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The Trustee's Avoiding Powers under the Bankruptcy Act and the New Code: A Comparative Analysis Selected Articles on the Bankruptcy Reform Act of 1978.

Vernon O. Teofan

L. E. Creel III

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**THE TRUSTEE'S AVOIDING POWERS UNDER THE
BANKRUPTCY ACT AND THE NEW CODE: A
COMPARATIVE ANALYSIS**

VERNON O. TEOFAN*

L. E. CREEL, III**

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Just as "discharge" may be characterized as the prime mover in the filing of voluntary bankruptcy proceedings,¹ the trustee's "avoiding powers" may be characterized as the prime mover in the instituting of involuntary bankruptcy proceedings. The trustee's avoiding powers are those given him to avoid and set aside transfers made and obligations incurred² by a bankrupt or debtor³ which violate the bankruptcy law's basic policy of effecting a fair and equal distribution of the debtor's assets among his creditors. The filing of the bankruptcy petition establishes a date of cleavage. After that date, the debtor's ability to effectively transfer his assets is

* A.B., LL.B., University of Notre Dame, Attorney at Law, Dallas, Texas.

** A.B., George Washington University, LL.B., Southern Methodist University, Attorney at Law, Dallas, Texas.

1. Comment, *Discharge: The Prime Mover of Bankruptcy*, 15 Sw. L.J. 308, 308 (1961).

2. Whenever the avoiding power also extends to obligations incurred, this fact will be noted at the beginning of the discussion of the avoiding power. For the sake of brevity, the accompanying discussion will be in terms of transfers made.

3. The "bankrupt" under the Bankruptcy Act has been replaced by the "debtor" under the Bankruptcy Reform Act. Compare Bankruptcy Act § 1(4) (repealed 1978, previously codified as 11 U.S.C. § 1(4)) with 11 U.S.C.A. § 101(12) (West Supp. 1979).

extremely curtailed. Certain transfers made and obligations incurred by the debtor within prescribed time limits prior to that date may be avoided by the trustee and the property recovered or preserved for the benefit of all the creditors.

Many of the provisions of the Bankruptcy Act (the Act) have worked well and are continued in the Bankruptcy Code (the Code) in simplified form with little substantive change. Other provisions of the Act have proven ineffective or counterproductive and have been eliminated in the Code or substantially revised. In this article the trustee's avoiding powers under the Code will be reviewed by comparing them with the avoiding powers under the Act for two basic reasons: (1) the provisions of the Act will continue to apply in all bankruptcy cases filed prior to October 1, 1979,⁴ and (2) the extent and significance of the changes made by the Code can best be understood by such a comparison.

Many of the provisions of the Code are derived from a bankruptcy bill proposed by the Commission on the Bankruptcy Laws of the United States (the Commission's bill)⁵ and a bill proposed by the National Conference of Bankruptcy Judges (the Judge's bill).⁶ Thus, the legislative history of these two bills is important in understanding the reasons for the changes which have been made in the trustee's avoiding powers under the Code. Additionally, a substantial body of case law has developed construing and applying the provisions of the Act, much of which will continue to be relevant in applying the provisions of the Code. Although this article will discuss the avoiding powers as being those of the trustee, it must be kept in mind that these powers may also be exercised by a debtor-in-possession under both the Act⁷ and the Code,⁸ and in some instances under the Code by the debtor himself.⁹

I. TRUSTEE AS A HYPOTHETICAL JUDICIAL LIEN CREDITOR

Under the Act

The "strong-arm clause" of section 70c gives the trustee the rights

4. See Bankruptcy Reform Act, Pub. L. No. 95-598, sec. 403(a), 92 Stat. 2683 (1978).

5. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, Pt. II, 93d Cong., 1st Sess. (1973).

6. H.R. REP. No. 32, 94th Cong., 1st Sess. (1975); S. REP. No. 235, 94th Cong., 1st Sess. (1975).

7. See Bankruptcy Act § 342 (repealed 1978, previously codified as 11 U.S.C. § 742).

8. See 11 U.S.C.A. § 1107(a) (West Supp. 1979).

9. See *id.* § 522(h),(i).

and powers of a hypothetical creditor who obtained, at the commencement of the bankruptcy proceedings: (1) a judgment against the bankrupt, (2) an execution returned unsatisfied against the bankrupt, and (3) a judicial lien on all property upon which a simple contract creditor of the bankrupt could have obtained such a lien.¹⁰ A "savings clause" makes it clear that a transfer can be valid in part and voidable in part against the trustee and a "chameleon clause" provides that the trustee can maintain inconsistent positions with reference to different parties, remedies or transactions.¹¹

Of the three capacities under the strong-arm clause, the trustee's status as a judicial lien creditor is by far the most significant, affording for most purposes the greatest rights and powers that a creditor can obtain.¹² Whenever such a creditor might prevail over prior transfers, liens or encumbrances under applicable law, the trustee will prevail and the subject property recovered or preserved for the benefit of the bankruptcy estate.¹³

The trustee's additional status as a holder of an execution returned unsatisfied insures that he will have all of the equitable remedies and procedural rights available under applicable state law only to such a creditor.¹⁴ In addition, this status may afford the trustee a presumption that the judgment debtor is insolvent and thereby materially assist him in avoiding transfers under applicable state law.¹⁵

The trustee's status as a "judgment creditor" was added by amendment in 1966 to insure that the trustee fell within the cate-

10. See Bankruptcy Act § 70c (repealed 1978, previously codified as 11 U.S.C. § 110(c)).

11. See S. REP. No. 1159, 89th Cong., 2nd Sess. 12 (1966); H.R. REP. No. 686, 89th Cong., 1st Sess. 11 (1965); Kennedy, *The Bankruptcy Amendments of 1966*, 41 REF. J. 53, 54 (1967). See generally Bankruptcy Act § 70c (repealed 1978, previously codified as 11 U.S.C. § 110(c)).

12. It is the status of "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." *In re Kravitz*, 278 F.2d 820, 822 (3d Cir. 1960) (quoting *In re Waynesboro Motor Co.*, 60 F.2d 668, 669 (S.D. Miss. 1932)).

13. 4B COLLIER ON BANKRUPTCY ¶ 70.46, at 559-60 (14th ed. 1978).

14. Kennedy, *The Bankruptcy Act Amendments of 1966*, 41 REF. J. 53, 54 (1967). These rights and remedies include discovery, injunction, receivership, levy on an equitable asset, reformation, or cancellation of a writing. Professor Kennedy also notes that due to the decline in the distinction between law and equity, the legislative liberalization of the rules governing the availability of equitable relief and the formidable battery of weapons with which the trustee in bankruptcy is armed, the availability of equitable relief under state law has become moot.

15. See *Bartlett v. Webber*, 252 N.W. 892, 895 (Iowa 1934).

gory of persons protected against an unfiled federal tax lien.¹⁶

These strong-arm powers have proved to be necessary, important tools in the trustee's efforts to secure all of the bankrupt's property for an equal distribution according to the terms of the Act.

Under the Code

These avoiding powers are brought forward in sections 544(a)(1) and (2) with little or no substantive change.¹⁷ The "savings clause," "chameleon clause" and the trustee's status as a "judgment creditor" were dropped as being surplusage.¹⁸ To avoid potential confusion or controversy, new language was included to make it clear that: (1) the trustee's status is purely hypothetical and his rights are in no way dependent on the existence of an actual creditor,¹⁹ (2) the trustee's status is unaffected by any knowledge which he or any or all creditors may have,²⁰ and (3) the hypothetical extension of credit and the obtaining of the judicial lien both occur at the commencement of the case and not before.²¹

While these provisions of the Act and the Code vest the trustee with the rights and remedies of a creditor with a judicial lien and an execution returned unsatisfied, the extent of these powers are

16. See Kennedy, *The Bankruptcy Act Amendments of 1966*, 41 REF. J. 53, 54 (1967). Contemporaneously, the Federal Tax Lien Act was amended by changing "judgment creditor" to "judgment lien creditor." Both amendments were unnecessary in light of the Supreme Court's holding in *United States v. Speers*, that the trustee's greater status as a judicial lienholder included the lesser status of a mere judgment holder. See *United States v. Speers*, 382 U.S. 266, 275 (1965); Countryman, *The Use of State Law In Bankruptcy Cases (Part II)*, 47 N.Y.U. L. Rev. 631, 649-50 (1972).

17. See 11 U.S.C.A. § 544(a)(1),(2) (West Supp. 1979). "Judicial Lien" is defined as "lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding." *Id.* § 101(27).

18. See REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, Pt. I, 93d Cong., 1st Sess. 200 (1973).

19. See 11 U.S.C.A. § 544(a)(1) (West Supp. 1979).

20. See *id.* § 544(a).

21. See 124 CONG. REC. H11089 (daily ed. Sept. 28, 1978) (statement of Hon. Don Edwards).

In particular, section 544(a)(1) overrules *Pacific Finance Corp. v. Edwards*, 309 F.2d 224 (9th Cir. 1962), and *In re Federals, Inc.*, 553 F.2d 509 (6th Cir. 1977), insofar as those cases held that the trustee did not have the status of a creditor who extended credit immediately prior to the commencement of the case. *Id.* at H11097 (daily ed. Sept. 28, 1978). But see *Constance v. Harvey*, 215 F.2d 571, 575 (2d Cir. 1954), cert. denied, 348 U.S. 913 (1955) (trustee entitled to assert lien of hypothetical creditor who extended credit before filing of petition and before perfection of security transaction in issue). *Constance* was later overruled by the Supreme Court. See *Lewis v. Manufacturers Nat'l Bank*, 364 U.S. 603, 610 (1961).

measured by the substantive law of the jurisdiction governing the property in question. Neither the Code nor the Act confers on the trustee rights any greater than those accorded such a creditor by applicable state law.²² Therefore, in every situation where the trustee seeks to use his strong-arm powers to avoid a transfer made or obligation incurred by the debtor, the following two issues are presented: (1) what state's law is applicable, and (2) under that law, are the rights of such a judicial lien creditor superior to the rights of the transferee or obligee? Inasmuch as the strong-arm provisions of the Code are substantially similar to those of the Act, legislative history and court decisions construing the provisions of the Act continue to be relevant in answering these questions.

The first issue may prove difficult to determine if the state in which the bankruptcy proceeding is pending differs from the state where the transfer was made or the property is situated. While some bankruptcy courts have applied the conflict of laws rules of the forum state,²³ others have held that they should be free to choose which state law is to apply.²⁴ Most courts, however, have applied the law of the situs of the property at the time of the commencement of the bankruptcy proceedings.²⁵ Under the second issue, the following are examples of transfers and obligations which have been and will continue to be avoided by the trustee: unperfected Uniform Commercial Code security interests;²⁶ consignments where the post-

22. See 11 U.S.C.A. § 544(b) (West Supp. 1979); Bankruptcy Act § 70c (repealed 1978, previously codified as 11 U.S.C. 110(c)). See generally 4B COLLIER ON BANKRUPTCY ¶ 70.49, at 602-04 (14th ed. 1978).

23. See *United Constr. Co. v. Milam*, 124 F.2d 670, 672 (6th Cir.), cert. denied, 317 U.S. 642 (1942).

24. See 1A MOORE'S FEDERAL PRACTICE ¶ 0.322[1], at 3301 (2d ed. 1948, as revised 1979).

25. 4B COLLIER ON BANKRUPTCY ¶ 70.49, at 605-06 (14th ed. 1978).

26. See, e.g., *In re Ronald A. Florio*, 4 BANKR. CT. DEC. 647 (D. R.I. 1978); *In re Forrest Paschal Mach. Co.*, 3 BANKR. CT. DEC. 1227 (M.D. N.C. 1977); *In re Butler's Tire & Battery Co.*, 2 BANKR. CT. DEC. 496 (Ore. 1975). See generally 4B COLLIER ON BANKRUPTCY ¶ 70.51, at 617 (14th ed. 1978). Section 9-301 of the Uniform Commercial Code provides as follows:

(1) Except as otherwise provided in subsection (2), an unperfected security interest is subordinate to the rights of

(b) a person who becomes a lien creditor before the security interest is perfected

(2) If the secured party files with respect to a purchase money security interest before or within ten days after the debtor receives possession of the collateral, he takes priority over the rights of . . . a lien creditor which arise between the time the security interest attaches and the time of filing.

U.C.C. § 9-301 (1972 version). Thus, a postpetition filing within the ten-day period would insulate the transaction from the trustee's strong-arm attack. See generally notes 31-33, *infra* and accompanying text.

ing or filing requirements have not been met;²⁷ unrecorded real estate transfers and mortgages where the state recording act protects subsequent judicial lien creditors;²⁸ unfiled federal tax liens;²⁹ and, certain transfers fraudulent under state law.³⁰

If the transfer is perfected as against subsequent judicial lien creditors at any time prior to the commencement of the bankruptcy proceedings, the rights of the transferee will prevail over the rights of the trustee under the strong-arm clause. Some state laws, and in particular those relating to mechanics' and materialmen's liens and purchase money security interests in equipment, provide that where the required recordation is accomplished within a certain length of time or period of grace, it will relate back to the time of the initial transaction and thus prevail over intervening interest holders just as if recordation had been effected at the time of the initial transaction.³¹ These "relation back" laws were recognized

27. See 4B COLLIER ON BANKRUPTCY ¶¶ 70.59, 70.62A [7.4], at 686, 726 (14th ed. 1978). Section 2-326 of the Uniform Commercial Code provides in part:

(2) . . . [G]oods held on sale or return are subject to such claims [of the buyer's creditors] while in the buyer's possession.

(3) . . . The provisions of this subsection are applicable even though an agreement purports to reserve title to the person making delivery until payment or resale or uses such words as "on consignment" or "on memorandum". However, this subsection is not applicable if the person making delivery

(a) complies with an applicable law providing for a consignor's interest or the like to be evidenced by a sign, or

(b) establishes that the person conducting the business is generally known by his creditors to be substantially engaged in selling the goods of others, or

(c) complies with the filing provisions of the Article on Secured Transactions (Article 9).

Id. § 2-326 (1972 version).

28. 4B COLLIER ON BANKRUPTCY ¶ 70.55, at 647 (14th ed. 1978). Texas' recording act protects subsequent judicial lien creditors. See *Cooper Grocery Store v. Park*, 218 F. 42, 43-44 (5th Cir. 1914); *McDonald v. Powell Lumber Co.*, 243 S.W.2d 192, 195 (Tex. Civ. App.—Beaumont 1951, writ ref'd); cf. *In re Bessie Himmelstein*, 5 BANKR. CT. DEC. 288, 290 (D. N.J. 1979) (trustee's strong-arm status prevailed over bank's mortgage mistakenly omitting description of portion of property). See generally TEX. REV. CIV. STAT. ANN. art. 6627 (Vernon Supp. 1978-1979).

29. See 26 U.S.C. § 6323(a) (1970).

30. See 4B COLLIER ON BANKRUPTCY ¶ 70.61, at 689-90 (14th ed. 1978). In Texas, for example, gifts of tangible personal property not accompanied by possession nor evidenced by recorded deed or a probated will and fictitious loans of personal property are viewed as fraudulent transfers. See TEX. BUS. & COM. CODE ANN. §§ 24.04 - .05 (Vernon 1968). *But cf. In re Ludlum Enterprises, Inc.*, 510 F.2d 996, 1002 (5th Cir. 1975) (Florida statute voiding fraudulent transfers held not applicable to lease of tangible personal property).

31. 4B COLLIER ON BANKRUPTCY ¶ 70.51, at 619 (14th ed. 1978); see, e.g., TEX. REV. CIV. STAT. ANN. arts. 5459, § 2 (relation back of mechanic's and materialman's liens), 5476a (relation back of certain liens on oil and mineral property) (Vernon Supp. 1978-1979); TEX.

by the Act³² and remain effective under the Code.³³ Thus, a lien based upon a transaction occurring prior to bankruptcy, but timely perfected after bankruptcy, may acquire superiority over the trustee's judicial lien status.

Under both the Act and the Code, the strong-arm rights and powers of the trustee are not dependent upon the bankruptcy court's actual or constructive possession of the property in issue except to the extent that possession by an adverse claimant prior to the institution of the proceedings might constitute perfection under applicable state law.³⁴ In addition, under the Act, the issue of possession may be relevant in determining whether the trustee can proceed summarily in the bankruptcy court to avoid the transaction or must institute plenary proceedings.³⁵ Inasmuch as the distinction between summary and plenary jurisdiction is not carried forward in the Code, that issue is mooted.³⁶

II. TRUSTEE AS A BONA FIDE PURCHASER OF REAL PROPERTY

Under the Act

The trustee is not entitled to the rights and powers of a bona fide purchaser or encumbrancer for value³⁷ unless the applicable state law confers such rights on a judicial lien creditor.³⁸ Consequently, under the Act, when the bankrupt holds property impressed with an express, implied or constructive trust, the strong-arm clause has usually proved ineffective in avoiding the equitable title or interests of the beneficiaries.³⁹ In addition, the trustee cannot cut off equities

BUS. & COM. CODE ANN. § 9.302(b) (Tex. UCC) (Vernon Supp. 1978) (relation back of purchase money security interests under U.C.C.).

32. See Bankruptcy Act § 67c(1)(B) (repealed 1978, previously codified as 11 U.S.C. § 107(c)(1)(B)).

33. See 11 U.S.C.A. § 546(b) (West Supp. 1979).

34. See 4B COLLIER ON BANKRUPTCY ¶ 70.55, at 645-50 (14th ed. 1978); 77 AM. JUR. 2d, *Vendor and Purchaser*, § 671, at 779 (1975) (possession of real estate); U.C.C. § 9-305 (1968 version) (possession of collateral).

35. See 2 COLLIER ON BANKRUPTCY ¶ 23.04, at 453-55 (14th ed. 1976).

36. See 28 U.S.C.A. § 1471(b), (c) (West Supp. 1979) (granting of jurisdiction).

37. See, e.g., *Carroll v. Holliman*, 336 F.2d 425, 429-30 (10th Cir. 1964), *cert. denied*, 380 U.S. 907 (1965); *Commercial Credit Co. v. Davidson*, 112 F.2d 54, 56 (5th Cir. 1940); 4B COLLIER ON BANKRUPTCY ¶ 70.52, at 628-33 (14th ed. 1978). See generally Bankruptcy Act § 70c (repealed 1978, previously codified as 11 U.S.C. § 110(c)) (defenses available to trustee).

38. See *American Soda Fountain Co. v. Parsons*, 32 F.2d 737, 738 (1st Cir. 1929) (applying Massachusetts law).

39. 4B COLLIER ON BANKRUPTCY ¶ 70.62, at 695 (14th ed. 1978).

such as reformation or rescission which are created by mutual mistake, fraud or other similar situations.⁴⁰

Under the Code

Section 544(a)(3) expands the trustee's strong-arm powers by granting him additional status of a hypothetical "bona fide purchaser of real property from the debtor, against whom applicable law permits such transfer to be perfected" who obtains that status at the commencement of the case.⁴¹ No similar provision was contained in either the Commission's bill⁴² or the Judge's bill.⁴³ Little is said about the provision in the legislative history except that it is new and that under the bona fide purchaser test a transferee should not be required "to perfect a transfer against an entity with respect to which applicable law does not permit perfection."⁴⁴

The extent of the rights, remedies and powers of the trustee as such a bona fide purchaser are again measured by the substantive law of the state in which the real property is situated.⁴⁵ Therefore, where the trustee seeks to avoid unrecorded or undisclosed interests in real property by the use of his bona fide purchaser status, the following two issues are presented: (1) under the applicable state law, are the rights of such a bona fide purchaser superior to the rights of the interest holder, and (2) under applicable state law, can the transfer sought to be avoided be perfected against a bona fide purchaser?

The first issue is probably the easiest to answer for in most instances a bona fide purchaser takes title free from legal or equitable claims of which he has no actual or constructive notice.⁴⁶ The second question is far more difficult to answer. Practically every interest in

40. *Id.* ¶ 70.62, at 695.

41. 11 U.S.C.A. § 544(a)(3) (West Supp. 1979). The Code does not contain a definition of a "bona fide purchaser" as did both the Commission's bill and the Judges' bill. *See* H.R. 31, 94th Cong., 1st Sess. § 1-102(8) (1975); H.R. 32, 94th Cong., 1st Sess. § 1-102(c) (1975).

42. *See* H.R. 31, 94th Cong., 1st Sess. § 4-604(a) (1975).

43. *See* H.R. 32, 94th Cong., 1st Sess. § 4-604(a) (1975).

44. S. REP. No. 989, 95th Cong., 2d Sess. 85, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5871; H.R. REP. No. 595, 95th Cong., 1st Sess. 370, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6326.

45. *See* *Sunderland v. United States*, 266 U.S. 226, 233 (1924); *Cummings v. Bullock*, 367 F.2d 182, 183 (9th Cir. 1966).

46. *See* *Carter v. Converse*, 550 S.W.2d 322, 329 (Tex. Civ. App.—Tyler 1977, writ ref'd n.r.e.); *Socony Mobil Oil Corp. v. Belveal*, 430 S.W.2d 529, 535 (Tex. Civ. App.—El Paso 1968, writ ref'd n.r.e.), *cert. denied*, 396 U.S. 825 (1969).

or right relating to real property, legal or equitable, can be perfected as against a subsequent bona fide purchaser (1) either by recordation or possession where the interest is created by instrument,⁴⁷ or (2) by possession or the institution of legal or equitable proceedings and the filing of an appropriate notice of *lis pendens*,⁴⁸ where it is created by operation of law.⁴⁹

The most obvious impact of the trustee's new status will be in those states where the recording act protects subsequent bona fide purchasers, but not judicial lien creditors. Thus, unrecorded real estate transfers, by way of grant or security, previously good against the trustee as a hypothetical judicial lien creditor⁵⁰ will now be voidable by the trustee as a hypothetical bona fide purchaser. Equitable interests of beneficiaries under unperfected express or implied trusts, resulting trusts and constructive trusts will also fall before the attack of the trustee as a bona fide purchaser.⁵¹ In addition, the trustee will cut off equities created by mutual mistake, fraud, or similar situations for which equitable relief is afforded by state law.⁵² This new strong-arm status may well be the *coupe de grace* in bankruptcy proceedings to all non-possessory equitable interests in real property which are not disclosed in a written instrument properly recorded prior to the commencement of the bankruptcy proceedings.

47. See 77 AM. JUR. 2d, *Vendor and Purchaser*, § 671, at 779 (1977); 59 TEX. JUR. 2d, *Vendor and Purchaser*, § 765, at 295 (1964); Annots, 79 A.L.R.2d 1204, § 9 (1961); 87 A.L.R. 1505, 1529 (1933); 74 A.L.R. 353, 356 (1931); 44 A.L.R. 78, 100 (1926).

48. See materials cited at note 47 *supra*.

49. TEX. REV. CIV. STAT. ANN. arts. 6640, 6641, 6643 (Vernon 1959); 51 AM. JUR. 2d, *Liens* §§ 21, 22 (1970).

50. See *In re Clifford*, 566 F.2d 1023, 1025-27 (5th Cir. 1978); 4B COLLIER ON BANKRUPTCY ¶ 70.55, at 646 (14th ed. 1978).

51. Cf. *Realty Trust Co. v. Craddock*, 112 S.W.2d 440, 442 (Tex. 1938) (rights of bona fide purchaser held superior to equitable rights of beneficiary under trust). *But see* 11 U.S.C.A. § 541(d) (West Supp. 1979). The effect, if any, this provision will have on the trustee's avoiding powers as a bona fide purchaser is unclear.

52. See *Landry v. Williamson*, 335 S.W.2d 400, 404 (Tex. Civ. App.—Houston 1960, writ ref'd n.r.e.); *Mineral Holdings Trust v. Stovall*, 288 S.W.2d 849, 852 (Tex. Civ. App.—Galveston), *rev'd sub nom. Aluminum Co. of America v. Mineral Holding Trust*, 157 Tex. 54, 64, 299 S.W.2d 279, 286 (1956), *cert. denied*, 355 U.S. 814 (1957) (all equities); *Carothers v. Mills*, 233 S.W. 155, 158 (Tex. Civ. App.—Austin 1921, no writ) (reformation of a deed); *Swann v. Mills*, 219 S.W. 850, 852 (Tex. Civ. App.—Texarkana 1920, writ *dism'd w.o.j.*) (reformation of a deed); *Dowdy v. Furtner*, 198 S.W. 647, 650 (Tex. Civ. App.—San Antonio 1917, no writ) (homestead claim); *Lynn v. Sims*, 43 S.W. 554, 556 (Tex. Civ. App. 1897, no writ).

III. TRUSTEE AS SUCCESSOR TO ACTUAL CREDITORS

Under the Act

Section 70e of the Act confers upon the trustee the power to avoid transfers made and obligations incurred by the debtor that are voidable for any reason under any applicable federal or state law⁵³ by any creditor having a claim provable under the Act,⁵⁴ including a secured claim.⁵⁵ The provision reaches out and gathers in for the trustee all the powers of avoidance available to the actual creditor and, with one exception, confers upon the trustee no greater rights of avoidance than the creditor himself would have if he were asserting invalidity on his own behalf.⁵⁶ The exception, which is a significant one, is that once the right of avoidance is established, the extent of the trustee's recovery is not measured by the size of the claims on the creditor whose rights and powers he asserted.⁵⁷ The trustee sets aside such a transaction entirely for the benefit of all creditors including those who themselves could not have avoided the transaction.⁵⁸ Thus, a \$10.00 claim of a qualified creditor can be used to invalidate *in toto* a transfer of property having a value of \$1,000,000.00 which was completely valid with respect to all of the debtor's other creditors.⁵⁹

53. For the purpose of simplicity, the following discussion may at times be in terms of state law. For examples of transactions voidable under applicable federal law, see, e.g., *In re Leasing Consultants, Inc.*, 5 BANKR. CT. DEC. 34, 39 (2d Cir. 1979) (payments made to Congressmen in violation of federal conflict of interests statutes); *In re Associated Underwriters, Inc.*, 5 BANKR. CT. DEC. 9, 10 (D. Utah 1978) (transfer of subordinated securities in violation of federal law); *Benner v. Scandinavian Am. Bank*, 131 P. 1149, 1152 (Wash. 1913) (mortgage of registered vessel not properly recorded at places required by federal law).

54. See Bankruptcy Act § 70e (repealed 1978, previously codified as 11 U.S.C. § 110(e)).

55. See, e.g., 4B COLLIER ON BANKRUPTCY ¶ 70.90, at 1035 (14th ed. 1978); Countryman, *The Use of State Law in Bankruptcy Cases (Part II)*, 47 N.Y.U. L. REV. 631, 657-61 (1972); Kennedy, *The Trustee in Bankruptcy as a Secured Creditor Under the Uniform Commercial Code*, 65 MICH. L. REV. 1419, 1428-29 (1967). See generally Bankruptcy Act § 70e (repealed 1978, previously codified as 11 U.S.C. § 110(e)).

56. See H.R. REP. NO. 1409, 75th Cong., 1st Sess. 32 (1937).

57. See *Moore v. Bay*, 284 U.S. 4, 5 (1931); 4B COLLIER ON BANKRUPTCY ¶ 70.95, at 1110 (14th ed. 1978). The Bankruptcy Commission's recommendation that the doctrine of *Moore v. Bay* be overruled was rejected, and the doctrine continues to apply. See REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, Pt. I, 93d Cong., 1st Sess. 200 (1973).

58. See, e.g., S. REP. NO. 989, 95th Cong., 2d Sess. 85, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5787, 5871; H.R. REP. NO. 595, 95th Cong., 1st Sess. 370, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6326; REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, Pt. I, 93d Cong., 1st Sess. 200 (1973).

59. See REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, Pt. I, 93d Cong., 1st Sess. 18 (1973).

Whenever the trustee seeks to avoid a transfer by stepping into the shoes of an actual creditor, the following two key issues are presented: (1) is the transfer fraudulent or voidable for any reason by a creditor under applicable state law, and (2) is that creditor's claim provable under the Act? The first issue is to be answered by referring to the applicable state law and the trustee is subject to all of the defenses which the transferee could have asserted against such creditor.⁶⁰ For instance, if the creditor's claim was barred by limitations prior to the commencement of the bankruptcy proceeding, then the trustee's claim is likewise barred.⁶¹ The second issue is answered by referring to section 63 of the Act which specifies nine categories of debts which may be proven.⁶²

If the transaction is avoided, the trustee can recover the property or collect its value from whomever may hold or may have received it except a person as to whom the transfer is valid under applicable federal or state laws.⁶³

It should be noted that the trustee is not given any cause of action in favor of any creditor, the creditors as a class, or some portions of the creditors as a class which is not related to specific property.⁶⁴

Under the Code

These omnibus avoiding rights and powers are carried forward in

60. See 4B COLLIER ON BANKRUPTCY ¶¶ 70.71, 70.90, at 787, 789, 1037-38 (14th ed. 1978).

61. See *id.* at 799-800.

62. See Bankruptcy Act § 63a (repealed 1978, previously codified as 11 U.S.C. § 103(a)).

The nine categories of provable debts are:

- (1) a fixed liability, as evidenced by a judgment or an instrument in writing, absolutely owing at the time of the filing of the petition . . . ;
- (2) costs taxable against a bankrupt who was at the time of the filing of the petition by or against him plaintiff in a cause of action which would pass to the trustee and which the trustee declines to prosecute after notice;
- (3) a claim for taxable costs incurred in good faith by a creditor before the filing of the petition in an action to recover a provable debt;
- (4) an open account, or a contract express or implied;
- (5) provable debts reduced to judgments after the filing of the petition and before the consideration of the bankrupt's application for a discharge . . . ;
- (6) an award of an industrial-accident commission, body, or officer of any State having jurisdiction to make awards of workmen's compensation . . . if . . . injury occurred prior to adjudication;
- (7) the right to recover damages in any action for negligence instituted prior to and pending at the time of the filing of the petition in bankruptcy;
- (8) contingent debts and contingent contractual liabilities; or
- (9) claims for anticipatory breach of contracts

Id. § 63a (repealed 1978, previously codified as 11 U.S.C. § 103(a)).

63. *Id.* § 70e(2) (repealed 1978, previously codified as 11 U.S.C. § 110(e)(2)).

64. *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416, 434 (1972); see H.R. REP. No. 595, 95th Cong., 1st Sess. 179, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963,

section 544(b) of the Code⁶⁵ with the following two changes or clarifications: (1) the claim of the creditor relied upon must be unsecured,⁶⁶ and (2) the class of claims upon which the trustee can rely has been expanded from "provable" claims to all "allowable" claims⁶⁷ and certain non-allowable claims for reimbursement or contribution.⁶⁸ Therefore, the two key issues presented with reference to the trustee's avoiding power under the Code are: (1) is the transfer fraudulent or voidable for any reason by an unsecured creditor of the debtor under applicable state law, and (2) is that creditor's claim allowable under the Code?

The first issue is to be answered by referring to applicable state law and the second by referring to the definition of claim set out in section 101(4)⁶⁹ and the allowance provisions of section 502⁷⁰ of the Code. Since the provisions of the Act and the Code are similar, the court decisions construing and applying these provisions of the Act, for the most part, will continue to be relevant. The following are examples of transactions which have been and will continue to be avoidable by the trustee as successor to actual creditors: state law fraudulent transfers;⁷¹ state law preferential

6140. The following provision was supported by both the Judges and the Commission but deleted from the enacted Code:

(2) CREDITORS' CLAIMS. — The trustee may, when in the best interest of the estate, enforce any claim which any class of creditors has against any person and if necessary for that purpose, the court may stay any other pending action on such claims. If the trustee brings an action on such a claim, he shall give notice to all creditors who could have brought an action on the claim if the trustee had not done so. Any judgment entered for or against the trustee on such claim shall be binding on all such creditors and any recovery by the trustee shall be for the benefit only of such creditors after the deduction of all expenses incurred by the trustee in effecting such discovery.

H.R. 31, 94th Cong., 1st Sess. § 4-604(b)(2) (1975); H.R. 32, 94th Cong., 1st Sess. § 4-604(b)(2) (1975).

65. See 11 U.S.C.A. § 544(b) (West Supp. 1979).

66. See *id.* § 544(b).

67. Compare Bankruptcy Act 63a (repealed 1978, previously codified as 11 U.S.C. § 103(a)) with 11 U.S.C.A. § 502(b) (West Supp. 1979).

68. See 11 U.S.C.A. § 502(e) (West Supp. 1979).

69. See *id.* § 101(4). "Claim" is defined as "(A) right to payment . . . or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment . . ." *Id.* § 101(4).

70. See *id.* § 502(e). As mentioned, the Bankruptcy Act recognized only those debts that can be proved according to the terms of given categories. See Bankruptcy Act 63a (repealed 1978, previously codified as 11 U.S.C. § 103(a)). On the other hand, all claims are allowed by the Code, except to the extent they fall under given categories such as unmatured interest. See 11 U.S.C.A. § 502(e) (West Supp. 1979).

71. See TEX. BUS. & COM. CODE ANN. §§ 24.01-.05 (Vernon 1968); 4B COLLIER ON

transfers;⁷² bulk transfers where the required notices are not given;⁷³ liens whose recordation was intentionally delayed for the purpose of creating, bolstering or preserving false credit unjustified by the actual financial status of the debtor;⁷⁴ and, certain corporate transactions avoidable by creditors.⁷⁵

It now appears clear that a delayed perfection, absent fraud, of a Uniform Commercial Code security interest is not subject to attack by the trustee as successor to actual creditors; for after perfection, the security interest is valid and superior to the rights of prior unsecured creditors. This would likewise appear to be true in the case of consignments where filing or posting was delayed, but accomplished prior to the commencement of the bankruptcy proceeding.⁷⁶

BANKRUPTCY ¶ 70.71, at 778 (14th ed. 1978).

72. See, e.g., *Burroughs v. Fields*, 546 F.2d 215, 218 (7th Cir. 1976); 4B COLLIER ON BANKRUPTCY ¶ 70.88, at 1020-21 (14th ed. 1978); Countryman, *The Use of State Law in Bankruptcy Cases (Part II)*, 47 N.Y.U. L. REV. 631, 661 (1972).

73. 4B COLLIER ON BANKRUPTCY ¶ 70.74, at 818 (14th ed. 1978). To be avoided by the trustee, the transfer must be "voidable" under applicable state or federal law. The Uniform Commercial Code provides that a non-complying bulk transfer is "ineffective against" creditors. As far as the remedy is concerned, "ineffective" is the same as "voidable." See *id.* ¶ 70.74, at 834 (14th ed. 1978). See generally U.C.C. § 6-104 (1968 version). Would the term "subordinated" have the same effect? See Countryman, *The Use of State Law in Bankruptcy Cases (Part II)*, 47 N.Y.U. L. REV. 631, 660 (1972).

74. See, e.g., *In re Gill*, 92 F.2d 810, 811 (5th Cir. 1937); *In re Farm & Home Co.*, 84 F.2d 933, 935 (6th Cir. 1936); 4B COLLIER ON BANKRUPTCY ¶ 70.73, at 814 (14th ed. 1978).

75. See *Burroughs v. Fields*, 546 F.2d 215, 218 (7th Cir. 1976) (preferential payments to corporation's president fraudulent under state law); *In re Kettle Fried Chicken of America, Inc.*, 513 F.2d 807, 813 (6th Cir. 1975) (corporation's repurchase of stock when capital impaired); *In re Leasing Consultants, Inc.*, 5 BANKR. CT. DEC. 34, 39 (1979) (payments made to U.S. Congressman in violation of federal conflict-of-interests statutes); *In re Associated Underwriters, Inc.*, 5 BANKR. CT. DEC. 9, 10 (D. Utah 1978) (transfer of subordinated securities in violation of federal law); *In re Modern Engineering & Tool Co.*, 4 BANKR. CT. DEC. 713, 719 (D. Conn. 1978) (corporation's repurchase of stock while insolvent). *But see Palmer v. Justice*, 451 F.2d 371, 371 (5th Cir. 1971) (upholding corporation's repurchase of stock when done to compromise a debt).

76. Consignments are generally treated the same as security interests under the Uniform Commercial Code. See U.C.C. § 9-114 (1972 version). For an opposing view, see 4B COLLIER ON BANKRUPTCY ¶ 70.87A, at 1018 (14th ed. 1978). The author states:

The word creditor is defined in the Uniform Commercial Code as including unsecured creditors. Thus, the noncompliance renders the consignor's title subject to the claims of the buyer's unsecured creditors and this would certainly appear to include creditors whose claims arise before there is compliance with the listed alternatives. If any such creditor has a provable claim in the bankruptcy proceeding, the trustee may stand in his shoes, by virtue of § 70e; and hold the goods free of the consignor's interest. It would not matter, apparently, that the consignor may have filed a financing statement before the bankruptcy petition was filed. As long as there existed any period of time during which there was a creditor who could have prevailed over the consignor, and that creditor has a provable claim at the date of bankruptcy, the consignor will lose out to

IV. FRAUDULENT TRANSFERS

Under the Act

Section 67d, constituting a federal codification for bankruptcy purposes of the Uniform Fraudulent Conveyance Act,⁷⁷ empowers the trustee to avoid certain transfers of the debtor's non-exempt property made within one year prior to the commencement of the bankruptcy proceeding as being actually or constructively fraudulent as against creditors.⁷⁸ In addition, section 67d(3) empowers the trustee to reach transfers made within four months of bankruptcy for a consideration which enables the debtor to make a preferential transfer.⁷⁹ These rights of the trustee are in addition to his rights under the strong-arm clause and as the successor to the rights of actual creditors, and, for the most part, are not dependent upon state law. The working of the section is complex due to the attempt of its draftsmen to conform its language to the language of the Uniform Fraudulent Conveyance Act and thereby take advantage of the developing body of case law construing that Act.⁸⁰

Transfers made and obligations incurred under prescribed conditions are declared fraudulent as to then existing or future creditors or both. If an actual creditor of the class specified having a claim provable under the Act exists, the trustee can avoid the transaction except as to bona fide purchasers, lienors or obligees who have given present fair equivalent value.⁸¹ If the consideration given was less than fair, absent actual fraudulent intent, the transferee may retain the property as security for repayment.⁸²

the trustee because of § 70e.

Id. ¶ 70.87A, at 1018.

77. See UNIFORM FRAUDULENT CONVEYANCES ACT §§ 1-14 (1978).

78. Bankruptcy Act § 67d (repealed 1978, previously codified as 11 U.S.C. § 107(d)).

79. Bankruptcy Act § 67d(3) (repealed 1978, previously codified as 11 U.S.C. § 107(d)(3)) (codified rule of *Dean v. Davis*, 242 U.S. 438, 440 (1917)).

80. See REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, Pt. I, 93d Cong., 1st Sess. 211 (1973); H.R. Doc. No. 137, Pt. II, 93d Cong., 1st Sess. 176 (1973).

81. Bankruptcy Act § 67d(6) (repealed 1978, previously codified as 11 U.S.C. § 107(d)(6)). When only one such creditor existed at the time of the transfer but was paid before bankruptcy, is the transfer voidable by the trustee? See *generally* 4 COLLIER ON BANKRUPTCY ¶ 67.34, at 521-22 (14th ed. 1978). When the trustee can avoid the transfer, because it was fraudulent toward one class of qualified creditor, the extent of his recovery is not limited to the amount of such creditor's claims. The recovery inures to the benefit of all general creditors having allowable claims in the proceeding. See *Moore v. Bay*, 284 U.S. 4, 5 (1931).

82. Bankruptcy Act § 67d(6) (repealed 1978, previously codified as 11 U.S.C. § 107(d)(6)).

The following transfers and obligations are condemned as fraudulent as to specified classes of creditors:

- (1) Those made or incurred within one year prior to the commencement of the bankruptcy proceeding:
 - (a) without fair consideration at a time when:
 - (i) the debtor was insolvent or thereby rendered insolvent (fraudulent as to then existing creditors);⁸³
 - (ii) the debtor was engaged or about to engage in a business or transaction for which his remaining property is an unreasonably small capital (fraudulent as to then existing creditors and those who became creditors during the continuance of the business or transaction);⁸⁴ or
 - (iii) the debtor intended to incur, or believed that he would incur debts beyond his ability to pay as they mature (fraudulent as to then existing and future creditors);⁸⁵ and
 - (iv) in partnership cases, when the partnership is insolvent, if made or incurred (a) to a partner, or (b) to a person not a partner without fair consideration to the partnership (fraudulent as to then existing and future partnership creditors).⁸⁶
 - (b) with actual intent to hinder, delay or defraud existing or future creditors (fraudulent as to then existing and future creditors).⁸⁷
- (2) Those made or incurred within four months prior to the commencement of the bankruptcy proceedings:
 - (a) in contemplation of the initiation of bankruptcy proceedings or liquidation of all or a greater portion of the debtor's property;
 - (b) with intent to use the consideration obtained to

83. *Id.* § 67d(2)(a) (repealed 1978, previously codified as 11 U.S.C. § 107(d)(2)(a)).

84. *Id.* § 67d(2)(b) (repealed 1978, previously codified as 11 U.S.C. § 107(d)(2)(b)).

85. *Id.* § 67d(2)(c) (repealed 1978, previously codified as 11 U.S.C. § 107(d)(2)(c)). That the debtor intended to incur a particular debt need not be shown; a general intention will suffice. 4 COLLIER ON BANKRUPTCY ¶ 67.36, at 527 (14th ed. 1978).

86. Bankruptcy Act § 67d(4) (repealed 1978, previously codified as 11 U.S.C. § 107(d)(4)).

87. *Id.* § 67d(2)(d) (repealed 1978, previously codified as 11 U.S.C. § 107(d)(2)(d)).

make a preferential transfer to any creditor; and
 (c) the transferee or obligee knew or believed that the debtor intended to make such use of such consideration (fraudulent as against then existing and future creditors).⁸⁸

A transfer is deemed made when perfected against a bona fide purchaser unless not so perfected at the time of the commencement of the bankruptcy proceeding, in which case it is deemed made immediately prior thereto.⁸⁹ It is at this point in time, rather than when the transfer actually occurred, that the one year or four months period begins to run,⁹⁰ and the validity of the transfer is to be tested.⁹¹

In determining the debtor's insolvency, the balance sheet test is used, exempt property is excluded, and the assets are taken at "present fair salable value."⁹² Thus, if no current market exists for the asset or it is temporarily distressed, the asset will be scheduled at little or no value.⁹³ Fair consideration includes present value and antecedent debt that must be a "fair equivalent" of the property transferred.⁹⁴ When the transfer is to secure a debt, the amount of the debt secured cannot be "disproportionately small" as compared to the value of the property transferred.⁹⁵ Furthermore, to be adjudged fair, the consideration must be given in good faith.⁹⁶ This last requirement has enabled trustees to avoid preferential transfers made to insiders more than four months but less than one year prior to the commencement of the bankruptcy proceedings.⁹⁷

88. *Id.* § 67d(3) (repealed 1978, previously codified as 11 U.S.C. § 107(d)(3)).

89. *Id.* § 67d(5) (repealed 1978, previously codified as 11 U.S.C. § 107(d)(5)).

90. 4 COLLIER ON BANKRUPTCY ¶ 67.34[3], at 517 (14th ed. 1978). *See generally* Bankruptcy Act §§ 14c(4), 67a(1), d(2) (repealed 1978, previously codified as 11 U.S.C. §§ 32(c)(4), 107(a)(1), (d)(2)).

91. *See* *Kindom Uranium Corp. v. Vance*, 269 F.2d 104, 106-07 (10th Cir. 1959); 4 COLLIER ON BANKRUPTCY ¶ 67.40, at 579 (14th ed. 1978). This construction has not been universally accepted. The Eighth Circuit has declined to apply the test to any element save the running of the one year period. *See Jackson v. Star Sprinkler Corp.*, 575 F.2d 1223, 1231 (8th Cir. 1978). It appears that the Code adopts the interpretation set out in COLLIER. *See REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES*, H.R. DOC. NO. 137, Pt. II, 93d Cong., 1st Sess. 178 (1973).

92. *See* Bankruptcy Act § 67d(1)(d) (repealed 1978, previously codified as 11 U.S.C. § 107(d)(1)(d)).

93. *See* 4 COLLIER ON BANKRUPTCY ¶ 67.32, at 501 (14th ed. 1978).

94. *See* Bankruptcy Act § 67d(1)(e) (repealed 1978, previously codified as 11 U.S.C. § 107(d)(1)(e)).

95. *See id.* § 67d(1)(e) (repealed 1978, previously codified as 11 U.S.C. § 107(d)(1)(e)).

96. *See id.* § 67d(1)(e) (repealed 1978, previously codified as 11 U.S.C. § 107(d)(1)(e)).

97. *See, e.g.,* *Burroughs v. Fields*, 546 F.2d 215, 218 (7th Cir. 1976); *Bullard v. Aluminum*

Under the Code

These fraudulent transfer provisions are for the most part brought forward in revised form in section 548 of the Code.⁹⁸ The language has been simplified and several substantive changes have been made. Some of the more significant changes are:

(1) The provisions under which the trustee could avoid transfers made within four months of bankruptcy for a consideration which enables the debtor to make a preferential transfer are eliminated.⁹⁹

(2) The voidable transactions are no longer designated as being fraudulent only with respect to certain creditors. Although creditors must have existed at the time of the transaction in order for the debtor to have been insolvent, there is no longer any requirement that an actual creditor exist with a provable or allowable claim.¹⁰⁰

(3) The invalidating rules now apply to exempt as well as non-exempt property.¹⁰¹

(4) For insolvency purposes, the debtor's property is taken at a "fair valuation" rather than at "present fair salable value."¹⁰²

(5) The fair consideration test has been replaced by a "reasonably equivalent value" test thereby eliminating the good-faith requirement.¹⁰³ Transfers made for full consideration will be valid even if not made in good faith. The impact of this change has been lessened because the voidable preference period on transfers to insiders is extended by one year.¹⁰⁴

Co. of America, 468 F.2d 11, 13 (7th Cir. 1972); *In re Windor Indus., Inc.*, 459 F. Supp. 270, 278-79 (N.D. Tex. 1978).

98. See generally 11 U.S.C.A. § 548 (West Supp. 1979).

99. See REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, Pt. I, 93d Cong., 1st Sess. 211-12 (1973). See generally Bankruptcy Act § 67d(3) (repealed 1978, previously codified as 11 U.S.C.A. § 107(d)(3)).

100. See REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, Pt. II, 93d Cong., 1st Sess. 177 (1973).

101. Compare Bankruptcy Act § 67d(1)(a) (repealed 1978, previously codified as 11 U.S.C. § 107(d)(1)(a) with 11 U.S.C.A. § 548 (West Supp. 1979). See generally REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, Pt. II, 93d Cong., 1st Sess. 177 (1973).

102. Compare Bankruptcy Act § 67d(1)(d) (repealed 1978, previously codified as 11 U.S.C. § 107(d)(1)(d) with 11 U.S.C.A. § 101(26) (West Supp. 1979).

103. Compare Bankruptcy Act § 67d(1)(e) (repealed 1978, previously codified as 11 U.S.C. § 107(d)(1)(e) with 11 U.S.C.A. § 548(a)(2)(A) (West Supp. 1979).

104. See 11 U.S.C.A. § 547(b)(4) (West Supp. 1979). See generally *id.* § 101(25) (definition of "insider").

Accordingly, much of the case law developed under section 67d of the Bankruptcy Act and under the Uniform Fraudulent Conveyance Act will remain relevant.

V. PREFERENTIAL TRANSFERS

Under the Act

The most frequently invoked of the trustee's avoiding powers is his power to recover for the benefit of all creditors a pre-bankruptcy transfer which enables one creditor to recover more on his claim than other creditors of the same class. This power serves two basic functions: it deters the "race of diligence" of creditors to dismember the debtor during his slide into bankruptcy, and facilitates the prime bankruptcy policy of equality of distribution among creditors.¹⁰⁵

Under the Act,¹⁰⁶ the trustee can avoid and recover for the benefit of the bankrupt estate any transfer made:

- (1) within four months of the date of the filing of the petition originally instituting the bankruptcy proceeding;
- (2) to or for the benefit of a creditor;
- (3) on account of an antecedent debt;¹⁰⁷
- (4) when the bankrupt was insolvent;
- (5) when the creditor, or its agent acting with reference thereto, had reasonable cause to believe that the bankrupt was insolvent;¹⁰⁸
- (6) which has the effect of allowing the creditor to obtain a greater percentage of his debt than some other creditor of the same class;¹⁰⁹ and
- (7) which results in a diminution of the bankrupt estate available to such creditors.¹¹⁰

105. See H.R. REP. NO. 595, 95th Cong., 1st Sess. 177-78, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6138; REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, Pt. I, 93d Cong., 1st Sess. 202 (1973); 3 COLLIER ON BANKRUPTCY ¶ 60.01, at 743-44 (14th ed. 1977).

106. Bankruptcy Act § 60a, b (repealed 1978, previously codified as 11 U.S.C. § 96(a), (b)).

107. Antecedent means pre-existing at the time of the transfer. In *National City Bank v. Hotchkiss*, the Supreme Court held that security given before 3:00 P.M. for money borrowed at 10:00 A.M. to buy stock which would be used to obtain cash elsewhere on the same day, thus supplying funds for repayment before 3:00 P.M. was a voidable preference. *National City Bank v. Hotchkiss*, 231 U.S. 50, 59 (1913).

108. Bankruptcy Act § 60b (repealed 1978, previously codified as 11 U.S.C. § 96(b)).

109. *Id.* § 60a(1) (repealed 1978, previously codified as 11 U.S.C. § 96(a)(1)).

110. See 3 COLLIER ON BANKRUPTCY ¶ 60.20, at 859-60 (14th ed. 1977).

For the purposes of this avoiding power, a transfer of real property is deemed to have been made when perfected against a bona fide purchaser and a transfer of personal property is deemed made when perfected against a judicial lien creditor.¹¹¹ A transfer not so perfected prior to the filing of the petition initiating the bankruptcy proceedings is deemed to have been made immediately prior thereto.¹¹² It is at this point in time that all of the elements of a voidable preference must be shown to have been present,¹¹³ and the trustee has the burden of proof on all elements.¹¹⁴

The issue of the debtor's insolvency is determined by the use of a balance sheet test in which the fair value of the debtor's exempt property is included as an asset even though it is not available to his creditors.¹¹⁵ A creditor has "reasonable cause to believe" his debtor is insolvent when such a state of facts is brought to his notice respecting the affairs and pecuniary condition of his debtor as would lead a prudent business person to the conclusion that the debtor is insolvent.¹¹⁶ While mere suspicion will not suffice, actual knowledge of or belief in the debtor's insolvency is not required.¹¹⁷ The element that the transfer had the effect of enabling the preferred creditor to receive a greater percentage of this debt than some other creditor of the same class is established by a showing that there will not be sufficient funds in the bankrupt estate to pay such creditor in full.¹¹⁸

If the elements of a voidable preference are established, the trustee is entitled to recover the property,¹¹⁹ or if it has been converted, its value, from any person who has received or converted it except a bona fide purchaser from or lienor of the initial transferee for "present fair equivalent value."¹²⁰ When less than such value

111. Bankruptcy Act § 60a(2) (repealed 1978, previously codified as 11 U.S.C. § 96(a)(2)).

112. *Id.* § 60a(2) (repealed 1978, previously codified as 11 U.S.C. § 96(a)(2)).

113. *See id.* § 60a(1), (2) (repealed 1978, previously codified as 11 U.S.C. § 96(a)(1), (2)). *See generally* 3 COLLIER ON BANKRUPTCY ¶ 60.56, at 1089-91 (14th ed. 1977).

114. 3 COLLIER ON BANKRUPTCY ¶ 60.62, at 1123 (14th ed. 1977).

115. Bankruptcy Act § 1(19) (repealed 1978, previously codified as 11 U.S.C. § 1 (19)). *See generally* 1 COLLIER ON BANKRUPTCY ¶ 1.19, at 110-11 (14th ed. 1976).

116. *See* 3 COLLIER ON BANKRUPTCY ¶ 60.53[1], at 1057-58 (14th ed. 1977). When circumstances are such that a man of ordinary prudence would inquire, the creditor is charged with notice of those facts that would be disclosed by a reasonably diligent inquiry. *See id.* ¶ 60.53[1], at 1063.

117. *See id.* ¶ 60.53[1], at 1063.

118. *See* Palmer Clay Prods. Co. v. Brown, 297 U.S. 227, 229 (1936).

119. *See* Bankruptcy Act § 60b (repealed 1978, previously codified as 11 U.S.C. § 96(b)).

120. *See id.*

was given, the purchaser or lienor is granted a lien upon the property to the extent of the consideration he actually gave.¹²¹ Additionally, if the preferred creditor, after receiving the preferential transfer, in good faith gives the debtor further unsecured credit for property which becomes a part of the debtor's estate, the "net result rule" is applied and the unpaid amount of such new credit is set off against the amount which the trustee otherwise would have been entitled to recover.¹²²

Most of the elements of a voidable preference are reasonably susceptible to proof with the exception of the debtor's insolvency and the creditor's state of mind. In many cases the bankrupt's books and records are in a state of disarray, incomplete, and list non-liquid assets at other than fair value. While the creditor might be willing to concede some knowledge that the debtor was experiencing "cash flow" problems or not paying his debts as they matured, rarely will the creditor admit that he knew or had reason to believe that the debtor's liabilities exceeded the fair value of his assets. Unless the transferee was an insider, in the absence of direct evidence that the creditor was actually informed of the debtor's insolvency prior to or at the time of the transfer, the requirement that the trustee prove his state of mind is practically insurmountable.¹²³

The problems of proof relating to these two elements and the adoption of the Uniform Commercial Code which permits floating security interests in after-acquired property to be perfected by the filing of a financing statement long before the goods even come into existence or the debtor acquires any rights in them have greatly diminished the effectiveness of the trustee's powers to avoid preferential transfers under the Act.¹²⁴

Under the Code

To effectuate the goals of the preference provisions more fully, promote clarity, avoid unessential litigation, and effect coordination with the Uniform Commercial Code, in 1973 the Commission on the Bankruptcy Laws of the United States recommended a wholesale

121. *Id.*

122. *Id.* § 60c (repealed 1978, previously codified as 11 U.S.C. § 96(c)).

123. See H.R. REP. No. 595, 95th Cong., 2d Sess. 178-79, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6139.

124. See *id.* at 178-79, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6139; REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, Pt. I, 93d Cong., 1st Sess. 203 (1973).

revision of the preference provisions of the Act.¹²⁵ This has been done in section 547.¹²⁶ The trustee's burden has been substantially lightened and certain transfers whose avoidability are not within the policy reasons for the provisions are excepted from attack.

Except for the excepted transactions,¹²⁷ the trustee can avoid and recover for the benefit of the estate any transfer of the debtor's property made:

- (1) to or for the benefit of a creditor;
- (2) for or on account of an antecedent debt owed by the debtor;
- (3) when the debtor was insolvent;
- (4) within 90 days before the date of the filing of the petition or within one year thereof if made to an insider who had reasonable cause to believe the debtor was insolvent; and
- (5) which enables the creditor to receive more than he would have received if the transfer had not been made and distribution to creditors made in a straight liquidating bankruptcy proceeding.¹²⁸

The two major obstacles to the trustee's recovery under the provisions of the Act, if not totally removed, have been substantially diminished. The trustee is armed with a presumption that the debtor was insolvent during the 90 days immediately preceding the filing of the petition.¹²⁹ Exempt assets are no longer included on the asset side of the balance sheet.¹³⁰ While the trustee still must prove that an insider who received a preference outside the 90-day period but within the one year period had reasonable cause to believe his debtor was insolvent,¹³¹ an insider may often be charged with knowledge of the debtor's financial condition, as a matter of law.¹³²

125. See H.R. REP. No. 595, 95th Cong., 2d Sess. 179, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6139-40; REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. No. 137, Pt. II, 93d Cong., 1st Sess. 169 (1973).

126. See generally 11 U.S.C.A. § 547 (West Supp. 1979).

127. See *id.* § 547(c).

128. See *id.* § 547(b). Thus, the court must focus on the allowance and priority of the claim preferred. If the claim would have been entirely disallowed, the test will be met. If the claim is allowable as a fifth priority tax claim, and in liquidation, the creditor holding fourth priority would not be paid in full, the test is likewise met. See H.R. REP. No. 595, 95th Cong., 1st Sess. 372, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6328.

129. See 11 U.S.C.A. § 547(f) (West Supp. 1979).

130. See *id.* § 101(26) (definition of "insolvent").

131. *Id.* § 547(b)(4)(B)).

132. See 3 COLLIER ON BANKRUPTCY ¶ 60.53, at 1061 n.2 (14th ed. 1977).

The time that the transfer is deemed to have been made and, therefore, its validity is to be tested, remains substantially the same as it is under the Act¹³³ except that: (1) the transferee is given a ten-day grace period from the actual date of the transfer within which to perfect the transfer,¹³⁴ and (2) the transfer cannot be made until the debtor has acquired rights in the property transferred.¹³⁵ This latter provision prevents the perfection, as against the trustee, of a security interest in after-acquired property from relating back to the date of the filing of the financing statement.¹³⁶

Preferential transfers of the debtor's exempt property¹³⁷ can now be recovered by the trustee as can preferential transfers to the tax collector including the Internal Revenue Service.¹³⁸

Six categories of transfers are placed beyond the trustee's reach.¹³⁹ If the creditor can qualify under any one or more of these exemptions, he is protected by each to the extent of his qualification.¹⁴⁰ Included in the six categories are:

- (1) transfers intended as, and which substantially are, contemporaneous exchanges for new value;¹⁴¹
- (2) transfers in payment of a debt incurred and paid in the

133. Compare Bankruptcy Act § 60a(1), (2) (repealed 1978, previously codified as 11 U.S.C. § 96(a)(1), (2)) with 11 U.S.C.A. § 547(e)(2), (3) (West Supp. 1979).

134. See 11 U.S.C.A. § 547(e)(2)(A) (West Supp. 1979).

135. See *id.* § 547(e)(3).

136. H.R. REP. No. 595, 95th Cong., 1st Sess. 374, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6330. This provision, more than any other in the section, overrules *DuBay* and *Grain Merchants*, and in combination with subsection (b)(2), overrules *In re King-Porter Co.*, 446 F.2d 722 (5th Cir. 1971). *Id.* at 374.

137. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. No. 137, Pt. I, 93d Cong., 1st Sess. 204 (1973).

138. This is the result of the combined effect of sections 106(c), 547(b)(5) and 507(a)(6) of the Code. See 11 U.S.C.A. §§ 106(c), 507(a)(6), 547(b)(5) (West Supp. 1979). "As provided, section 106(c) of the House amendment overrules contrary language in the House report with the result that the Government is subject to avoidance of preferential transfers." 124 CONG. REC. H11089 (daily ed. Sept. 28, 1978) (statement of Hon. Don Edwards).

139. See 11 U.S.C.A. § 547(c) (West Supp. 1979).

140. See S. REP. No. 989, 95th Cong., 2d Sess. 88, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5787, 5874; H.R. REP. No. 595, 95th Cong., 1st Sess. 373, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6329.

141. 11 U.S.C.A. § 547(c)(1) (West Supp. 1979). Under this provision, a check is "intended to be contemporaneous" and if presented for payment in the ordinary course of affairs, which the Uniform Commercial Code specifies as thirty days, it will be protected. *Id.* § 547(c)(1); H.R. REP. No. 595, 95th Cong., 1st Sess. 373, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6329. See generally U.C.C. § 3-503(2) (1968 version). This exception will not apply if the check is dishonored. See 124 CONG. REC. H11089 (daily ed. Sept. 28, 1978) (statement of Hon. Don Edwards).

ordinary course of business or financial affairs of the debtor and the transferee according to ordinary business terms not later than 45 days after the debt was incurred;¹⁴²

(3) a transfer of a security interest in property acquired by the debtor to the extent that the security interest secures new value given by or on behalf of the secured party to enable the debtor to acquire such property and it is in fact so used.¹⁴³ The new value cannot be given prior to the signing of a security agreement containing a description of the property as collateral, and the security interest must be perfected within ten days after it attaches;¹⁴⁴

(4) preferential transfers which would otherwise be voidable to the extent that the creditor thereafter gave new value to or for the benefit of the debtor. The new value cannot be secured by an otherwise unavoidable security interest or be for an otherwise unavoidable transfer made to or for the benefit of the creditor.¹⁴⁵

(5) transfers of a perfected security interest in inventory or a receivable, or their proceeds to the extent that the creditor's position is not improved within the applicable preference period.¹⁴⁶ To the extent that the creditor's position is improved

142. 11 U.S.C.A. § 547(c)(2) (West Supp. 1979); H.R. REP. No. 595, 95th Cong., 1st Sess. 373, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6329.

In the tax context, this exception will mean that a payment of taxes when they are due, either originally or under an extension, or within 45 days thereafter, will not constitute a voidable preference. However, if a payment is made later than the last day on which the tax may be paid without penalty, then the payment may constitute a preference, if the other elements of a preference are present. In that case, the tax debt would be an antecedent debt and would not fall under this exception.

H.R. REP. No. 595, 95th Cong., 1st Sess. 373, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6329.

143. If challenged, the lender may be required to trace the funds advanced into the seller of the property.

144. 11 U.S.C.A. § 547(c)(3) (West Supp. 1979). This is to enable the debtor to obtain such loans to acquire property. H.R. REP. No. 595, 95th Cong., 2d Sess. 373, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6329.

145. 11 U.S.C.A. § 547(c)(4) (West Supp. 1979). This codifies the "net result rule" of Bankruptcy Act § 60 as expressed in *In re Hygrade Envelope Corp.*, 393 F.2d 60, 65 (2nd Cir.), cert. denied sub nom. *Gilbraltor Factors Corp. v. Baranow*, 393 U.S. 837 (1968). See H.R. REP. No. 595, 95th Cong., 1st Sess. 374, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6330.

146. 11 U.S.C.A. § 547(c)(5) (West Supp. 1979). This provision overrules cases such as *Dubay v. Williams* and *Grain Merchants, Inc. v. Union Bank* which held that such security interests were not subject to attack since their perfection related back to the filing of the financing statements outside such period. See *DuBay v. Williams*, 417 F.2d 1277, 1285, 1288

during the preference period, and such improvement prejudices other unsecured creditors, the trustee can avoid the security interest.¹⁴⁷ A two-point test is provided. The amount by which the debt secured exceeds the value of the collateral on the date the petition is filed is subtracted from the amount by which the debt secured exceeded the value of the collateral at the beginning of the preference period or if no debt then existed, the date on which new value was first given during the period under the security agreement creating the security interest.¹⁴⁸

(6) the fixing of statutory liens not otherwise avoidable by the trustee.¹⁴⁹

Inasmuch as the "reasonable cause to believe" requirement has been eliminated, judicial liens obtained within four months of the

(9th Cir. 1969); *Grain Merchants, Inc. v. Union Bank & Sav. Co.*, 408 F.2d 209, 212 (7th Cir.), cert. denied, 396 U.S. 827 (1969).

147. As to when other creditors are prejudiced, see REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. 137, Pt. I, 93d Cong., 1st Sess. 209-10 (1973):

Improvement in position is alone not enough. The trustee must also establish that the improvement was at the expense of the estate. This is intended partially to meet Professor Kripke's criticism that increases in value of collateral due to, e.g., harvesting crops, completing work in process, sales of inventory, and seasonal fluctuations in value, would constitute improvement in position and be recoverable:

In my opinion the creditor should keep the benefit of the improvements in the cases mentioned, so long as it is not at the expense of other parties interested in the estate. I think there is a formula for protecting the other parties against depletion of the estate for the benefit of the secured creditor in this respect. That formula is found in *Meinhard, Greeff & Co. v. Edens*, 189 F.2d 792 (4th Cir. 1951) which I cited to Professor Gilmore as a model for this problem on May 31, 1966. The court was there considering the problem of the allocation between the secured creditor and the estate of the value of goods which had been in process at the moment of bankruptcy and which had been finished by the trustee. The court held that the secured creditor was entitled to the entire value of the finished goods, less the costs expended by the trustee in finishing the goods. This of course was for operations which occurred after bankruptcy. There is no reason why the same principle may not be applied to expenditures by the bankrupt or debts incurred by the bankrupt within the four-month period.

Id. at 209-10 (quoting letter from Prof. Homer Kripke to Gilmore Committee, Sept. 17, 1970).

148. For example: assume a constant debt of \$100. If at the beginning of the preference period, the value of the inventory collateral is \$50 and at the time of the filing of the petition it is \$80, the trustee can recover \$30 [(100-50) - (100-80) = 30]. If the value of the collateral at the beginning of the period is \$100, then during the period drops to \$10 but builds back up to \$150 at the filing of the petition, there would be no recovery since there was no deficiency at the beginning of the period. See H.R. Doc. No. 137, Pt. I, 93d Cong., 1st Sess. 208 (1973). The estate, of course, would own the \$50 equity at the time of the petition. See 11 U.S.C.A. § 541(a)(1) (West Supp. 1979).

149. *Id.* § 547(c)(6).

filing of the bankruptcy petition previously voidable under section 67a of the Act¹⁵⁰ are now voidable as preferences under the Code as are transfers to a surety who furnished a bond to dissolve such a judicial lien.¹⁵¹ As before, the surety is discharged of his liability under the bond to the extent of the value of the property recovered.¹⁵²

VI. SETOFF

Under the Act

Section 68 preserves the long-recognized right of offset¹⁵³ and provides that when mutual debts¹⁵⁴ and credits exist between the bankrupt estate and a creditor, one shall be offset against the other and only the balance allowed.¹⁵⁵ Specifically excepted from the creditor's claims which can be used for offset purposes are claims which are not provable debts of the bankrupt, claims of persons who received voidable transfers and have not surrendered them to the trustee, and claims acquired from third parties after or within four months before the filing of the bankruptcy petition with a view toward offset with knowledge or notice that the bankrupt was insolvent or had committed an act of bankruptcy.¹⁵⁶ A setoff may be made before or after the filing of the bankruptcy petition¹⁵⁷ and no court action is required.

Inasmuch as the act of offset does not constitute a "transfer," absent special circumstances, the transaction cannot be set aside by the trustee.¹⁵⁸ The offset most commonly encountered in bankruptcy proceedings is when a bank debits the bankrupt's general checking account and credits the amount against the bankrupt's indebted-

150. See Bankruptcy Act § 67a (repealed 1978, previously codified as 11 U.S.C. § 107(a)).

151. See 11 U.S.C.A. § 547(d) (West Supp. 1979).

152. See *id.* § 547(d).

153. 4 COLLIER ON BANKRUPTCY ¶ 68.01, at 843 (14th ed. 1978).

154. The debts or credits must be in the same right and between the same parties, standing in the same capacity. *Id.* ¶ 68.04, at 867.

155. See Bankruptcy Act § 68a (repealed 1978, previously codified as 11 U.S.C. § 108(a)).

156. See *id.* § 68b (repealed 1978, previously codified as 11 U.S.C. § 108(b)).

157. *Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 526 (1913). This right may be modified or denied if the offset would frustrate rehabilitation of the debtor. See, e.g., *Lowden v. Northwestern Nat'l Bank & Trust Co.*, 298 U.S. 160, 166 (1936); *In re Penn Cent. Transp. Co.*, 453 F.2d 520, 521-22 (3d Cir. 1971), *cert. denied*, 408 U.S. 923 (1972); *In re Williams*, 422 F. Supp. 342, 345 (N.D. Ga. 1976).

158. *Katz v. First Nat'l Bank*, 568 F.2d 964, 969 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

ness to the bank.¹⁵⁹ The practical effect of this transaction, especially when the balance in the account has substantially increased during the four months prior to bankruptcy, is to enable the bank to receive a greater percentage of its claim than other creditors. Unless the trustee can prove that the debtor "built-up" the account for the express purpose of permitting the setoff, the trustee has little chance under the Act of avoiding the setoff and recovering the offset amounts.¹⁶⁰ Even then, he must prove all of the elements of a voidable preference.¹⁶¹

Under the Code

With some additional limitations, the Code continues to recognize the right of a creditor to offset a prepetition mutual debt of the debtor against a prepetition claim of the creditor.¹⁶² However, the creditor's right of offset is now automatically stayed upon the filing of the bankruptcy petition¹⁶³ and is subject to a limited and qualified right of the trustee to use the amount subject to offset.¹⁶⁴

Under section 553(a), the following claims against the debtor cannot be used to offset the creditor's debt to the debtor:

- (1) non-allowable claims;¹⁶⁵
- (2) debts owed by the debtor to a third party, acquired by the offsetting creditor:
 - (a) after the commencement of the case; or
 - (b) after 90 days before the filing of the petition; and
 - (c) while the debtor was insolvent;¹⁶⁶
- (3) debts owed by the creditor to the debtor, incurred by the creditor:
 - (a) after 90 days before the filing of the petition;

159. The fact that the debtor gave the bank a check on the account subject to offset does not change this result. See *McKee v. Hood*, 312 F.2d 394, 397 (5th Cir. 1963).

160. See, e.g., *In re PRS Prods., Inc.*, 574 F.2d 414, 418 (8th Cir. 1978); *Katz v. First Nat'l Bank*, 568 F.2d 964, 969 (2d Cir. 1977), cert. denied, 434 U.S. 1069 (1978); *Jensen v. State Bank*, 518 F.2d 1, 4 (8th Cir. 1975).

161. See, e.g., *In re PRS Prod. Inc.*, 574 F.2d 414, 416 (8th Cir. 1978); *Katz v. First Nat'l Bank*, 568 F.2d 964, 969 (2d Cir. 1977), cert. denied, 434 U.S. 1069 (1978); *Jensen v. State Bank*, 518 F.2d 1, 4 (8th Cir. 1975).

162. See generally 11 U.S.C.A. § 553 (West Supp. 1979).

163. See *id.* § 362.

164. See *id.* § 362.

165. See *id.* § 553(a)(1). See generally *id.* § 503(b)(3).

166. *Id.* § 553(a)(2).

- (b) while the debtor was insolvent; and
- (c) in order to obtain a setoff.¹⁶⁷

The debtor is presumed to have been insolvent during the 90-day period.¹⁶⁸

Section 553(b) creates a new trustee's avoiding power.¹⁶⁹ The trustee may now recover for the benefit of the estate any prepetition setoff occurring within 90 days of the filing of the petition to the extent that the creditor's position was improved. The trustee's recovery is measured by subtracting the amount of the creditor's insufficiency on the setoff date from the amount of the insufficiency on the 90th day before the filing of the petition or the first day during the 90-day period on which there was an insufficiency, whichever occurred later. "Insufficiency" is defined as the amount by which the claim owed by the debtor exceeds the debt owed to the debtor.¹⁷⁰ This test is a simple two-point test similar to that provided for inventory and receivable security interests under the preference section.¹⁷¹ However there is no requirement that the debtor be insolvent at any time during the 90-day period.¹⁷² Postpetition setoffs, which can be effected only after the automatic stay has been lifted, are not subject to this avoiding power.¹⁷³

VII. JUDICIAL LIENS

Under the Act

Under section 67a(1), the trustee can avoid any lien obtained against the bankrupt's non-exempt property by legal or equitable process such as attachment, garnishment, or levy of execution within four months prior to the commencement of the case if:

167. *Id.* § 553(a)(3).

168. *Id.* § 553(c).

169. *Id.* § 553(b)(1).

170. *Id.* § 553(b)(2).

171. *See id.* § 547(c)(5). *See also* text accompanying notes 146-148 *supra*. For example, assume a constant debt of \$100. If at the ninetieth day before filing, the account balance is \$50 and at time of offset is \$80, the trustee can recover \$30; if at the ninetieth day, the balance is \$150, then falls to \$50 on the sixtieth day and at time of offset is \$80, the trustee can still recover \$30. To this extent, the test differs from the inventory/receivables test.

172. Section 547(b) contains no such requirement. *See* 11 U.S.C.A. § 547(b) (West Supp. 1979).

173. *See generally id.* §§ 362(a)(7), 549. In part, the purpose of excepting postpetition setoff is to encourage banks to carry a debtor through the difficult immediate pre-bankruptcy period. *See* H.R. REP. NO. 595, 95th Cong., 1st Sess. 184, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6145.

- (1) the debtor was insolvent at the time the lien was obtained; or
- (2) the lien was sought and permitted in fraud of the provisions of the Act.¹⁷⁴

Any transfer of the debtor's non-exempt property by way of grant or security, given to indemnify a surety who furnished a bond or other obligation to dissolve such judicial lien is likewise avoidable by the trustee,¹⁷⁵ and to the extent avoided, the surety's obligation under the bond is discharged.¹⁷⁶ Bona fide purchasers of the property are protected, but if they acquired the property at other than a judicial sale held to enforce the lien, their title is valid only to the extent of the present consideration paid.¹⁷⁷

Under the Code

These provisions are not carried forward in the Code because such liens may now be avoided as preferential transfers.¹⁷⁸

VIII. STATUTORY LIENS

Under the Act

As a general rule, statutory liens created or recognized by state or federal law will be valid against the trustee even if perfected within four months prior to the commencement of the bankruptcy proceeding while the debtor was insolvent.¹⁷⁹ However, some statutory liens are merely disguised priorities enacted to favor a particular class of creditors at the expense of unsecured creditors and thereby circumvent the priorities of distribution established by the Act. Still other statutory liens, such as tax liens, may be so pervasive and all encompassing that their enforcement would produce inequitable results.¹⁸⁰

To avoid such results, section 67c of the Act, in complex and

174. Bankruptcy Act § 67a(1) (repealed 1978, previously codified as 11 U.S.C. § 107(a)(1)).

175. *Id.* § 67a(2) (repealed 1978, previously codified as 11 U.S.C. § 107(a)(2)).

176. *Id.* § 67a(5) (repealed 1978, previously codified as 11 U.S.C. § 107(a)(5)).

177. *See id.* § 67a(3) (repealed 1978, previously codified as 11 U.S.C. § 107(a)(3)).

178. *See* notes 150-151 *supra* and accompanying text. *See generally* 11 U.S.C.A. § 547(b) (West Supp. 1979).

179. *See* Bankruptcy Act § 67b (repealed 1978, previously codified as 11 U.S.C. § 107(b)).

180. S. REP. NO. 277, 89th Cong., 1st Sess. 6 (1965); H.R. REP. NO. 686, 89th Cong., 1st Sess. 5 (1965); *see* 4 COLLIER ON BANKRUPTCY ¶ 67.20, at 223-24 (14th ed. 1978).

confusing terms, renders voidable by the trustee every statutory lien which:

- (1) first becomes effective upon
 - (a) the insolvency of the debtor, or
 - (b) upon distribution or liquidation of his property, or
 - (c) upon execution against his property levied at the instance of someone other than the lienor;¹⁸¹ or
- (2) is not perfected or enforceable at the date of bankruptcy against one acquiring the rights of a hypothetical bona fide purchaser from the debtor on that date;¹⁸² or
- (3) is for rent or is a lien of distress for rent, whether statutory or not.¹⁸³

In addition, unless accompanied by possession, tax liens on personal property are subordinated to the payment of costs of administration and priority wage claims.¹⁸⁴

These avoidance provisions are not applicable: when the lien is enforced by sale before the commencement of the bankruptcy proceeding; when the property is abandoned by the trustee or not administered in the bankruptcy proceeding; or, in railroad or corporate reorganization proceedings.¹⁸⁵

Under the Code

These avoiding provisions, rewritten in vastly improved and

181. See Bankruptcy Act § 67c(1) (repealed 1978, previously codified as 11 U.S.C. § 107(c)(1)).

182. If the lien is not invalid in bankruptcy against the trustee as a judicial lien creditor and the time for perfection against bona fide purchasers under the applicable lien law has not expired, the lien may be so perfected after bankruptcy. If the means of perfection is seizure, it is perfected instead by filing a notice with the bankruptcy court. See *id.* § 67c(1)(b) (repealed 1978, previously codified as 11 U.S.C. § 107(c)(1)(B)). The language of the section is confusing and subject to different interpretations. See Countryman, *The Use of State Law In Bankruptcy Cases (Part II)*, 47 N.Y.U. L. REV. 631, 640-45 (1972); Kennedy, *The Bankruptcy Amendments of 1966*, 41 REF. J. 1, 7 (1967).

183. See Bankruptcy Act § 67c(1) (repealed 1978, previously codified as 11 U.S.C. § 107(c)(1)).

184. See *id.* § 67c(3) (repealed 1978, previously codified as 11 U.S.C. § 107(c)(3)). This subordination gives rise to some interesting circuitry of liens problems when the tax lien is superior to a contractual lien that is superior to costs of administration and priority wage claims that are superior to the tax liens, etc. See H.R. REP. NO. 686, 89th Cong., 1st Sess. 17 (1965); Kennedy, *The Bankruptcy Amendments of 1966*, 41 REF. J. 1, 9-10 (1967).

185. See Bankruptcy Act § 67c(5) (repealed 1978, previously codified as 11 U.S.C. § 107(c)(5)).

clearer language, essentially are carried forward into the Code.¹⁸⁶ In condensed form, section 545 empowers the trustee to avoid a statutory lien on the debtor's property insofar as the lien:

- (1) first becomes effective against the debtor
 - (a) when a bankruptcy case is commenced;
 - (b) when a non-bankruptcy insolvency proceeding is commenced;
 - (c) when a custodian is appointed or takes possession of the property;
 - (d) when the debtor becomes insolvent;
 - (e) when the debtor's financial condition fails to meet a specified standard; or
 - (f) at the time of a levy of an execution against the property by someone other than the statutory lien claimant;
- (2) is not perfected on the date of the filing of the petition against a hypothetical bona fide purchaser from the debtor on that date;¹⁸⁷
- (3) is for rent; or
- (4) is a lien of distress for rent.

The lien can now be avoided even though it may have been enforced by sale prior to the commencement of the case.¹⁸⁸

The subordination of tax liens is continued and expanded by section 724(b).¹⁸⁹ Tax liens on real property and on personal property accompanied by possession are not excluded. Property, or its proceeds, subject to a tax lien, or any statutory lien whose priority is determined in the same manner as a tax lien, is to be distributed in the following order of priority:

- (1) to the holders of liens senior to the tax lien;
- (2) to all priority claims, except tax claims, but only to the extent of the amount of the allowed tax claim secured by the lien;
- (3) to the tax lien claimant to the extent that priority claims did not use up the amount of his entire claim;

186. See generally 11 U.S.C.A. § 545 (West Supp. 1979).

187. Again, if under the applicable lien law a later perfection will relate back to before the filing of the bankruptcy petition, the subsequent perfection will be good against the trustee. See *id.* § 546(b).

188. See H.R. REP. No. 595, 95th Cong., 1st Sess. 371, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6327.

189. See 11 U.S.C.A. § 724(b) (West Supp. 1979).

- (4) to junior lienholders;
- (5) to the tax lien claimant to the extent he was not paid under (3); and
- (6) to the debtor's estate.¹⁹⁰

These subordination provisions apply only in liquidation proceedings under Chapter 7 of the Code.¹⁹¹

In addition, the trustee in a Chapter 7 liquidation proceeding may avoid a lien that secures a claim for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, that arose before the earlier of the order for relief or the appointment of a trustee.¹⁹² Avoidance, however, is limited to the extent the claim secured is not compensation for actual pecuniary loss suffered by the claim holder.¹⁹³ If the case is thereafter converted to a Chapter 11 reorganization proceeding, the lien will be revitalized.¹⁹⁴

IX. POSTPETITION TRANSFERS

Under the Act

The filing of a bankruptcy petition, voluntary or involuntary, under the Act establishes a date of cleavage after which the debtor's ability to validly dispose of his non-exempt property is severely curtailed. It is at this point in time that the title to all of his non-exempt property vests by operation of law in the trustee in bankruptcy upon his appointment and qualification.¹⁹⁵ Theoretically, the debtor thereafter has no title which he can transfer.¹⁹⁶ Because the strict application of this principle would work a hardship on innocent parties who, without knowledge of the pending bankruptcy proceedings, deal with the debtor on a bona fide basis for a present consideration, these parties are afforded limited protection.¹⁹⁷

Thus, the trustee cannot avoid a postpetition transfer of real

190. *Id.* § 724(b).

191. *See id.* § 103(b). These provisions, however, will have an indirect application in reorganization and individual adjustment cases in determining whether under the plan the creditor will receive as much as they would have received in a liquidation case. *See generally id.* §§ 1129(a)(7), 1325(a)(4).

192. *See id.* § 724(a).

193. *See id.* § 726(a)(4).

194. *See H.R. REP. No. 595, 95th Cong., 1st Sess. 382, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6338.*

195. *See Bankruptcy Act* § 70a (repealed 1978, previously codified as 11 U.S.C. § 110(a)).

196. *See 4A COLLIER ON BANKRUPTCY* ¶ 70.04, at 50.1-50.2 (14th ed. 1978).

197. *See id.* ¶ 70.05, at 70 (14th ed. 1978); 4 *id.* ¶ 70.67, at 742.

property to a bona fide purchaser or lienor for present fair equivalent value who was without actual notice of the pendency of the proceedings or to a purchaser at a judicial sale unless: (1) the property is situated in the county in which the bankruptcy proceeding is pending, or (2) a certified copy of the petition with schedules omitted, of the decree of adjudication, or of the order approving the trustee's bond was recorded in the real estate records of the county in which the realty is situated prior to the perfection of the transfer.¹⁹⁸ When the consideration is less than a present fair equivalent value, the bona fide purchaser is given a lien upon the property to the extent of the value actually given.¹⁹⁹

With relation to personal property, the trustee can avoid all post-petition transfers unless they were made to a person acting in good faith for a present fair equivalent value during the interim period after the filing of an involuntary petition and before adjudication or a receiver took possession of the bankrupt's property, whichever occurred first.²⁰⁰ If the transfer was made for less than such value, the transferee is given a lien upon the property to the extent of the present value actually paid.²⁰¹ Also protected are persons indebted to the bankrupt or holding the bankrupt's property who, during this interim period between the filing of the involuntary petition and adjudication or a receiver's taking possession, in good faith pay the indebtedness or deliver the property to the bankrupt or another upon his order.²⁰² A person having actual knowledge of the pending bankruptcy proceeding is deemed to have acted not in good faith unless he had reasonable cause to believe that the bankruptcy petition was not well founded.²⁰³ The party asserting the validity of the transfer is given the burden of proof.²⁰⁴

Under the Code

These provisions are carried forward in sections 542(c), 549 and

198. Bankruptcy Act § 21g (repealed 1978, previously codified as 11 U.S.C. § 44(g)).

199. *Id.* § 21g (repealed 1978, previously codified as 11 U.S.C. § 44(g)).

200. *See id.* § 70d(1) (repealed 1978, previously codified as 11 U.S.C. § 110(d)(1)).

201. *Id.* § 70d(1) (repealed 1978, previously codified as 11 U.S.C., § 110(d)(1)).

202. *Id.* § 70d(2) (repealed 1978, previously codified as 11 U.S.C. § 110(d)(2)). This protection was extended beyond adjudication, at least for banks. *See Bank of Marin v. England*, 385 U.S. 99, 103 (1966).

203. Bankruptcy Act § 70d(3) (repealed 1978, previously codified as 11 U.S.C. § 110(d)(3)).

204. *Id.* § 70d(5) (repealed 1978, previously codified as 11 U.S.C. § 110(d)(5)).

550 of the Code with minor substantive modifications.²⁰⁵ With relation to real estate transfers, the document to be filed in the real estate records is limited to a copy of the petition.²⁰⁶ In situations involving personal property transfers during the interim period between filing and the entry of an order for relief, the transferee's good faith and knowledge of the pendency of the proceeding is now immaterial,²⁰⁷ the burden of proof provision has been omitted and the transfer is valid to the extent of any postpetition value, including services given in exchange for such transfer.²⁰⁸ The protection afforded a third party who, in good faith, transfers the debtor's property or pays a debt owing to the debtor after the filing of the petition has been expanded to cover transfers made after the entry of the order for relief but before he acquires actual notice or knowledge of the commencement of the case.²⁰⁹

X. LIABILITY OF TRANSFEREES

Under the Act

Seven sections of the Bankruptcy Act partially define the relative rights of the trustee and initial and subsequent transferees of avoided transactions.²¹⁰ There are variations depending upon the nature of the transaction and the avoiding power utilized. These have been discussed previously in reviewing each of the trustee's avoiding powers under the Act. As a general rule, the trustee can recover the property, or its value, from any person who received or converted it except a bona fide purchaser, lienor or obligee for a present fair equivalent value. To the extent that such value was not given, a good-faith transferee is given a lien on the property to the extent of the consideration actually given, which, in most cases, need not be a present consideration.

Under the Code

The Code prescribes the liability of and protection granted to transferees in greater detail than the Act.²¹¹ Section 550 differen-

205. See generally 11 U.S.C.A. §§ 542(c), 549, 550 (West Supp. 1979).

206. See *id.* § 549(c).

207. See *id.* § 549(b).

208. *Id.* § 549(b).

209. See *id.* § 542(c).

210. See generally Bankruptcy Act §§ 21g, 60b, 67a(3), d(6), 70d(1), d(5), e(2) (repealed 1978, previously codified as 11 U.S.C. §§ 44(g), 96(b), 107(a)(3), (d)(6), 110(d)(1), (d)(5), (e)(2)).

211. See generally 11 U.S.C.A. § 550 (West Supp. 1979).

tiates between the concepts of avoiding the transfer and recovering from the transferee, and related to all transfers avoided under the Code. To the extent that a transfer is avoided, the trustee may recover the property, or if the court so orders, the value of such property from:

- (1) the initial transferee or entity for whose benefit the transfer was made;²¹² or
- (2) any immediate or mediate transferee of the initial transferee except:²¹³
 - (a) a transferee who takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer;²¹⁴ or
 - (b) any immediate or mediate good-faith transferee of such transferee.²¹⁵

The requirement of good faith is imposed to prevent a "washing" of the transaction through an innocent third party.²¹⁶ The Act's requirement of present consideration has been eliminated.

Additionally, the Code protects a good-faith transferee of a voidable transfer who thereafter improves the property by granting him a lien on the property to secure the lesser of (1) the cost of the improvements made less any profit realized from the property, and (2) any increase in the value of the property resulting from the improvement.²¹⁷ The definition of improvement includes physical additions or changes to the property, repairs, payment of taxes on the property, discharge of any lien on the property equal or superior to the rights of the trustee, and preservation of the property.²¹⁸ The trustee, of course, is limited to only a single satisfaction on account of any avoided transfer.²¹⁹

212. *Id.* § 550(a)(1).

213. *Id.* § 550(a)(2).

214. *Id.* § 550(b)(1).

215. *Id.* § 550(b)(2).

216. See H.R. REP. NO. 595, 95th Cong., 1st Sess. 376, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6332.

217. 11 U.S.C.A. § 550(d)(1) (West Supp. 1979).

218. *Id.* § 550(d)(2).

219. *Id.* § 550(c).

XI. PRESERVATION OF AVOIDED TRANSFER

Under the Act

The bankruptcy court may, on due notice, order a transfer or obligation avoided by the trustee to be preserved for the benefit of the estate, in which event the trustee succeeds to and may enforce the rights of the transferee or obligee.²²⁰ The purpose of this preservation is to prevent junior lienholders from improving their position at the expense of the estate when a senior lien is avoided.²²¹

Under the Code

Any transfer avoided by the trustee is now automatically preserved for the benefit of the estate, but only with respect to property of the estate.²²² The purpose of the qualification is to prevent the trustee from asserting an avoided tax lien against after-acquired property of the debtor.²²³

XII. LIMITATION

Under the Act

Section 11e of the Act requires that suits brought by the receiver or trustee in behalf of the bankruptcy estate based upon pre-bankruptcy transactions must be instituted:

- (1) within two years subsequent to the date of adjudication;
- or
- (2) within such further period of time as the applicable federal or state law may permit;

provided that any applicable period of federal or state law limitation had not expired prior to the commencement of the bankruptcy proceeding.²²⁴

When the cause of action asserted by the trustee is created by the Act such as one to recover a voidable preference under section 60²²⁵

220. BANKR. PROC. R. 611.

221. S. REP. No. 989, 95th Cong., 2d Sess. 91, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5787, 5877; H.R. REP. No. 595, 95th Cong., 1st Sess. 376, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6332.

222. See 11 U.S.C.A. § 551 (West Supp. 1979).

223. See 124 CONG. REC. H11089 (daily ed. Sept. 28, 1978) (statement of Hon. Don Edwards).

224. See Bankruptcy Act § 11e (repealed 1978, previously codified as 11 U.S.C. § 29(e)).

225. See *id.* § 60 (repealed 1978, previously codified as 11 U.S.C. § 96).

or avoid a fraudulent transfer under section 67d,²²⁶ it is clear that the two-year limitation applies.²²⁷ While it is not as clear, when the claim is asserted under the trustee's section 70c²²⁸ strong-arm powers or as successor to the rights of actual creditors under section 70e,²²⁹ because the extent of those rights are governed by applicable state or federal non-bankruptcy law it would appear the trustee also has the benefit of the applicable federal or state limitation period.²³⁰ Thus, if the state period of limitation expires after, but within two years of, the date of adjudication, the trustee would have the benefit of the two-year period. If, however, the period under applicable state law expires after the two-year period, the trustee would have the benefit of the additional time afforded by the state law. In determining the length of the period of limitations afforded by state law, reference should also be made to those situations in which the running of that period would be tolled.²³¹

The running of the period of time prescribed by section 11e is suspended during the pendency of the case under Chapters X,²³² XI,²³³ XII²³⁴ or XIII²³⁵ of the Act.²³⁶ For example, if the debtor is adjudicated a bankrupt upon an involuntary petition filed against him on September 1, 1979, and one year thereafter, on September 1, 1980, files a Chapter XI arrangement petition in the case which is then dismissed two years later on September 1, 1982, the trustee would still have one year within which to file a suit to recover a voidable preference made before the filing of the involuntary petition.²³⁷

Under the Code

Any action by the trustee to avoid prepetition transactions must be commenced before the earlier of:

226. See *id.* § 67d (repealed 1978, previously codified as 11 U.S.C. § 107(d)).

227. See *Herget v. Central Nat'l Bank & Trust Co.*, 324 U.S. 4, 8-9 (1945); 1A COLLIER ON BANKRUPTCY ¶ 11.13[2], at 1214-15 (14th ed. 1978).

228. Bankruptcy Act § 70c (repealed 1978, previously codified as 11 U.S.C. § 110(c)).

229. *Id.* § 70e (repealed 1978, previously codified as 11 U.S.C. § 110(e)).

230. See *Bannister v. Salamon*, 126 F.2d 740, 742-44 (2d Cir. 1942).

231. *Id.* at 742-44.

232. Bankruptcy Act § 261 (repealed 1978, previously codified as 11 U.S.C. § 661).

233. *Id.* § 391 (repealed 1978, previously codified as 11 U.S.C. § 791).

234. *Id.* § 516 (repealed 1978, previously codified as 11 U.S.C. § 916).

235. *Id.* § 676 (repealed 1978, previously codified as 11 U.S.C. § 1076).

236. 9 COLLIER ON BANKRUPTCY ¶ 12.01, at 706 (14th ed. 1978).

237. See *id.* ¶ 12.01, at 706.

- (1) two years after the appointment of a non-interim trustee;
or
- (2) the close or dismissal of the case.²³⁸

Any action against a transferee of an avoided transfer must be commenced before the earlier of:

- (1) one year after the avoidance of the transfer; or
- (2) the close or dismissal of the case.²³⁹

Any action to avoid postpetition transfers must be commenced before the earlier of:

- (1) two years after the transfer; or
- (2) the close or dismissal of the case.²⁴⁰

XIII. CONCLUSION

The trustee's avoiding powers as renovated by the Code have been clarified, modernized and strengthened. Many substantial transfers clearly violative of bankruptcy's fundamental policy of equality of distribution that were previously unavoidable are now subject to the trustee's reach. Conversely, transfers previously voidable that were not violative of such policy are now clearly defined and excepted. These powers are now synchronized with modern commercial practices. Disabling burdens of proof have either been eliminated or lessened by the benefit of presumptions. These changes, when taken together with the extinction of the distinction between summary and plenary jurisdiction, will eliminate much unnecessary litigation and bring about a faster and fairer distribution of the bankrupt's property to creditors.

238. 11 U.S.C.A. § 546(a) (West Supp. 1979).

239. *Id.* § 550(e).

240. *Id.* § 549(d).