state law, not bankruptcy law, since it stems from differences between the state recording acts involved. However, there has been a policy of preventing this difference in state recording acts from spilling over into bankruptcy, as evidenced by section 60(a)(2), which provides a different test of perfection for real property so that section 60 will have the same force against real and personal liens.

all transfers which were unperfected at any time within the four months prior to bankruptcy and which uses a workable test of perfection [61] would solve the entire secret lien problem.

Such a section could follow the pattern of many present bankruptcy provisions. Where recording is appropriate, all unrecorded transfers, whether by way of lien or grant, could be condemned if the failure to record continued into the crucial four month period and the debtor was insolvent. A grace period of 21 days (or some other appropriate period) could be permitted during which nonperfection would be excused. Voided transfers could be preserved for the benefit of the estate at the trustee's option. Jurisdiction to hear controversies concerning these matters could be granted to state and bankruptcy courts.

An amendment along these lines would make possible other changes in the Act. Section 70(c), the strong arm clause, would no longer be needed to strike down secret liens. It has, however, proved valuable in other contexts and it might well be retained in its present form.[62] In addition, the troublesome fiction could

61. The judicial lien test of section 70 is not workable in cases involving real property. Many recording acts only protect subsequent purchasers of realty. Furthermore, the purchaser test effectively destroys equitable liens. Such liens are still possible as to realty, and as to personalty the matter is in flux. *See* note 46 *supra*. It would be possible, however, to have a split test much along the lines of section 60(a)(2), with suitable limitations to prevent the use of hypothetical claimants with super-priority as tests. *See* notes 39 & 40 *supra*. My preference is for a single good faith purchaser test for all assets. But it really comes down to a matter of aesthetics, rather than law, since practically the same results can be achieved either way. The single test can be stated more simply in the statute. It also avoids a knotty problem concerning fixtures. *See* Kohn, *Preferential Transfers on the Eve of the Bankruptcy Amendments*, 2 PROSPECTUS 259, 269-271 (1968). On the other hand, it might give rise to some problems concerning consignments, the solution of which would destroy the simplicity of a single test statute. *See* note 78 *infra*.

62. For instance, the trustee's section 70(c) rights against secret federal tax liens have been finally settled in United States v. Speers, 382 U.S. 266 (1965). It would be unwise to jeopardize the holding of the *Speers* case by repealing section 70(c) and thereby giving the courts an opportunity to make their old mistakes under the proposed new section.

In addition, the trustee can avoid secret consignments in the bankruptcy of the consignee under section 70(c). *See* U.C.C. §§ 2-326(2), (3). Retention of a consignor's interest in a true consignment is not a transfer within section 1(30), so the status of consignments under the proposed new section is in doubt. Repeal of section 70(c) might leave some secret consignments immune from attack. This suggests however, the need for amending section 1(30) to handle the problem.

In general, there is a certain symmetry in leaving section 70(c) in the Act. An involuntary petition in bankruptcy is, from the petitioning then be removed from section 60. Thus, the new version would apply only to true preferences. By removing secret liens from section 60, the second act of bankruptcy would be similarly limited, and to avoid a change in the law additions to section 3 would be necessary to make the granting or suffering of a secret lien an act of bankruptcy. Examples of amendments along these lines are appended to this article.

These amendments would not only effectuate the legislative intent of the 1910 amendments; they would also meet the needs seen in 1903. The 1903 amendment sought to condemn preferences more than four months old which were withheld from record until four months before bankruptcy. The new section would void all transfers withheld from record, whether preferential or not.

B. A Grace Period for All Preferences

Although section 60 should be amended to limit it to its original role of avoiding actual preferences, one of its provisions which now applies primarily to secured transactions ought to be retained and given wider application. The grace period of section 60(a)(7) excuses short delays in the perfection of transfers. This provision was enacted to protect transactions which require a ritual such as recording for their perfection, so that such transactions would not be regarded as preferential merely because the ritual could not be performed at the same instant as the rest of the transaction. But, in this regard, transactions requiring perfection rituals are not unique. Many other transactions take time. What is unique about transactions involving perfection rituals is that many of them are secured transactions, and secured transactions occupied center stage at the time of the 1950 amendments. The application of section 60 to unsecured transactions was not under consideration at that time. When a grace period was enacted, it was intended to fit the needs of secured transactions as they were then understood. It was feared that delays in perfection would convert what were functionally contemporaneous transfers into preferences. The

creditors' viewpoint, an alternative to proceeding at law to assert their creditors' rights. It appears unwise to give the debtor immunities in bankruptcy he would not have enjoyed in the creditors' proceeding. In a voluntary proceeding the debtor is trying to forestall his creditors' use of state creditors' process; but he should not be able thereby to put some assets beyond his creditors which, under that process, they could have reached.

danger of other delays was not recognized. Consideration should be given to providing a grace period for all transfers—those which require some additional act of perfection and those which do not.

A great number of routine transactions have small, immaterial gaps if transactions are analyzed on a fine enough time scale. Even payment at a gasoline station is for an antecedent debt. A great number of transactions are paid by checks which are honored in due course, but at a time after the sale. The usual blue collar-white collar division of labor often requires that delivery of goods be made by one set of agents and acceptance of payment by another. Sale on 10 day terms to facilitate this kind of transaction is not generally thought to be a significant extension of credit. Furthermore, many things cannot be paid for even when the debt is incurred. Utility bills cannot be calculated until the meters are read. Wages and rents must be paid periodically though the buyer enjoys the fruits over continuous periods of time. Many dealings are not instantaneous and thus do not fit the pattern that seems normative under section 60.

For a number of reasons few of these transactions have given the courts trouble. First, the transferee does not usually have reasonable cause to believe the transferor insolvent. Most sellers who have such cause demand cash on delivery, not because of any rule in bankruptcy but out of fear of nonpayment. Most wage earners have no insight into the financial condition of their employers, and some payments to them cannot be preferential because of their priority in bankruptcy.[63] Rents are usually paid in advance, and no bankrupt lessor's trustee has claimed that the tenant's subsequent quiet enjoyment and use was a "transfer . . . on account of an antecedent debt."[64] Fi-

63. Section 64(a)(2) gives priority to "wages and commissions, not to exceed $600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding . . . ." Since a preference is defined as a payment which enables a recipient creditor "to obtain a greater percentage of his debt than some other creditor of the same class," section 60(a)(1), and different classes are defined by section 64(a), it is said that "payment of a debtor of wages to his employees, within the terms of section 64(a)(2), would not constitute a preference so long as all employees were paid alike and were not paid in excess of their priority . . . ." 3 W. COLLIER, BANKRUPTCY ¶ 60.34 at 907 (14th ed. 1969).

64. In leases of real estate any such attack would flounder on the concept that the lessee purchased a leasehold, an estate in land, at the time of the lease or at the time he paid the rent. His subsequent enjoyment and possession, then, would not be the *quid pro quo* for his

nally, the courts have often had good sense to avoid analyzing transactions on such a minute time scale. Multiple acts are looked upon as a single transaction.[65]

There are, however, cases which can cause difficulty. Sellers discover facts which should put them on their guard after they have granted the usual 10 day period for payment. Because of inflation, employees' wages are now likely to exceed the value of their statutory priority. In any event, that priority is only for three months whereas payments four months old can be avoided as preferential.[66] The debtor's bookkeeper is one

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payment but merely an incident of the leasehold he acquired at that earlier instant. Equipment leases, on the other hand, may not have the benefit of such ancient learning, particularly where the bailment is at will or for an indefinite time.

65. *Sales:* Cumberland Portland Cement Co., v. Reconstruction Fin. Corp., 140 F. Supp. 739 (E.D. Tenn. 1953), *aff'd on other grounds sub nom.*, Ralph Rogers & Co. v. Reconstruction Fin. Corp., 232 F.2d 930 (6th Cir. 1956) (mere delay of a few days does not convert a cash sale into a credit transaction); Dunn v. E. L. Gayvert & Co., 263 App. Div. 785, 31 N.Y.S.2d 370 (1941), *appeal dismissed*, 288 N.Y. 669, 43 N.E.2d 72 (1942) (payment of utility bills. "Those services were essential to the operation of the Kendall Station . . . . Payment of the aforementioned itms was in no sense preferential."); *In re* Perpall, 271 F. 466 (Manton, J.) (2d Cir. 1921) (delivery of bonds at 10:30 a.m., partial payment therefor at 3:00 p.m., 10 minutes before the petition was filed). *Compare In re* John Morrow & Co., 134 F. 686 (S.D. Ohio 1901). *See* language quoted, note 68 *infra*.

Payment by check: Engstrom v. Wiley, 191 F.2d 684 (9th Cir. 1951); Engstrom v. Benzel, 191 F.2d 689 (9th Cir. 1951). For reasons not apparent, the trustee in bankruptcy in both these cases sought to avoid the payments under a state preference statute rather than section 60. In *Benzel* the check was dishonored and had to be redeposited. Since no credit was intended the ultimate honoring of these checks was held nonpreferential. *Compare* Engelkes v. Farmers Cooperative Co., 194 F. Supp. 319 (N.D. Iowa 1961), where a check was dishonored and redeposited a number of times. The court assumed that had it been initially honored there would have been no preference, but dishonor plus redeposit converted the sale to a credit transaction. *See also* Note, *Cash Sales: Bad Check Doctrine Waiver: Voidable Preference*, 37 CORNELL L.Q. 477 (1952).

Payments to employees: Blauvelt v. Walker, 72 F.2d 915 (4th Cir. 1934) (wages paid during the month earned are paid for a present consideration); Bridgers v. Hart, 200 N.C. 685, 158 S.E. 242 (1931) (travel expenses of bankrupt's president reimbursed two or three days after his return; held jury should have been permitted to decide whether or not this was one transaction).

66. There are issues here which appear to be unexplored. The maximum priority under section 64(a)(2) is $600. If within three months of bankruptcy a workman has earned only $600 and that is all he has been paid, there can be no preference problem so long as other workmen have been treated similarly. However, suppose he has earned $600 per month for the previous four months. At the end of January he is owed $600 and is paid that amount. Leaving aside the argument

person with reason to know his employer's financial condition, and other wage earners will have reason to know if an occasional payroll has been late or if the employer's troubles are matters of common knowledge. Though courts have often assimilated a series of events into one transaction, they have sometimes done so in the face of settled rules to the contrary.[67] In some cases there is no good guide for the courts to use in establishing the scope of the transaction.[68] This is most obvious in

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that the entire month is one transaction, so that the payment is not for an antecedent debt (*see* note 67 *infra*), it would still not be preferential because it would be within the priority of section 64(a)(2) if the employer filed a voluntary petition on February 1. Assume further that the employer does not file such a petition and at the end of February the workman is owed another $600 which is paid him. Is this payment preferential? Or, alternatively, if it is not, has the previous payment in January now become preferential? The payment at the end of March will also raise the same issues. Assume that $600 is again earned in April but not paid, the employer files a voluntary petition on April 30. The employee claims his priority for the April wages. The January payment, which was not preferential when made, is now a preference because it is for wages earned more than three months prior to the petition and hence beyond the reach of the statutory priority. Have the February and March payments suffered a similar metamorphosis because the total priority is limited to $600?

67. In Blauvelt v. Walker, 72 F.2d 915 (4th Cir. 1934), the bankrupt's bookkeeper, whose salary was $200 per month, received only $116 during the fourth month before bankruptcy. The court said:

> Wage payments are not preferential, if applied on wages currently earned; for in such case the payment is made, not on a past due debt, but for a present consideration. . . . [P]ayments made on account of [wages earned during the fourth month preceding bankruptcy] should be considered in all fairness as having been made for a present consideration, the labor performed during the month, and not on account of old debts due the wage earner.

Id. at 916-17. The result is commendable, but it is difficult to rationalize. If the payment was made on the last day of the month, although the bookkeeper's contract called for semimonthly payments of $100 each, it would seem obvious that $16 of the $116 would be preferential. The entire employment relationship is not one continuous transaction. Even the *Blauvelt* court held preferential $316 paid during the last three months but credited to wages earned earlier. If, then, the relationship is a series of transactions, how long are they? One pay period? This would be a convenient rule but one without warrant in the statute. "Antecedent debt" does not mean "debt heretofore not due and payable." The payment of a debt on its due date can be a preference. Nor has commercial custom been permitted to convert a credit transaction into a cash transaction. *In re* John Morrow & Co., 134 F. 686 (S.D. Ohio 1901). *See* language quoted, note 68 *infra*. Consequently, even if the $116 had been paid on the established pay day, it could have been held preferential.

68. In answer to a contention that sale upon 10 day terms was, by commercial usage, a cash transaction, a court answered:

> If the parties, by agreement, can treat a sale of goods on 10

the case of the floating lien since there is no middle ground between considering the entire arrangement a single transaction and analyzing it down to its smallest components.

In an attempt to solve many of these problems, the suggested amendment of section 60 appended to this article provides a 21 day grace period for all preferential transactions. Under this grace period approach, creditors who accepted payment by check or gave 10 day terms could retain payments seasonably made whether or not they discovered disturbing facts about the debtor in the interim.[69] Payments to wage earners would present no problems so long as the pay period was less than three weeks and payments were kept current. Anytime a putative preference was given in return for value received within the previous three weeks, the transaction would be undisturbed.

Furthermore, this approach would more adequately handle floating liens. In the usual case such liens would be undisturbed because liens on new items could be matched with liens that had expired no more than 21 days before. Only if the hiatus between liens exceeds the grace period is the new lien voidable as a preference. In addition, it would not be necessary for the trustee or the courts to match carefully each new lien with a recently expired one. The trustee could merely calculate the value of liens outstanding on test days no more than three weeks apart during the four months before bankruptcy. In many cases the bankrupt's books would give such values on a weekly, biweekly or semimonthly basis. In most cases, these values would resolve all issues. If the values never dipped below the amount of the debt, the creditor was fully secured dur-

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> days' time as a cash transaction, they may also, by agreement, treat a sale on 30 or 60 days or longer time as a cash transaction, and practically defeat the operation of sections 57 (g) and 60(a) of the bankrupt [*sic*] act. [Those sections] do not contemplate a usage of merchants or a conventional arrangement between the parties which would enable any one of the creditors of a bankrupt to obtain a greater percentage of his debt than any other of such creditors of the same class. A sale of goods to be paid for in 10 or 30 days is not, in fact, a cash transaction, and cannot, by agreement of the parties, or a usage of merchants, be regarded as such within the meaning of the bankrupt [*sic*] law.

In re John Morrow & Co., 134 F. 686, 687-88 (S.D. Ohio 1901).

69. It would also protect creditors who, knowing the insolvency of their debtors, had extended terms or accepted payment by check and received their money within three weeks. However, fear of nonpayment would discourage most such transactions regardless of the provisions of the Bankruptcy Act.

ing the four month period and hence enjoyed no preference. Furthermore, if the value at bankruptcy was lower than at any previous time the creditor was not preferred because the liens at bankruptcy were successors to earlier liens of equal or greater value without any hiatus of more than three weeks. If, on the other hand, these test values showed an upward trend over the four month period, some of the final liens could not be successors to previous ones, and the increase would be considered preferential. Finally, if the values showed a decrease followed by a climb, the trustee must study in detail the value of the security at the time of the dip. Dips of less than three weeks duration would be protected by the grace period, but if the highest value in the worst three week period were less than the value at bankruptcy, the difference would be preferential. Discovering this value might be difficult in an occasional case, but finding some value which clearly equalled or exceeded it would normally not be. And in many cases, the initial test values would show that there was no dip of three weeks duration which required detailed study.

A committee of the National Bankruptcy Conference is currently considering a "two point" test to remedy the floating lien problem. This test compares the value of the security on the date of bankruptcy with its value four months earlier and voids any increase so found.[70] Professor Hogan has pointed out that this test will catch only the grossest cases. The debtor will be given free reign to prefer his secured creditor so long as he does not go beyond the value of four months before. He offers the further criticism that the test will void some unintended preferences caused by business expansion or natural cyclical fluctuations.[71] It can be answered, however, that the likelihood of a business failure is slight if the business is either expanding or at the top of a business cycle. Another difficulty with the two point test is its reliance on conditions on an arbitrary day—four months before bankruptcy. There could be an unusually low or high amount of security on that day. For example, it might be the day after a clearance sale or the day after the debtor, hard pressed for cash, had solicited and received several payments which otherwise would have been paid the following week. The advocates of this test argue that more subtle tests would be difficult to administer. Certainly a test that attempts to trace the value of the security to its lowest point would be impossible

70. *See* Kohn, *supra* note 61, at 261.
71. Hogan, *supra* note 56, at 564-65.

to apply. The nadir could occur at any instant during the critical four months. If a number of accounts were by chance paid simultaneously or if an unusually large order was filled on one day, a precipitous drop in accounts or inventory might result. To find such a low point, the trustee would have to reconstruct the history of the security instant by instant. Moreover, the replacement of this security in the next week or so would deprive such a decrease of much commercial significance. On the other hand, the two point test may sacrifice too much to ease of administration. Certainly the trustee could make a more detailed study of the history of the security than that test requires. Furthermore, it dwells on the value at an arbitrary instant, four months before bankruptcy, which may also be of little commercial significance. The grace period approach appears workable. An instant-by-instant study of the security is not required. It does not search for the lowest value during the last four months, but for the lowest value which persisted for a significant time during that period. And, unlike the two point test, the grace period approach does not permit a debtor who is contemplating bankruptcy to feed the security up to the value existing four months before.

Furthermore, the grace period approach is consonant with the reason behind abolition of policing requirements. The lender on the security of a floating lien may require policing if he feels it is necessary for him to be adequately secured. If he lends on unpoliced security, it is because he is satisfied with the normal continuity of collateral in the debtor's business. Expired liens are replaced rapidly enough to suit him. As long as section 60 contains a preference provision without a grace period, lawyers, judges and referees will have to play games with the floating lien, taking either the distant view which recognizes continuity of lien no matter how discontinuous the collateral or the myopic view which emphasizes discontinuities no matter how small. A grace period permits a middle view which sustains floating liens in the absence of any extended discontinuity. While the two point test also sustains most floating liens, it is in fact a grace period test with a period of just under four months. An expired lien ought to be replaced more quickly than that for the law to recognize continuity.[72]

72. Consider a case at the outer reaches of the two point test. A used car dealer with a security arrangement covering all cars on his lot discontinues business with the sale of two cars on August 1. After almost four months of inactivity, he acquires a car on November 29 and

The main difficulty with the grace period approach is that some preferences now condemned would be specifically permitted. Debts less than three weeks old could be preferred, thus decreasing the amount distributable in bankruptcy. Would this be undesirable? By and large, the holders of such claims would be trade creditors. Less would be available for priority claimants; less would be available for general creditors in the occasional case where payments are made to them. Insofar as general creditors are also trade creditors, the class that enjoyed the benefit would also suffer the burden. The amounts involved would generally be small, since it would be a rare case in which a debtor raises significant capital and repays it within three weeks. The danger that he would borrow large sums and secure them by a lien within three weeks is not significantly different from the risk that security for a debt will be withheld from record for three weeks. The business world has been able to live with this risk; it probably could live with the risk of a short grace period for all transactions.

Once the grace period approach is accepted in principle, there is some difficulty deciding what its proper length should be. Three weeks seems appropriate because experience with it in section 67(a)(7) indicates it does not impose too great a burden on the community of unsecured creditors. However, some factors may indicate a need for a longer period. For instance, accounts receivable often move in a monthly rhythm, so that a 21 day period would not span the gap between maximum values.[73] It would, however, probably span the gap between average values, and thus assure the holder of a floating lien on receivables the average value of his lien, if he were lucky enough for bankruptcy to occur when the estate held accounts of that

a petition in bankruptcy is filed the following day. The lien on the single car is validated by the two point test because its value does not exceed the value of the liens on the two cars four months before. This case would not, of course, be typical but it would be possible, and it flys in the face of the underlying assumption in bankruptcy that current creditors have made crucial decisions during the four months prior to bankruptcy based upon the apparent financial condition of the debtor.

73. It should be kept in mind that such a lien remains perfected as to cash proceeds for an additional 10 days under U.C.C. § 9-306. Thus, in a business which retains an adequate cash position, a grace period of 21 days, when added to this 10 day period, would adequately bridge any gap in a monthly cycle. Healthy businesses which receive cash payments on a monthly basis probably do keep reasonable cash balances for the 10 days following such receipts in order to pay their current expenses, but a failing business might not retain sufficient cash or bank deposits upon which this 10 day lien could attach.

value.[74] However, some transactions appear to require a longer grace period. Purchases on open account may not be paid until as much as a month and a half later, since with monthly billing, the buyer may not receive the bill until a month after delivery. Given 10 day terms and including time for his check to clear, it may be another two weeks until payment is actually received. While a three week or one month grace period is workable, a six week period would give a failing debtor too much room in which to maneuver. Thus, some transactions cannot be bridged by a statutory grace period.

This means that the grace period can only be a supplement to the other techniques used to protect casually preferred creditors. The courts must continue to view some dealings as continuing transactions. In general, creditors who are preferred under circumstances in which they had no reason to believe their debtors were insolvent should continue to be permitted to keep their preferences as they now are under section 60(b) regardless of whether the transaction is protected by the statutory grace period.

In the case of liens created by an after-acquired property clause, however, the lienor's lack of knowledge concerning his debtor's fortunes seems quite irrelevant. The creditor in such cases is not a party to the transaction which prefers him. Other preferred creditors, who accept payment or the grant of a lien, are parties to the transactions involved. If they could not have

74. A grace period approach which puts in jeopardy liens on bodies of assets which are quite discontinuous probably will not seriously upset the expectations of the creditor community. When a floating lien is accepted, and it is recognized that the body of encumbered assets fluctuates widely and has large discontinuities, the lender recognizes that he is lending on relatively insecure security. The grace period approach will somewhat aggravate that risk by holding him to the highest value in the worst three weeks of the past four months. This value will occasionally be lower than the value at the date of bankruptcy. But such a creditor has already taken the risk of more severe injury that bankruptcy will occur during such a discontinuity and there is no way that the creditor can receive more than the actual value of the encumbered assets on the date of bankruptcy. Having then accepted the rather sizable risk that events will overtake him during a discontinuity, a creditor willing to lend on the security of such assets will not be much dissuaded by this additional risk. On the other hand, creditors who look to relatively continuous bodies of assets probably do not take into account the slight risk that they will be caught by a chance instant of low value. While the grace period approach cannot help them if the date of bankruptcy is one of those chance instants, it will protect them from the impact of section 60 if such an instant occurred during the recent four months.

connived with the debtor due to lack of reasonable grounds to know he was distressed, they are permitted to keep their preferences. But the beneficiary of a lien on after-acquired property has neither accepted the specific lien nor had knowledge of the particular transaction which created it, so his state of mind at that instant seems irrelevant to the case. The theory underlying floating liens is that they have continuity and are to be judged according to the circumstances existing when the arrangement was first instituted. If a grace period approach is used to assure sufficient continuity of a lien, the creditor has received adequate protection and the reasonable cause test of section 60(b) ought not to give further protection.[75] The proposed amendment to section 60(b) appended to this article so provides.

C. SUMMARY

The grace period approach would remove a number of small problems inherent in the area of preferences and would provide sensible administration of secret liens. The proposed new section voiding secret transfers would correct the unfortunate decision made in 1910. The new section would also remove the need for fictitious dating of transfers, a fiction which has certain analytic beauty but often obscures the real problem. Finally, the new section would invalidate all transfers withheld from record without regard to the transferee's knowledge of the debtor's solvency, thereby recognizing that any prolonged failure to record is a failure to abide by an important legal norm.

On the other hand, practically every amendment to the Bank-

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75. Professor Hogan suggests that this problem be dealt with by recognizing liens on after-acquired property only if the property was acquired in the ordinary course of business, as is currently provided in U.C.C. § 9-108. Hogan, *supra* note 56, at 569-73. Since intentional feeding arises from transactions beyond the ordinary course of business, feeding would be voided as a preference. This test would have the advantage of validating floating liens in businesses whose normal rhythm is too slow to fall within a reasonable statutory grace period. It might also catch cases of intentional feeding which merely sustained the value of a lien rather than increasing it. However, determining what the normal course of business is for an entrepreneur on the brink of ruin might be an impossible task. It would require trying the issue of his intent, an issue already found untriable in the preference context. Professor Hogan attempts to ease the burden of such trials by presumptions, depending upon whether the value of encumbered property had increased or not during the four month period; but the trustee would be duty bound to attempt to rebut such presumptions if he thought it possible, thereby enmeshing such cases in a search for the debtor's intent.

ruptcy Act in this area has had unwanted results, and there is a good chance that these amendments would have them also. Certainly the above suggestions, which are the product of only one mind, are quite likely to be defective in this regard. No doubt many readers will see unintended results which can be avoided by rephrasing the proposals. Even then, if history is any guide, enactment of new sections in this area will probably present us with some disturbing surprises.

APPENDIX

A. Proposed Section on Secret Transfers

Section 70(k).[76]

(1) For the purposes of this subsection, a voidable transfer is a transfer of any property of the debtor (a) which has not been perfected as defined by the next paragraph of this subsection, (b) which has remained so unperfected for a period in excess of 21 days,[77] and (c) has remained so unperfected at a time when the debtor was insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this act.

(2) A transfer is perfected when no subsequent ordinary good faith purchaser from the debtor could obtain rights superior to those of the transferee. Ordinary good faith purchaser shall not include purchasers who, under applicable law, enjoy special priorities such as: buyers in the ordinary course of trade or business, holders in due course of negotiable instruments, good faith purchasers or investment securities or negotiable documents of title or chattel paper or other specially favored classes of purchasers.[78]

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76. This new section has to go somewhere, but if it is put in section 60, 67 or 70 it will be unnecessary to amend section 23(b). Section 60, from which its central idea came, is entitled "preferences," and tacking it on to the end of that section might prolong the present confusion. Since the new section is related to section 70(c), I have attached it to section 70.

77. This retains the grace period now found in section 60(a)(7). It is somewhat more liberal, giving 21 days whether or not local law specifies a shorter period. Obviously, this could be changed to specify 21 days or the local law period, whichever is shorter.

78. This section adopts the good faith purchaser test for all transactions, as discussed in note 61 *supra*. The purchaser test does, however, have one disadvantage. Consignments, or goods held on sale and return, are subject to creditors' claims unless perfected. U.C.C. § 2-326 (3). A creditor test, therefore, would properly take care of these cases;

(3) Any voidable transfer may be avoided by the trustee. Should any voidable transfer create a lien, security title or security interest and should the debtor thereafter make or suffer a transfer in satisfaction, either in whole or in part, of the debt so secured, such subsequent transfer may also be avoided by the trustee.[79]

(4) Where any transfer is voidable under this subsection, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a purchaser with special priority or a good faith purchaser from or lienor of the debtor's transferee for a present fair equivalent value: Provided, however, that where such purchaser or lienor has given less than such value, he shall nevertheless have a lien upon such property, but only to the extent of the consideration actually given by him.

(5) Where a transfer voidable under this section results in a lien, security title or other security interest, the court may on due notice order such lien, title or interest to be preserved for the benefit of the estate, in which event the lien, title or interest shall pass to the trustee.

(6) For the purpose of any recovery or avoidance under this subsection, where plenary proceedings are necessary, any state court which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction.[80]

B. Proposed Amendments of the Preference Provisions

Section 60(a). A preference is a transfer of any property of a debtor to or for the benefit of a creditor for or on account

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it is not clear that a purchaser test will. This could be cured by a special provision, using a creditor test, for consignments. The section would appear a bit cumbersome, but it would not cause much trouble in the administration of the act. Unlike the realty-personalty dichotomy in section 60(a)(2), which can cause trouble with fixtures, the consignment-nonconsignment dichotomy would not cause trouble in classification. An asset is either consigned or it is not.

If consignment were to be properly handled under the act, not only would a creditor test need to be adopted, but the definition of transfer in section 1(30) would have to be expanded to include the retention by a consignor of the consignor's interest, much as it now includes the retention of a vendor's security interest.

79. This sentence permits the trustee to void step transactions. Once the secret lien is voidable, any subsequent payment or surrender of the property to the lienor should also be voidable.

80. These last three subsections repeat provisions of section 60(b).

of an antecedent debt, made or suffered by such debtor while insolvent not more than four months prior to the filing of a petition 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, no transfer is a preference if it is given in consideration of value received no more than 21 days before the transfer.[81] If any transfer is given in consideration of value, part of which was received more than 21 days before the transfer and part of which was received no more than 21 days before the transfer, the transfer is a preference only insofar as it was given in consideration of the value received more than 21 days before the transfer.[82] For the purposes of subdivisions (a) and (b) of Section 60 of this Act, transfers shall be deemed to have been made or suffered when they became binding between the parties thereto according to applicable law.[83]

(b). Any preference which is a lien created under an after-acquired property clause may be avoided by the trustee.[84] Any preference other than one created under an after-acquired property clause may be avoided by the trustee if the creditor receiving it or to be benefitted thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe the debtor is insolvent. Where the preference is voidable, . . . [etc.].

C. Proposed Amendments to Section 3

Section 3 (a). Acts of bankruptcy by a person shall consist of his having (1) . . . [etc.] *(7) made or suffered a voidable transfer as defined in subdivision (k) of section 70 of this act.*[85]

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81. This proviso is intended to establish the grace period suggested in the text accompanying note 73 *supra*.

82. This sentence is included to deal with cases in which a debt protected by the grace period and one not so protected are preferred by the same transfer.

83. This sentence is inserted out of caution to make it absolutely clear that the fictional dating of transfers which has been embodied in this section since 1910 is repealed.

84. This sentence and the one following it are intended to withdraw the element of the transferee's reasonable cause to know of the debtor's insolvency from all after-acquired lien cases while retaining this element in all other cases, as suggested in the text accompanying note 75 *supra*. The remaining part of the section, as indicated by elipsis marks, is to be unchanged.

85. Since much of section 3 is to remain unchanged, most of the unchanged parts are indicated by elipsis marks. The italicized words are new. They create a new act of bankruptcy but do not create any

(b). A petition may be filed against a person within four months after the commission of an act of bankruptcy. Such time with respect to the third act of bankruptcy shall expire . . . [etc.] and such time with respect to the second act of bankruptcy shall not expire until four months after the date when the transfer [became perfected] *occurred*[86] as prescribed in subdivision (a) of section 60 of this Act, *and such time with respect to the seventh act of bankruptcy shall not expire until four months after the date when the transfer became perfected as prescribed in subdivision (k) of section 70 of this Act.*[87] For the purposes . . . [etc.].

(c). . . . .

(d). Whenever a person against whom a petition has been filed alleging the commission of the second, third, [or] fifth, *or seventh* act of bankruptcy takes issue with . . . the allegation of his insolvency . . . he shall appear in court . . . [etc.].[88]

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new law. If unperfected transactions are no longer condemned by section 60, they are no longer examples of the second act of bankruptcy. An amendment to section 3 is necessary so that they will continue to be an act of bankruptcy. The second act of bankruptcy could be expanded to include both preferences and unperfected transfers, but that would make difficult the wording of the timing provisions of section 3(b). Indeed, this act of bankruptcy has more in common with the first act in that the four month period is extended by failure to perfect the transfer. However, the first act of bankruptcy uses both a purchaser and a creditor test, with no specific language ruling out the use of hypothetical third parties with super-priority. Thus, failure to perfect a transfer cannot be inserted into the first act unless the entire matter of perfection under sections 3(a)(1) and 67(d) is rethought, a task which probably ought to be done but which is beyond the scope of this article.

86. Since fictitious dating of transfers is to be eliminated from section 60(a), the bracketed words should be removed and the italicized word added. The problem of unperfected transfers will be governed by the new act of bankruptcy. They will be acts of bankruptcy whether received as a preference or not.

87. This provision, which parallels the present rule concerning the second act of bankruptcy, has the effect of delaying the running of the four month period until perfection.

88. This provides for the same method of trial concerning the issue of solvency in the new act of bankruptcy as is provided in all others where the issue is relevant, excepting the first act of bankruptcy which is specially governed by section 3(c).