

Constance v. Harvey — The “Strong-Arm Clause” Re-Evaluated

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Section 70c of the Bankruptcy Act, colloquially known as the “strong-arm clause,” provides that a trustee in bankruptcy, as to all property upon which a creditor of the bankrupt could have obtained a lien by legal or equitable proceedings, shall be deemed vested as of the date of bankruptcy “with all the rights, remedies, and powers of a creditor then holding a lien thereon by such proceedings, whether or not such a creditor actually exists.”¹ This provision in its original form was first inserted in the Bankruptcy Act in 1910,² in order to strike down certain secret liens and transfers made by a bankrupt, which would have been vulnerable to his creditors in state court proceedings, but which had been upheld as against the trustee because he “stood in the shoes” of the bankrupt.³

Prior to 1950, this clause applied only to property which was in the possession or under the control of the bankrupt at the time of bankruptcy, “or otherwise coming into the possession of the bankruptcy court.”⁴ Under this provision, it was clear, for example, that a fraudulent transfer by the bankrupt, where possession was delivered to the transferee, could not be attacked by the trustee under this clause of Section 70c, since the property was no longer in the possession of the bankrupt at the date of bankruptcy. As to such property, the trustee was vested by Section 70c only with the rights of a creditor who has had execution returned unsatisfied.⁵ However, in 1950 this restriction was eliminated, and the strong-arm clause in the form stated in the preceding paragraph now applies to “all property, whether or not coming into possession or control of the court . . .”⁶ Under this present provision, the strong-arm clause arguably might be used to

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

² 36 STAT. 838 (1910).

³ *Zartman v. First National Bank*, 216 U.S. 134 (1910); *York Manufacturing Co. v. Cassell*, 201 U.S. 344 (1906).

⁴ 52 STAT. 840, 881 (1938). This was the wording introduced by the Chandler Act in 1938. Between 1910 and 1938, although the wording of the clause was somewhat different, the substance of it was apparently the same. See 36 STAT. 838, 840 (1910) for the original wording.

⁵ See citations in note 4 *supra*.

⁶ Note 1 *supra*.

attack any transfer by a debtor which could have been attacked by any of his creditors under the state law.

By the express provisions of the statute, and under the decisions, the rights of the actual creditors of the bankrupt existing at the date of bankruptcy are, however, immaterial under this clause. Even though all of the actual creditors might have been incapacitated from attacking an unrecorded chattel mortgage, for example, because they all had actual knowledge thereof, the trustee under the strong-arm clause is to be considered an "ideal" creditor acquiring a lien without notice and therefore acquiring superior rights to the mortgagee.⁷ As Judge Holmes has poetically said, the trustee under this clause "stands here as the ideal creditor, irreproachable and without notice, armed cap-a-pie with every right and power which is conferred by the law of the state upon its most favored creditor who has acquired a lien by legal or equitable proceedings."⁸

In this respect the strong-arm clause is to be contrasted with Section 70e, which gives the trustee the right to avoid any transfer made or suffered by a bankrupt, which under state or federal law "is fraudulent as against or voidable for any other reason by any creditor of the debtor, having a claim provable under this title . . ."⁹ Under Section 70e it is clear that the trustee's rights are measured entirely by the rights of some actual creditor with a provable claim, except that the transfer may be set aside *in toto* regardless of the amount of the claim of the creditor who is entitled to attack it and in whose shoes the trustee stands.¹⁰ Thus, if the cause of action of the only creditor otherwise entitled to set aside a fraudulent conveyance by the bankrupt would be barred under the state statute of limitations, then the trustee is similarly barred when proceeding under Section 70e.¹¹

It is apparent that, prior to the 1950 amendment to the strong-arm clause, Section 70e was usually the only recourse of the trustee in attacking a transfer of property by the bankrupt when the property was no longer in the bankrupt's possession at the time of bankruptcy. We will consider later whether Section 70e still serves any function since the 1950 amendment to the strong-arm clause.

As has been stated, under the strong-arm clause the court will "play like" the trustee is a creditor without notice who acquired a lien by legal or

⁷ *Hoffman v. Cream-O-Products*, 180 F.2d 649 (2d Cir. 1950), *cert. denied*, 340 U.S. 815 (1950).

⁸ *In re Waynesboro Motor Co.*, 60 F.2d 668, at 669 (S.D. Miss. 1932).

⁹ 11 U.S.C. § 110(e) (1) (1952): "A transfer made or suffered or obligation incurred by a debtor adjudged a bankrupt under this title which, under any Federal or State law applicable thereto, is fraudulent as against or voidable for any other reason by any creditor of the debtor, having a claim provable under this title, shall be null and void as against the trustee of such debtor."

¹⁰ *Moore v. Bay*, 284 U.S. 4 (1931).

¹¹ *Heffron v. Duggins*, 115 F.2d 519 (9th Cir. 1940).

equitable proceedings at the time of filing the petition in bankruptcy. However, an additional assumption is necessary in some circumstances under the law of some states in order to determine the relative rights of the trustee and a third person who was a party to a security transaction with the bankrupt.

Suppose that the debtor gave a chattel mortgage to the Friendly Finance Company to secure a present loan. The applicable state law requires that the chattel mortgage must be recorded within a reasonable time in order to be valid as against creditors and there is an unreasonable delay in recordation. Under the law of many, perhaps most, states, however, if the mortgagee records the mortgage before any creditor attaches or levies execution upon the chattels, then the mortgage is validated as against all creditors.¹² In other words, it is merely a race of diligence between the mortgagee and the unsecured creditor as to whether the mortgagee first records or whether the unsecured creditor first levies attachment or execution. In such a state, it is clear that the recordation of the chattel mortgage at any time prior to the filing of the petition in bankruptcy will prevent the trustee from acquiring any rights under the strong-arm clause.¹³

However, in other states, such as New York, recordation of the chattel mortgage after the required time will not validate the mortgage as against creditors who extended credit prior to its recordation, although the mortgage will be valid as against any creditor extending credit thereafter.¹⁴ Suppose that, in such a state, a debtor executes a chattel mortgage to the Friendly Finance Company to secure a present loan, and there is an unreasonable delay in recordation so as to invalidate the mortgage as to pre-existing creditors. However, the mortgage is recorded prior to the filing of the petition in bankruptcy. Under the strong-arm clause, will the court "play like" the trustee as a hypothetical levying creditor extended credit prior to the recordation of the mortgage or afterwards? The answer to this question will determine whether the mortgage can be invalidated under that clause or not.

In *Constance v. Harvey*¹⁵ the Court of Appeals for the Second Circuit, in an opinion by Circuit Judge Harlan, held that in these circumstances the mortgage was valid because recorded prior to the filing of the petition.¹⁶ However, on the petition for rehearing on another point, the court *sua*

¹² 1 JONES, CHATTEL MORTGAGES AND CONDITIONAL SALES § 245 (Bowers ed. 1933).

¹³ *In re Consorto Const. Co.*, 212 F.2d 676 (3d Cir. 1954).

¹⁴ 1 JONES, CHATTEL MORTGAGES AND CONDITIONAL SALES § 245a (Bowers ed. 1933).

¹⁵ 215 F.2d 571 (2d Cir. 1954), *cert. denied*, 75 Sup. Ct. 294 (1955).

¹⁶ The record in the case did not show when the petition in bankruptcy was filed and therefore did not show whether the mortgage was recorded before or after the filing of the petition. However, for the purpose of reviewing the order invalidating the mortgage, since the trustee had the burden of proof, the court assumed that the mortgage was recorded before the petition was filed. On this assumption, it at first held the order below to be erroneous and remanded for further findings.

sponte reversed itself in a per curiam opinion on this construction of the strong-arm clause. The court held in effect that under the strong-arm clause the trustee could "play like" he extended credit at whatever time was most advantageous to him. This indecision of the court illustrates the inherent difficulty of this question,¹⁷ but it is the thesis of this article that the court was right the first time.

The strong-arm clause represents only one engagement in that continuing struggle between secured and unsecured creditors under the Bankruptcy Act. The two basic principles of the Bankruptcy Act, to promote equality of distribution among creditors and to preserve security interests fairly acquired, are of course directly in conflict. It is in the area where these two opposing principles meet and clash that almost all bankruptcy litigation of importance arises. It is probably safe to predict that the case of *Constance v. Harvey* will cause more anguish among secured lenders in some states than any other case since *Corn Exchange Bank v. Klauder*,¹⁸ although geographically the effect will not be as widespread.

In order to analyze the effect of this decision on security transactions and fraudulent conveyances, it will be helpful to be specific and relate the discussion to the law of one state. For this purpose, I have chosen the law of California, but to the extent that the law of other states is similar to that of California, the same results will follow.

CHATTEL MORTGAGES

Under the law of California, a chattel mortgage is required to be recorded "immediately."¹⁹ In the absence of such immediate recordation, the mortgage is invalid as to all creditors who were such at the time of execution

¹⁷ Cf. *Mercantile Trust Co. v. Kahn*, 203 F.2d 449 (8th Cir. 1953), dealing with the law of Missouri, where creditors who extend credit between the execution of a chattel mortgage and its delayed recordation can levy upon the chattels after recordation, but a creditor who existed before the execution of the chattel mortgage cannot levy after recordation. 1 JONES, CHATTEL MORTGAGES AND CONDITIONAL SALES § 245c (Bowers ed. 1933). The court in this case did not discuss Section 70c, but it very carefully found that there were two creditors with provable claims who extended credit between the date of execution of the chattel mortgage and the date of its delayed recordation, before invalidating it under Section 70e. Thus, the approach of this case is contrary to that of *Constance v. Harvey*. See also *McKay v. Trusco Finance Co.*, 198 F.2d 431 (5th Cir. 1952), dealing with the law of Alabama, which is apparently the same as that of Missouri, in which the court said by way of *dictum*: "It may be that in the case of a belated recording [of a chattel mortgage] prior to bankruptcy, the trustee would have to bring himself within the terms of Section 70, sub. c(1) of the Bankruptcy Act [and could not rely on Section 70c]." 198 F.2d at 435.

¹⁸ 318 U.S. 434 (1943).

¹⁹ CAL. CIV. CODE § 2957. The statute does not specify any time for recordation, but the court has reasoned that it must be "immediate" because it is a substitute for the "immediate" transfer of possession otherwise required under CAL. CIV. CODE § 3440. *Wolpert v. Gripton*, 213 Cal. 474, at 481, 2 P.2d 767, at 769 (1931). As used here and in the California cases, however,

of the mortgage and as to all creditors who became such without notice prior to recordation. Such creditors can levy on the property subject to the mortgage even after its recordation and acquire a lien superior to that of the mortgagee.²⁰ However, the mortgage is valid as to all creditors who became such after its recordation.²¹

Suppose that in California a debtor on January 1, 1952 executes a chattel mortgage to the Friendly Finance Company to secure a present loan. The mortgage is not recorded until February 1, 1952.²² Thereafter the debtor pays all of his creditors existing on January 1, 1952 and all who became such between January 1 and February 1, 1952. However, subsequently the debtor becomes involved in financial difficulties in the latter part of 1953 and a petition in bankruptcy is filed on January 1, 1954. All of the creditors with provable claims (other than the Friendly Finance Company) became such after January 1, 1953, more than eleven months after the mortgage was placed of record. Under the decision of *Constance v. Harvey* the mortgage would be invalid as against the trustee under the strong-arm clause, since the trustee can "play like" he is a creditor who extended credit prior to February 1, 1952.

The result obviously is that under this decision failure to record a chattel mortgage immediately in California would make it forever voidable should bankruptcy of the mortgagor subsequently ensue under any circumstances. This result is the more serious in view of the great strictness of the cases in interpreting what constitutes "immediate" recordation. For ex-

the word "immediate" is a word of art and does not really mean immediate. Recordation may be delayed for as much as a week or ten days without penalty if immediate recordation was "impractical." Nevertheless, it would seem that the California requirement is a more stringent one than the requirement in some states that recordation must take place within a "reasonable time." (CAL. VEH. CODE § 195 has, of course, substituted a fixed period of 30 days within which a chattel mortgagee of an *automobile* must notify the Department of Motor Vehicles of such security interest and deposit an endorsed certificate of title.)

²⁰ *Cardenas v. Miller*, 108 Cal. 250, 39 Pac. 783, 41 Pac. 472 (1895). It should be noted, however, that if the chattel mortgagee *takes possession* of the mortgaged property, this will validate his lien as to all prior creditors who have not levied attachment or execution, regardless of any delay in recordation or non-recordation. *Lemon v. Wolff*, 121 Cal. 272, 53 Pac. 801 (1898); *Adlard v. Rodgers*, 105 Cal. 327, 38 Pac. 889 (1894). This rule can be rationalized on the basis that the taking of possession with the consent of the mortgagor is equivalent to a present *pledge*, which would give the pledgee rights superior to those of all unsecured creditors. But compare *Noyes v. Bank of Italy*, 206 Cal. 266, 274 Pac. 68 (1929), in which the court either overlooked the existence of the *Lemon* and *Adlard* cases or (as seems more likely) adopted a wholly untenable construction of Section 70c of the Bankruptcy Act, *i.e.*, that the trustee could claim to be a creditor who acquired a lien as of some date prior to bankruptcy. Such a construction is contradicted by the express terms of the section.

²¹ *Wolpert v. Gripton*, 213 Cal. 474, 2 P.2d 767 (1931).

²² It is clear that a delay of one month would not constitute "immediate" recordation as required by the California rule. See *Citizens National Trust & Savings Bank v. Gardner*, 161 F.2d 530 (9th Cir. 1947), and cases cited therein.

ample, in one case the mortgagee mailed a copy of the mortgage immediately to the county recorder with a request that it be billed for the recording fees. The recorder put the mortgage in a "hold" basket and sent a statement to the mortgagee, who mailed a check for the fees, and the mortgage was then recorded. This entire process delayed the recordation of the mortgage until fourteen days after its execution. This was held not to constitute "immediate" recordation, since the recorder was not required to record the mortgage until receipt of the fees.²³

It is submitted that the result of the *Constance* case in invalidating a mortgage for the benefit of creditors none of whom could possibly have been injured by the delay in recordation is carrying the policy of equality of distribution too far at the expense of secured creditors. If the strong-arm clause were held inapplicable, then the trustee could still proceed to invalidate the mortgage under Section 70e if any actual creditor with a provable claim extended credit prior to recordation of the mortgage and therefore was possibly injured by the failure to record immediately.²⁴

TRUST RECEIPTS

Under the Uniform Trust Receipts Act, which has been adopted in California,²⁵ a failure to file a notice of trust receipts financing in the time required by the Act will only invalidate the trust receipt as against a creditor who levies attachment or execution prior to actual filing.²⁶ Therefore, since this statute establishes a different rule as to trust receipts than the one applicable to chattel mortgages, filing of a notice of trust receipts financing as required by the Act at any time prior to the filing of the petition in bankruptcy by or against the borrower will prevent the invalidation of the trust receipt even under the rule of the *Constance* case. After such filing of the

²³ *In re Kessler*, 90 F. Supp. 1012 (S.D. Cal. 1950).

²⁴ In *Moore v. Bay*, 284 U.S. 4 (1931), there was a delayed recordation of a chattel mortgage in California and there were creditors with provable claims who became such both before and after the recordation of the mortgage; however, the amount of the claims of the creditors who became such before recordation (the only ones who were entitled to attack the mortgage under California law) was less than the value of the mortgaged property. Nevertheless, the Supreme Court held that the mortgage could be avoided *in toto* for the benefit of the estate under the forerunner of Section 70e. It is difficult to understand the trouble the lower courts had with this case or the furor which the holding of the Supreme Court caused, if the same result followed automatically anyway under Section 70c [then Section 47a(2)] whether or not there were creditors who became such prior to recordation of the mortgage. It would seem that this case is inconsistent in theory with that of *Constance v. Harvey*.

²⁵ CAL. CIV. CODE §§ 3012-3016.16.

²⁶ CAL. CIV. CODE § 3016.4 (1) provides that the interest of the holder of the trust receipt shall be valid without any filing for thirty days, and thereafter except as provided in the Act. CAL. CIV. CODE § 3016.4(2) provides that the interest of the holder of the trust receipt "shall be void as against lien creditors who become such after such thirty-day period and without notice of such interest *and before filing*." (Italics added).

notice, under the California law no creditor can levy on the chattels subject to the trust receipt and acquire a superior lien regardless of when he extended credit and regardless of how delayed the filing was.²⁷

ACCOUNTS RECEIVABLE

A California statute²⁸ requires the filing of a notice of the assignment of an "open book account," as defined in the statute, within five days after the execution of the assignment. In the absence of such filing, the assignment is invalid as to any creditor of the assignor without actual notice, except those who extended credit after the notice was in fact filed.²⁹ With regard to accounts receivable assigned as security, the statute thus expressly provides for the same rule as has been reached by judicial construction of the chattel mortgage statute,³⁰ with the addition of a fixed period of five days allowed for filing.

Suppose a debtor assigns his accounts receivable to the Friendly Finance Company as security for a present loan, and the Friendly Finance Company does not file the required notice of the assignment until six days after its execution. If a petition in bankruptcy is filed with respect to the debtor at any time thereafter, the assignment will be invalid as to the trustee under the rule of the *Constance* case, even though all of the creditors with provable claims became such after the filing of the notice. Since there might conceivably have been (although there in fact is not) a creditor who extended credit prior to the filing of the notice, and since such a creditor would have been entitled to garnish the accounts and acquire a lien superior to the rights of the assignee under state law, the trustee can "play like" he is such a creditor.

It is submitted here also that this result unreasonably invades the rights of secured creditors in order to promote the policy of equality of distribution. It is also attaching a penalty to the one-day's delay in filing which seems disproportionate to the offense.

²⁷ How it is possible to reconcile this rule with the long standing policy of the state to the contrary under the chattel mortgage statute or to justify having different rules with respect to trust receipts and chattel mortgages, I do not know.

²⁸ CAL. CIV. CODE §§ 3017-3029.

²⁹ CAL. CIV. CODE § 3018: "... Except as to any credit extended by a creditor after the notice provided for in this chapter is filed, an assignment of an account shall be invalid as against any creditor of the assignor without actual notice unless notice of or of intention to make the assignment as provided for in this chapter is filed at the time of or before the execution of the assignment or within five days thereafter."

³⁰ The original assignment statute contained only general language making the assignment void as to "present or future creditors" of the assignor for lack of filing, but it was given the same construction as similar general language in the chattel mortgage statute in *Menick v. Carson*, 96 F.Supp. 817 (S.D. Cal. 1951). The statute in its present form, *supra* note 29, represents a codification of the rule of the *Menick* case.

FRAUDULENT CONVEYANCE

Under the Uniform Fraudulent Conveyance Act, which has been adopted in California,³¹ a conveyance made without fair consideration by a person who is, or will be thereby rendered, insolvent is void as to existing creditors without regard to his actual intent, but not as to future creditors.³² Therefore, if a person makes a gift while insolvent, but thereafter improves his financial health and pays all his creditors existing at the time of the gift, the gift is immune to attack in the state courts by creditors of the donor when he subsequently becomes insolvent again one year or five years or ten years thereafter.

However, under the 1950 amendment to the strong-arm clause and the rule of *Constance v. Harvey*, the opposite result would seem to follow in bankruptcy. Under the Uniform Fraudulent Conveyance Act, one of the remedies of a creditor against a fraudulent conveyance by his debtor is to disregard the conveyance and levy attachment or execution on the property conveyed.³³ Under the 1950 amendment to the strong-arm clause, the trustee is entitled to the rights of a creditor levying attachment or execution even as to property not in the possession of the bankrupt. Under the rule of the *Constance* case, the trustee can choose the time as of which he became a creditor, and can therefore say he is a creditor who was such at the time the gift was made ten years ago.

Nor would the statute of limitations apparently ever run on the right of the trustee thus to avoid the gift. Before 1950 some creditor must still have the right to attack a fraudulent conveyance for the trustee to recover under Section 70e. Therefore, if all of the actual creditors were barred by the state statute of limitations, the trustee would also be barred.³⁴ However, under

³¹ CAL. CIV. CODE §§ 3439.01-3439.12.

³² CAL. CIV. CODE § 3439.04: "Every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a fair consideration." The careful specification of "present and future creditors" in other sections of the Act makes it clear that "creditors" here refers only to present creditors.

³³ CAL. CIV. CODE § 3439.09(a).

³⁴ *Heffron v. Duggins*, 115 F.2d 519 (9th Cir. 1940). When the trustee could only proceed under Section 70e to set aside a fraudulent conveyance by the bankrupt, such a suit was properly treated in the *Heffron* case as equivalent to a suit in equity to set aside the conveyance and therefore governed in California by the three-year statute of limitations relating to actions for fraud. CAL. CODE CIV. PROC. § 338(4); *Pedro v. Soares*, 18 Cal.App.2d 600, 64 P.2d 776 (1937); *Richardson v. Michel*, 45 Cal. App.2d 188, 113 P.2d 916 (1941). For the different rule in California relating to the situation where a creditor levies execution upon and sells the fraudulently conveyed property, see notes 37 and 38 *infra*. Since 1950 the trustee can represent a hypothetical levying creditor under Section 70c, rather than an actual creditor in a suit to set aside the conveyance under Section 70e.

the present strong-arm clause, the trustee is an "ideal" creditor without notice of the fraudulent conveyance and with a lien on the property conveyed. If the "fraud" statute of limitations is applied, as in some states, to bar the right of a creditor to levy on property fraudulently conveyed,³⁵ such a statute does not generally start to run until discovery of the fraud,³⁶ and the trustee under Section 70c is "irreproachable and without notice."

On the other hand, under the California rule, a creditor of the transferor may levy upon and sell property fraudulently conveyed as long as a writ of execution can be procured. A suit by the purchaser at such execution sale to recover possession of the property is only barred by adverse possession of five years on the part of the fraudulent transferee,³⁷ and his possession cannot be considered adverse at any time prior to the execution sale.³⁸ The levy is not barred at any time, since a writ of execution may be procured indefinitely if the creditor shows "due diligence" in attempting to locate property of the judgment debtor during the five-year period that execution will issue as of right and thereafter.³⁹ I suppose that the trustee, as a creditor "irreproachable and without notice" under the strong-arm clause, would also be one who had exercised the "utmost diligence."

The foregoing problem relating to the statute of limitations arises of course from the 1950 amendment to the strong-arm clause, and not from the *Constance* case, but it renders even more undesirable the rule of that case when applied to a gift of property by a person while insolvent.

RELATIONSHIP OF SECTIONS 70c AND 70e

As we have seen, Section 70e permits the trustee to exercise the right under state or federal law of any actual creditor having a provable claim to avoid any transfer made or suffered by the bankrupt. Prior to 1950, this was the only one of the two weapons provided by Section 70c and Section 70e which the trustee could invoke with respect to property not in the possession of the bankrupt at the time of bankruptcy. Since the 1950 amendment this distinction has been abolished. Under the rule of the *Constance* case the trustee under the strong-arm clause can represent a hypothetical creditor who extended credit at whatever time is most advantageous to him. It is apparent that the rights of such a hypothetical creditor would always be

³⁵ *Brasie v. Minneapolis Brewing Company*, 87 Minn. 456, 92 N.W. 340 (1902).

³⁶ *Ibid.* CAL. CODE CIV. PROC. § 338(4), is typical of such provisions: "... The cause of action in such case not to be deemed to have accrued until the discovery, by the aggrieved party, of the facts constituting the fraud or mistake."

³⁷ *Scholle v. Finnell*, 166 Cal. 546, 137 Pac. 241 (1913); *Knapp v. Elliott*, 81 Cal. App.2d 667, 184 P.2d 934 (1947).

³⁸ *Puccetti v. Girola*, 63 Cal. App.2d 240, 146 P.2d 714 (1944).

³⁹ CAL. CODE CIV. PROC. §§ 681, 685; *Butcher v. Brouwer*, 21 Cal.2d 354, 132 P.2d 205 (1942).

equal to or greater than those of any actual creditor, and therefore if this interpretation is adopted Section 70e has become superfluous for the purpose of avoiding transfers by the bankrupt.⁴⁰ The trustee should always proceed under Section 70c.

It is true that this would not be the first time that Congress kept extending two originally distinct sections of the Bankruptcy Act, without any apparent consideration of their relationship, until one swallowed the other alive. But as long as Section 70e remains in the Act, it is at least arguable that it evidences an intent on the part of Congress that in some conceivable circumstances the rights of the trustee to avoid a transfer by the bankrupt should be measured by the rights of the actual creditors having provable claims. If there is a reasonable interpretation of Section 70c which will preserve some function for Section 70e, that interpretation should be preferred.

CONCLUSION

It is suggested that the trustee under Section 70c should be considered a creditor without notice who levied legal or equitable process at the time of bankruptcy and who also *extended credit at the time of bankruptcy*.⁴¹ If it be thought anomalous to consider the trustee as a creditor who levied

⁴⁰ Section 70e would, of course, remain the only one of the two sections under which the trustee could avoid an "obligation incurred" by the bankrupt, since there is no way in which a creditor can invalidate an "obligation" by levying execution or other legal or equitable process.

⁴¹ Essentially the same problem may arise under the provisions of Section 60 as amended in 1950. Section 60a(2) provides that a transfer of personal property shall be deemed to have been made for the purposes of that section "when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee." And it is provided in Section 60a(3) that it is immaterial "whether or not there are or were creditors who might have obtained such liens. . ."

In the example considered above where a chattel mortgage was executed in California on January 1, 1952 and recorded February 1, 1952, and the petition in bankruptcy was filed January 1, 1954, it could be argued that the mortgage was never perfected under this test and therefore should be considered as though made "immediately before the filing of the petition." Once there is an unreasonable delay in the recordation of a chattel mortgage in California it can never thereafter be perfected (except by the mortgagee taking possession of the mortgaged chattels) so that *no* subsequent lien obtained by any hypothetical creditor could become superior. It is always vulnerable to attachment or execution by a creditor who became such prior to the recordation. Therefore, the trustee could argue that the transfer should be deemed to have been made immediately prior to the filing of the petition.

If it were deemed to be made at that time, then the trustee could have it set aside as a voidable preference, if he could show insolvency on the part of the debtor and reasonable cause to believe that such insolvency existed on the part of the creditor, each as of the time of *the perfection of the transfer* (i.e., at the time of the filing of the petition). Of course, such insolvency and knowledge would be easy to show *as of that time* in most cases. See 3 COLLIER, BANKRUPTCY 920-924 (14th ed. 1941).

It is obviously quite a bizarre result to say that a transaction perfected, insofar as it is possible to do so (other than by the mortgagee taking possession of the mortgaged chattels), one year and eleven months prior to bankruptcy while the debtor was solvent will be set aside

execution or other process simultaneously with his extending credit, with no time intervening for the debt to become due and judgment to be recovered, it should be remembered, as has been emphasized here, that the measurement of the rights of the trustee under the strong-arm clause is a purely hypothetical process. Any interpretation can be adopted, however anomalous, which seems best to effectuate the intent of Congress.

This suggested interpretation would avoid rendering Section 70e completely nugatory. If any of the actual creditors with provable claims have rights superior to those of a creditor extending credit at the time of bankruptcy, then the trustee could enforce those rights for the benefit of the estate under Section 70e.

This interpretation would also, it is submitted, better preserve the balance between secured and unsecured creditors than the rule of *Constance v. Harvey*.⁴² It would avoid all of the results of that case which have been illustrated and criticized above, while at the same time it would properly fulfill the original purpose of the strong-arm clause to cut off secret liens and transfers as of the date of bankruptcy, for the benefit of the estate. Which interpretation ultimately will be adopted depends perhaps on the courts' judgment of the relative strength of the two competing policies of equality of distribution and the preservation of security interests fairly acquired. In deciding this question, it should be remembered that, as a practical matter, nothing can help the general unsecured creditor much anyway until Congress abolishes the unreasonable priorities given to tax and other government claims in the Bankruptcy Act itself.⁴³

as a voidable preference made within four months of bankruptcy while the debtor was insolvent. The result can be avoided by the same construction urged above with respect to Section 70c—i.e., the action allegedly resulting in perfection of the transfer should be tested against a lien obtained subsequent to such action by legal or equitable proceedings on a simple contract *extending credit subsequent to such action*. Such construction would seem to be the only reasonable one in this case.

⁴² Professor Stefan A. Riesenfeld of the University of California, Berkeley, has kindly furnished me with a copy of a letter which he addressed to the National Bankruptcy Conference shortly before the opinion in the *Constance* case was published, in which he pointed out the danger of the very construction of the strong-arm clause adopted in that case and suggested an amendment to the Bankruptcy Act to forestall it. Legislative action would, of course, be the quickest and most satisfactory method of dealing with this problem, and the need therefor has increased now that the danger correctly foreseen by Professor Riesenfeld has materialized.

⁴³ See *In the matter of Green*, 124 F. Supp. 481, 482 (N.D. Ala. 1954): "... to the legislative process is committed the task of deciding whether in many bankruptcy cases all of the assets of the estate are to be distributed to federal and state taxing authorities to the exclusion of practically all other creditors, including wage earners (where real estate is involved)." In this case the only question involved was whether the federal taxing authorities by claiming a "lien" could subordinate even first and second priority claims (administration expenses and wages) to the tax claim, and the holding of the case is somewhat dubious. However, there is no doubt under the express terms of the Act that tax claims are entitled to fourth priority, which in this case as in many others left the unsecured, non-priority creditors far out in the cold.