Vanderbilt Law Review

Volume 15
Issue 1 *Issue 1 - December 1961*

Article 5

12-1961

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The Bankruptcy Act allows the trustee in bankruptcy to avoid the effect of certain transactions entered into by the debtor on the ground that these transactions give some creditors a preference. In this article, Mr. Seligson examines section 60 of the Bankruptcy Act to determine when this can be done. He discusses the elements of preferential transfers, the problems of proof, the relationship between state and federal law, and the manner in which the statutory provisions have been applied by the courts.

I. Nature and Definition of a Preference

Equity is equality. That maxim is a theme of bankruptcy administration[1] —one of the cornerstones of the bankruptcy structure. All persons similarly situated are entitled to equality in treatment in the distribution of the assets of the bankrupt estate. It would be inequitable to disregard what has transpired prior to the filing of the bankruptcy petition. As has been aptly said, "if the creditors and debtor could deal with impunity with the debtor's assets up to the date of bankruptcy, only tag ends and remnants of unencumbered assets would too often remain."[2] Thus the Bankruptcy Act provides the trustee with an arsenal of weapons to enable him to bring into the estate for distribution property which in equity and good conscience should be available to all. The power to avoid preferential transfers is one of these weapons.

1. Preferences at Common Law

At common law a preferential transfer was not considered immoral or improper.[3] Courts of equity, as well as courts of law, allowed a debtor to prefer one creditor over another if the transfer was designed to pay or secure an honest debt.[4] The debtor had the unquestioned right "to confess a judgment in favor of a particular creditor, for an honest debt then due,"[5] and the right of such judgment to hold its priority could not be challenged. It is true that this attitude of the courts encouraged a race among creditors, engendered favoritism by the debtor and resulted in inequality of

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1. Canright v. General Fin. Corp., 35 F. Supp. 841 (E.D. Ill. 1940).
2. 3 Collier, Bankruptcy ¶ 60.01, at 742 (14th ed. 1956).
3. 3 Collier, Bankruptcy ¶¶ 60.02, .03 (14th ed. 1956).
4. 3 Collier, Bankruptcy ¶ 60.02 (14th ed. 1956).
5. Williams v. Brown, 4 Johns. Ch. R. 682, 685 (N.Y. Ch. 1820).

distribution. Nonetheless, as noted with regret by Chancellor Kent in regard to preferences, "in cases not provided for by statute, the proceeding cannot ordinarily be controlled."[6]

2. *State Statutes Outlawing Preferential Transfers*

Many of the states have attempted to meet the problem by statutory action outlawing preferential transfers made by corporations.[7] A few have gone further and have extended the prohibition against preferential transfers to individuals and partnerships as well as to corporations.[8] On the whole, state efforts in this field of the law have not been entirely successful in preventing favored creditors from absorbing all of the assets of their insolvent debtor. As a result thereof, Congress has in the Bankruptcy Act attempted to meet the problem on a national basis. This law of preferences has been said to be "the main contribution of the Bankruptcy Act to the law of creditors' rights."[9]

3. *Relationship of Various Sections of Bankruptcy Act Dealing With Preferences*

Section 60a(1)[10] defines a preference and sub-division b of section 60[11] states the circumstances under and the extent to which preferential transfers may be avoided. Section 3a,[12] dealing with acts of bankruptcy, is

6. *Ibid.*

7. See, *e.g.*, N.Y. STOCK CORP. LAW § 15; N.J. STAT. ANN. § 14:14-2 (1939).

8. OHIO REV. CODE ANN. § 1313.56 (Baldwin); W. VA. CODE ANN. § 3987 (1955).

9. McLaughlin, *Defining a Preference in Bankruptcy*, 60 HARV. L. REV. 233, 235 (1946).

10. Bankruptcy Act § 60a(1), ch. 541, 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96a(1) (1958), reads as follows: "A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class."

11. Bankruptcy Act § 60b, ch. 541, 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96b (1958), reads as follows: "Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona-fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value: *Provided, however,* That where such purchaser or lienor has given less than such value, he shall nevertheless have a lien upon such property, but only to the extent of the consideration actually given by him. Where a preference by way of lien or security title is voidable, the court may on due notice order such lien or title to be preserved for the benefit of the estate, in which event such lien or title shall pass to the trustee. For the purpose of any recovery or avoidance under this section, where plenary proceedings are necessary, any State court which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction."

12. Bankruptcy Act § 3a, ch. 541, 30 Stat. 546 (1898), as amended, 11 U.S.C. § 21a

correlated with section 60 by the provision therein that a preferential transfer as defined in section 60a made or suffered by a person shall be an act of bankruptcy. It should be noted here, however, that there may be a transfer which is a preference under section 60a and therefore an act of bankruptcy but which could not be avoided under section 60b.

4. Preferential Transfer Distinguished From Fraudulent Conveyance

The preferential transfer must be distinguished from the fraudulent transfer. Under the Statute of Elizabeth[13] as well as under the Uniform Fraudulent Conveyances Act[14] a transfer made with intent to hinder, delay or defraud creditors is null and void. Every preferential transfer necessarily hinders and delays other creditors in the collection of their claims. Undeniably, "whenever an insolvent debtor pays one of his creditors in full, he thereby puts the cash or property so used beyond the reach of execution by the others."[15] In such a transfer, however, the hindering and delaying is incidental and, so it has been held,[16] is not proscribed by the law applicable to fraudulent conveyances.

5. Elements of a Preference Under the Bankruptcy Act

What are the elements of a preference under section 60a? There are said to be six. These are (1) a transfer of the debtor's property, (2) to or for the benefit of a creditor, (3) for or on account of an antecedent debt, (4) made or suffered by the debtor while insolvent, (5) within four months before the filing of the petition initiating the proceeding, and (6) the effect of which transfer enables the creditor to obtain a greater percentage of his debt than some other creditor of the same class.

II. Technical Aspects of a Preference

1. Transfer of Property of Debtor

The term "transfer" is defined in most comprehensive terms by section 1(30) of the act.[17] It includes every mode, direct or indirect, of parting

(1958), so far as relevant, reads as follows: "Acts of bankruptcy by a person shall consist of his having . . . (2) made or suffered a preferential transfer, as defined in subdivision (a) of section 96 of this title . . . ."

13. Fraudulent Conveyances, 1571, 13 Eliz c. 5 (repealed).

14. Uniform Fraudulent Conveyances Act.

15. Irving Trust Co. v. Chase Nat'l Bank, 65 F.2d 409, 410 (2d Cir. 1933).

16. Irving Trust Co. v. Chase Nat'l Bank, 65 F.2d 409 (2d Cir. 1933).

17. Bankruptcy Act § 1(30), ch. 541, 30 Stat. 544 (1898), as amended, 11 U.S.C. § 1(30) (1958), defines transfer as follows: " 'Transfer' shall include the sale and every other and different mode, direct or indirect, of disposing of or of parting with property or with an interest therein or with the possession thereof or of fixing a lien upon property or upon an interest therein, absolutely or conditionally, voluntarily or involuntarily, by or without judicial proceedings, as a conveyance, sale, assignment, payment, pledge, mortgage, lien, encumbrance, gift, security, or otherwise; the retention of a

with property or with an interest therein or with the possession thereof. It covers the fixing of a lien upon property or upon any interest therein. The transfer may be voluntary or involuntary, by or without judicial proceedings, and a retention of a security title to property delivered to a debtor is deemed a transfer suffered by the debtor. Thus a transfer "may be effected irrespective of any voluntary action on the part of the debtor with reference to the transfer of his property."[18] And, as pointed out by one authority, "any judicial proceeding which fixes a lien upon the property of the debtor and which comes within the other requisites of § 60 will constitute a voidable preference, irrespective of the lack of consent, acquiescence or activity of the debtor."[19]

2. Transfer Must Be to or for Benefit of Creditor

Of course property of a third party, such as a surety, which is transferred to the creditor in payment of the debtor's obligation is not property of the debtor[20] unless the surety is in some fashion reimbursed or secured by the debtor.[21] If payment is made by the surety out of funds supplied to him directly or indirectly by the debtor then payment to the creditor will be regarded as a transfer of the debtor's property.[22]

The term "property" does not include exempt property of the bankrupt.[23] Thus in a case arising in the Tenth Circuit[24] it was held that a transfer of exempt property before bankruptcy and within four months thereof could not be challenged if preferential even though made for an antecedent debt and while the debtor was insolvent. A majority of the court saw no reason why the bankrupt could not make a valid transfer of exempt property[25] prior to bankruptcy if he could do so after bankruptcy and after the exempt property had been set apart from the bankrupt estate.[26]

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security title to property delivered to a debtor shall be deemed a transfer suffered by such debtor . . . ."

18. 3 COLLIER, BANKRUPTCY ¶ 60.09, at 787 (14th ed. 1956).

19. 3 COLLIER, BANKRUPTCY ¶ 60.11, at 792 (14th ed. 1956). See Adler v. Greenfield, 83 F.2d 955 (2d Cir. 1936).

20. Mason v. National Herkimer County Bank, 172 Fed. 529 (2d Cir. 1909), *aff'd sub nom.* National Bank v. National Herkimer County Bank, 225 U.S. 178 (1912).

21. *Cf.* Stone v. Allied Clothing Corp., 140 N.J. Eq. 224, 54 A.2d 625 (Ch. 1947).

22. In the Matter of Solenberger, 190 F. Supp. 512 (W.D. Va. 1960).

23. 3 COLLIER, BANKRUPTCY ¶ 60.25 (14th ed. 1956).

24. Rutledge v. Johanson, 270 F.2d 881 (10th Cir. 1959).

25. Exemptions allowed under federal and state laws in force in domicile of the bankrupt are allowed. Bankruptcy Act § 6, cb. 541, 30 Stat. 548 (1898), as amended, 11 U.S.C. § 24 (1958). The trustee is not vested with the title of the bankrupt "to property which is held to be exempt . . . ." Bankruptcy Act § 70a, ch. 541, 30 Stat. 565 (1898), as amended, 11 U.S.C. § 110a (1958).

26. The bankrupt must elaim his exemptions in his schedules, Bankruptcy Act § 7a(8), ch. 541, 30 Stat. 548 (1898), as amended, 11 U.S.C. § 25a(8) (1958); trustee shall "set apart the bankrupts' exemptions allowed by law, if claimed, and report the items and estimated value thereof to the courts as soon as practicable after their appointment," Bankruptcy Act § 47a(6), ch. 541, 30 Stat. 557 (1898), as

It should be noted that the return by the debtor of property acquired by him through fraud, theft or misappropriation and to which the debtor has no title does not qualify as a transfer of property of the debtor.[27] The owner is simply reclaiming his own property. But it is important in these cases to make certain that the person reclaiming the property and asserting title thereto has not waived the tort or fraud and elected to be treated as a creditor.[28]

A transfer cannot be preferential if it is not made to or for the benefit of a creditor. A transfer to one to whom the debtor owes no money cannot be a preferential transfer although it may be a fraudulent one. The term "creditor" is defined in section 1(11) of the act.[29] It includes only one owning a claim provable in bankruptcy and provability of claims is determined by section 63 of the act.[30] Thus a preferential transfer can be made only where it is to or for the benefit of a person holding a provable claim. A guarantor, surety or endorser for the bankrupt is a creditor since he is the holder of a provable claim.[31] Payment of an endorsed note or guaranteed claim inures to the benefit of the endorser or guarantor[32] and it is immaterial that the endorser or guarantor procures the payment.[33]

Cases freqnently arise in which a corporation borrows money from a bank and the bank's note is endorsed or guaranteed by the principal stockholder and officer of the corporation or his wife or relative. The corporation becomes insolvent, the bank is paid and the trustee sues both the bank and the endorser or guarantor to recover the amount of the payment. In these situations the payment to the bank is for the benefit of the endorser or guarantor; therefore, if the other elements of a voidable preference can be established the trustee may recover from both the bank and the endorser[34] or guarantor or from one[35] or the other.[36] It may not be possible

amended, 11 U.S.C. § 75a(6) (1958); the trustee shall make his report of the artieles set off to the bankrupt within five days after receiving the notice of his appointment, and any creditor or the bankrupt may object within ten days after the filing of the report, GENERAL ORDER No. 17; the bankruptcy court is vested with jurisdiction to "determine all claims of bankrupts to their exemptions," Bankruptey Act § 2a(11), ch. 575, 52 Stat. 842 (1938), 11 U.S.C. § 11a(11) (1958).

27. Keystone Warehouse Co. v. Bissell, 203 Fed. 652 (2d Cir. 1913).

28. Cunningbam v. Brown, 265 U.S. 1 (1924); 3 COLLIER, BANKRUPTCY ¶ 60.18 (14th ed. 1956).

29. Bankruptcy Act § 1(11), ch. 541, 30 Stat. 544 (1898), as amended, 11 U.S.C. § 1(11) (1958), defines creditor as follows: " 'Creditor' shall include anyone who owns a debt, demand, or claims provable in bankruptcy, and may include his duly authorized agent, attorney, or proxy . . . ."

30. Bankruptcy Act § 63, ch. 541, 30 Stat. 562 (1898), as amended, 11 U.S.C. § 103 (1958).

31. Stern v. Paper, 183 Fed. 228 (D.N.D. 1910), *aff'd*, 198 Fed. 642 (8th Cir. 1912); 3 COLLIER, BANKRUPTCY ¶ 60.17 (14th ed. 1956).

32. Irving Trust Co. v. Manufacturers Trnst Co., 6 F. Supp. 185 (S.D.N.Y. 1934).

33. 3 COLLIER, BANKRUPTCY ¶ 60.17 (14th ed. 1956).

34. Irving Trust Co. v. Bank of Manhattan Trust Co., 8 F. Supp. 686 (S.D.N.Y. 1934).

for the trustee to prove all of the elements of a voidable preference as against the bank but he may be able to do so against the endorser or guarantor. In one case arising in the southern district of New York,[37] the trustee succeeded in recovering a judgment against both and the court then entered a judgment over in favor of the bank against the endorsers.

3. Transfer Must Be for or on Account of Anteeedent Debt

A transfer for a present consideration cannot be preferential because the transferee is not being preferred over other creditors. In that situation there is no depletion or diminution of the estate.[38] It follows that a substitution of property by property of equal value cannot be preferential because there is no diminution or depletion of the estate.[39] A transfer made in satisfaction of an unassailable mortgage, pledge, trust receipt, mechanic's lien or other valid lien is supported by a present consideration where the property subject to lien is at least equal to the amount of the payment.[40] Hence such a transfer cannot be preferential. Both the Second[41] and Ninth[42] circuits have held that payments made to a subcontractor do not diminish or deplete the estate otherwise available for the general creditors of the bankrupt where the subcontractor could have filed a lien or a stop-notice under applicable local law (New York and California) or state law imposed a mandatory obligation upon the prime contractor to pay the subcontractor. This conclusion is in accord with the recent decision of the New York Court of Appeals in *Aquilino v. United States*[43] that a contractor has no interest in any moneys due from the owner of improved property except to the extent that the amount due exceeds the unpaid claims of subcontractors.

There may be a transfer supported by both a present and a past consideration.[44] The fact that there is a partial present consideration will not be sufficient to save the transfer from being preferential in regard to that part of the consideration which is past.[45] Problems frequently arise in connection with cash sales and the courts are not in agreement as to when a cash sale ceases to be such and a creditor-debtor relationship arises.

In a case involving the preference statutes of the State of Washington,[46]

35. 3 COLLIER, BANKRUPTCY ¶ 60.58 (14th ed. 1956).
36. See note 32 *supra.*
37. See note 34 *supra.*
38. *In re* Perpall, 271 Fed. 466 (2d Cir. 1921).
39. 3 COLLIER, BANKRUPTCY ¶ 60.21 (14th ed. 1956).
40. Dinkelspiel v. Weaver, 116 F. Supp. 455 (W.D. Ark. 1953); 3 COLLIER, BANKRUPTCY ¶ 60.22 (14th ed. 1956).
41. Rieotta v. Burns Coal & Bldg. Supply Co., 264 F.2d 749 (2d Cir. 1959).
42. Keenan Pipe & Supply Co. v. Shields, 241 F.2d 486 (9th Cir. 1956).
43. 10 N.Y.2d 271, 219 N.Y.S.2d 254 (1961).
44. In the Matter of Cable Link Corp., 135 F. Supp. 277 (E.D. Mich. 1955).
45. *Ibid.*
46. Engstrom v. Wiley, 191 F.2d 684 (9th Cir. 1951). Wash. Laws 1941, ch. 103,

the defendant sold and delivered wheat to the bankrupt and in exchange therefor received a check drawn upon a bank located in the city in which the bankrupt carried on business. Ten days later and within four months of bankruptcy the check was deposited by the defendant in his bank account in another city and was paid by the drawee bank the next day out of the bankrupt's funds then on deposit. The Ninth Circuit Court of Appeals agreed with the trial court in its conclusion that these facts gave rise to a cash transaction and that there was no diminution of the estate of the bankrupt. It recognized that if it was intended "to extend credit even for a day or to sell the property on credit, there would be no question."[47] However, the parties intended a completed transaction, they did not create a debt, the defendant was not a creditor and "the wheat and the money were equivalents and were exchanged."[48] As the appellate court pointed out, although "the conditions of delivery and payment are concurrent"[49] in a cash sale, if that is what the parties intend, "the delivery and payment need not be exactly simultaneous."[50] The acceptance of the check by defendant instead of cash did not change the character of the transaction. According to the appellate court "the seller who took the check had a reasonable time to deposit it and receive the cash."[51]

In another case involving the Washington preference statutes the same result was reached by the Ninth Circuit Court of Appeals.[52] There the defendant sold a negotiable warehouse receipt to the bankrupt "intending to make a cash sale . . . of the actual wheat at an agreed net price . . . ."[53] The bankrupt, without fault of the defendant, failed to issue its check for the wheat until ten days later. This check was payable to the defendant and was received by him the next day. The deposit was made in a bank in a city distant from that in which the drawee bank was located. The check was returned because of insufficient funds and was redeposited and presented to the drawee bank two weeks from the delivery of the warehouse receipt. It was not then paid because the bankrupt's account was overdrawn but was honored seven days later.

On the foregoing facts, the trial court decided that payment of the check did not constitute an unlawful preference under the Washington statutes

§ 1(c), entitled "Insolvent Corporation," reads as follows: "'Preference' means a judgment procured or suffered against itself by an insolvent corporation or a transfer of any of the property of such corporation, the effect of the enforcement of which judgment or transfer at the time it was procured, suffered, or made, would be to enable any one of the creditors of such corporation to obtain a greater percentage of his debt than any other creditor of the same class."

47. 191 F.2d at 687.
48. *Id.* at 686.
49. *Ibid.*
50. *Ibid.*
51. *Id.* at 687.
52. Engstrom v. Benzel, 191 F.2d 689 (9th Cir. 1951).
53. *Id.* at 690.

"as the transaction was in substance and effect a cash transaction . . . ."[54] The Ninth Circuit Court of Appeals affirmed. That court declared that the intention of the parties was "immaterial in determining whether there was a preference."[55] In its view, the important questions were whether there was an antecedent debt and whether the assets had been diminished. Both questions were answered in the negative. No creditor-debtor relationship had been intended or had arisen. The property in the warehouse receipt did not pass to the bankrupt until the defendant-seller was paid in cash. When that occurred there was no depletion of the bankrupt's estate. Until actual payment the defendant "still had a right to recover the negotiable instrument showing the delivery of the wheat to the warehouse."[56]

In a recent case,[57] however, arising in Iowa, where the trustee sought to recover under section 60a and b, a different view seems to have been taken by the court as to when a cash transaction ceases to be such. In that case the debtor's check was given to the defendant in payment of corn purchased and hauled away from the defendant's place of business. The check was returned for insufficient funds twice and was paid about one month from the date it was delivered to the defendant. The court pointed out that to effect a preference a transfer must diminish the fund to which other creditors of the same class may resort for payment. Thus, when a debtor engages in a straight cash transaction, wherein something of value is purchased for a reasonable price, a diminution of the debtor's estate does not occur. However, as the court noted, any extension of credit, no matter how brief, establishes an antecedent debt under section 60 of the act.

The court conceded that under ordinary circumstances "the holder of a check given as payment in a cash sale does not become a creditor on an antecedent debt by waiting a reasonable time to cash the check. . . . If the check is honored in due course, there has been a substantially simultaneous exchange of cash for goods."[58] Thus the issue before the court in the transaction which began as a cash one with no extension of credit was whether "the delay in the ultimate payment transformed that transaction into one involving an extension of credit."[59] Relying upon the rationale of a Ninth Circuit case,[60] which had been approved by the Eighth Circuit,[61] the court concluded "that the circumstances in the present case were such that the defendant did become a creditor of the bankrupt after the check

54. *Id.* at 691.
55. *Ibid.*
56. *Ibid.*
57. Engelkes v. Farmers Co-op. Co., 194 F. Supp. 319 (E.D. Iowa 1961).
58. *Id.* at 324.
59. *Ibid.*
60. Security Trust & Sav. Bank v. William R. Staats Co., 233 Fed. 514 (9th Cir. 1916), *cert. denied*, 242 U.S. 639 (1916).
61. Bostian v. Levich, 134 F.2d 284 (8th Cir. 1943).

was initially returned because of insufficient funds . . . ."[62] Accordingly, the payment ultimately made by the bankrupt was made upon this antecedent obligation.

Money which is not part of the general assets of the bankrupt cannot be the subject of a preferential transfer.[63] Hence if a loan is made to the debtor for the express purpose of paying or securing another creditor there is no diminution or depletion of the estate.[64] There is simply a substitution of creditors with no resulting preference in the bankruptcy sense.

Bank deposits occupy a special status. Ordinarily a deposit in a bank creates a debtor-creditor relationship.[65] If the bank is a creditor it has the right of set-off under section 68a[66] provided that the deposit is made in the regular course of business to the checking account of the depositor.[67] There is no diminution of the estate of the depositor-debtor when the deposit is made because he receives a credit which in the same amount becomes available to him at once.[68] The indebtedness from the bank to the depositor is an asset of the debtor's estate. The law is otherwise where the deposit or deposits to the account of the debtor are made pursuant to a scheme or device to enable the bank to exercise its right of set-off.[69]

Finally, in regard to consideration, it is well to remember that a transfer which is supported by a present consideration may, by reason of a postponement of recordation and thus effectiveness as against creditors, become a transfer supported by an antecedent indebtedness. Thus where conditional sales contracts were not timely filed as required by applicable New York law, the transfer was not deemed perfected until the date of actual filing, and what was originally a present consideration became an antecedent one.[70]

4. Transfer Must Be Made While Debtor Insolvent

The debtor must be insolvent at the time the transfer is made or is deemed to have been made. This insolvency must be in the bankruptcy sense; as defined by section 1(19),[71] this is an insufficiency of assets at fair

62. Engelkes v. Farmers Co-op. Co., *supra* note 57, at 325.

63. Grubb v. General Contract Purchase Corp., 94 F.2d 70 (2d Cir. 1938).

64. Saper v. Wood, 249 F.2d 401 (9th Cir. 1957); Chiarovano v. Buttnick, 358 P.2d 305 (Wash. 1961).

65. See 27 TEXAS L. REV. 252 (1948).

66. Section 68a states that "in all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid." Bankruptcy Act § 68a, ch. 575, 52 Stat. 878 (1938), 11 U.S.C. § 108a (1958).

67. New York County Nat'l Bank v. Massey, 192 U.S. 138 (1904); Citizens Nat'l Bank v. Lineberger, 45 F.2d 522 (4th Cir. 1930).

68. *Ibid.*

69. See note 65 *supra.*

70. *In re* Morasco, 233 F.2d 11 (2d Cir. 1956).

71. This section reads as follows: "A person shall be deemed insolvent within the provisions of this title whenever the aggregate of his property, exclusive of any

valuation to pay the aggregate of debts. This has been called "'a balance sheet' definition and requires the weighing of assets against liabilities."[72] In this respect "it differs . . . from the conventional definition of insolvency (in the equity sense) which is 'a general inability to meet pecuniary liabilities as they mature, by means of either available assets or an honest use of credit.'"[73]

The term "fair valuation" has been defined as "the fair cash value or the fair market value of the property (of the debtor) as between one who wants to purchase and one who wants to sell the property."[74] In other words, fair valuation is what a willing purchaser would pay to a willing seller. As applied to accounts receivable, fair valuation has been construed to mean "such as would be available to the bankrupt himself with which to meet his liabilities within a reasonable time."[75] It is not what could be realized on these receivables in time by patient and persistent effort, but rather their value now.[76] Of course property fraudulently transferred or concealed is by definition excluded from determination of insolvency.[77] As a result of the application of these principles of "fair valuation" the courts have determined the debtor to be insolvent in many cases where the book value of the assets was considerably in excess of the aggregate of the liabilities.[78]

Where insolvency is shown to exist at a given date it may be inferred that the debtor was insolvent at a prior or subsequent date where there is no showing of any substantial change in the intervening period.[79] There is a difference of opinion among the courts as to whether the amount actually realized for the assets in the bankruptcy liquidation may be considered as evidence bearing upon insolvency at the date of bankruptcy.[80] The courts also do not agree on the admissibility of the bankrupt's schedules as evidence of insolvency.[81]

The transfer may be voluntary of involuntary. The definition of transfer makes that clear. Moreover, the term "suffered" as used in the statute does

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property which he may have conveyed, transferred, concealed, removed, or permitted to be concealed or removed, with intent to defraud, hinder, or delay his creditors, shall not at a fair valuation be sufficient in amount to pay his debts . . . ." Bankruptcy Act § 1(19), ch. 541, 30 Stat. 544 (1898), 11 U.S.C. § 1(19) (1958).

72. Engelkes v. Farmers Co-op. Co., *supra* note 57, at 327.

73. *Ibid.*

74. Grandison v. National Bank of Commerce, 231 Fed. 800, 804 (2d Cir. 1916).

75. Louisiana Nat'l Life Assur. Soc'y v. Segen, 196 Fed. 903, 905 (E.D. La. 1912).

76. *In re* Coddington, 118 Fed. 281, 282 (M.D. Pa. 1902).

77. See note 71 *supra.*

78. See, *e.g.*, Irving Trust Co. v. Manufacturers Trust Co., 6 F. Supp. 185 (S.D.N.Y. 1934).

79. Engelkes v. Farmers Co-op. Co., *supra* note 57; New York Credit Men's Ass'n v. Chaityn, 29 F. Supp. 652 (S.D.N.Y. 1939).

80. 1 COLLIER, BANKRUPTCY ¶ 1.19[5] (14th ed. 1956).

81. *Ibid.*

not require any conscious participation by the debtor.[82] It is the result and not the knowledge or intent of the debtor which controls in determining whether a preference has been suffered.[83] Therefore a debtor may unintentionally and unwillingly suffer a preferential transfer. A good example of a transfer suffered is a sale of assets under an execution.[84] Certainly this sale cannot be held to be a voluntary or conscious act on the part of the debtor, assuming no fraud in the procurement of the judgment. Indeed in one case[85] it was held that a transfer had been suffered where trustees under a deed of trust executed by the debtor and covering his property had preferentially transferred portions of that property to other creditors.

5. Transfer Must Be Within Four Months of Petition

The trustee must establish that the transfer was made within four months prior to the date of the filing of the petition. Here the trustee is aided by section 60a which provides that a transfer is deemed to have been made when it is perfected. As to personal property a judicial lien-creditor test[86] is applied to determine perfection of transfer and as to real property a bona fide purchase test is used.[87] If a transfer is not so perfected before the petition is filed then it is deemed to have been made immediately before the filing of the petition.[88] The judicial lien-creditor and bona fide purchase tests are applied without regard to whether there are such creditors or bona fide purchasers.[89] It must be emphasized that this section does not

82. Warner v. Dworsky, 194 F.2d 277 (8th Cir. 1952).

83. *Ibid.*

84. Bronner v. Safinna, 25 F. Supp. 791 (S.D.N.Y. 1938).

85. Warner v. Dworsky, *supra* note 82.

86. Bankruptcy Act § 60a(2), ch. 541, 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96a(2) (1958), so far as relevant, reads as follows: "For the purposes of subdivisions (a) and (b) of this section, a transfer of property other than real property shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee."

87. Bankruptcy Act § 60a(2), ch. 541, 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96a(2) (1958), so far as relevant, reads as follows: "A transfer of real property shall be deemed to have been made or suffered when it became so far perfected that no subsequent bona fide purchase from the debtor could create rights in such property superior to the rights of the transferee."

88. Bankruptcy Act § 60a(2), ch. 541, 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96a(2) (1958), so far as relevant, reads as follows: "If any transfer of real property is not so perfected against a bona fide purchase, or if any transfer of other property is not so perfected against such liens by legal or equitable proceedings prior to the filing of a petition initiating a proceeding under this title, it shall be deemed to have been made immediately before the filing of the petition."

89. Bankruptcy Act § 60a(3), ch. 541, 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96a(2) (1958), so far as relevant, reads as follows: "If any transfer of real property subdivision shall apply whether or not there are or were creditors who might have obtained such liens upon the property other than real property transferred and whether or not there are or were persons who might have become bona fide purchasers of such real property."

make the trustee a bona fide purchaser.

Paragraphs (4), (5), (6), (7) and (8) of section 60a contain elaborate provisions devoted to the treatment of equitable liens and the judicial lien status of the trustee. The judicial lien test of perfection excludes liens given special priority over prior liens under applicable law.[90] This judicial lien which is the criterion as to when a transfer of personal property is perfected "is the one which a party to a simple contract might secure by a judicial proceeding, either by virtue of a pre-judgment attachment or garnishment, or by virtue of the decree or judgment itself (where state law gives rise to a lien upon the entry of such judgment or decree) or by further process to give effect thereto (as where the lien does not arise until levy of an execution) . . . ."[91]

The judicial lien which becomes superior to the rights of a transferee must arise from the lien itself or from the lien plus action solely within the control of the lienholder, aided only by ministerial acts of public officials.[92] Thus the lien used as the criterion for perfection of the transfer "must be one . . . which also can be obtained by steps within the control of the one securing the lien—such as registering or docketing a judgment, or the like even though that activity requires the cooperation of a ministerial official such as a clerk."[93] If the challenged transfer involves real estate "the trustee tests the transfer by the rights of a hypothetical purchaser who has taken the requisite steps"[94] to give him a prevailing status, such as recordation. Where the agreement or concurrence of any third party or further judicial action is required to make liens or purchases effective then such liens or purchases are excluded.

90. Bankruptcy Act § 60a(4), ch. 541, 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96a(4) (1958). This section provides: "A lien obtainable by legal or equitable proceedings upon a simple contract within the meaning of paragraph (2) of this subdivision is a lien arising in ordinary course of such proceedings upon the entry or docketing of a judgment or decree, or upon attachment, garnishment, execution, or like process, whether before, upon, or after judgment or decree and whether before or upon levy. It does not include liens which under applicable law are given a special priority over other liens which are prior in time."

91. See comment on § 60a, 1960 COLLIER PAMPHLET EDITION A 93.

92. See Bankruptcy Act § 60a(5), ch. 541, 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96a(5) (1958). This section provides: "A lien obtainable by legal or equitable proceedings could become superior to the rights of a transferee or a purchase could create rights superior to the rights of a transferee within the meaning of paragraph (2) of this subdivision, if such consequences would follow only from the lien or purchase itself, or from such lien or purchase followed by any step wholly within the control of the respective lien holder or purchaser, with or without the aid of ministerial action by public officials. Such a lien could not, however, become so superior and such a purchase could not create such superior rights for the purposes of paragraph (2) of this subdivision through any acts subsequent to the obtaining of such a lien or subsequent to such a purchase which require the agreement or concurrence of any third party or which require any further judicial action, or ruling."

93. Note 91 *supra.*

94. *Id.* at A 94.

Equitable liens which arise under state law where available means of perfecting legal liens have not been employed are denied recognition.[95] Since in most cases there will be means available for the perfection of legal liens, if equitable liens result under local law, the liens will not be regarded as perfected within the meaning of section 60a. As an illustration, in those states where an equitable lien arises upon failure of a mortgagee to record a chattel mortgage, the transfer will not be regarded as perfected despite local law because the mortgagee could have obtained a valid legal lien by recording the mortgage. Such an equitable lien created for a valuable consideration will not be recognized even though "both parties intend to perfect it and they take action sufficient to effect a transfer as against [judicial] liens . . . on a simple contract."[96] However, an equitable interest may be transferred by the debtor "by any means appropriate to transfer fully an interest of that character."[97]

The purpose of the statute is to strike down secret liens and to eliminate the doctrine of relation-back.[98] Notwithstanding this objective, a limited relation-back is permitted with respect to transfers of both real and personal property made for a new and contemporaneous consideration.[99] A

95. See Bankruptcy Act § 60a(6), ch. 541, 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96a(6) (1958). This section provides: "The recognition of equitable liens where available means of perfecting legal liens have not been employed is hereby declared to be contrary to the policy of this section. If a transfer is for security and if (A) applicable law requires a signed and delivered writing, or a delivery of possession, or a filing or recording, or other like overt action as a condition to its full validity against third persons other than a buyer in the ordinary course of trade claiming through or under the transferor and (B) such overt action has not been taken, and (C) such transfer results in the acquisition of only an equitable lien, then such transfer is not perfected within the meaning of paragraph (2) of this subdivision. Notwithstanding the first sentence of paragraph (2) of this subdivision, it shall not suffice to perfect a transfer which creates an equitable lien such as is described in the first sentence of this paragraph, that it is made for a valuable consideration and that both parties intend to perfect it and that they take action sufficient to effect a transfer as against liens by legal or equitable proceedings on a simple contract: *Provided, however,* That where the debtor's own interest is only equitable, he can perfect a transfer thereof by any means appropriate fully to transfer an interest of that character: *And provided further,* That nothing in this paragraph shall be construed to be contrary to the provisions of paragraph (7) of this subdivision."

96. See comment on § 60a, 1960 COLLIER PAMPHLET EDITION A 94.

97. See note 95 *supra.*

98. 3 COLLIER, BANKRUPTCY ¶ 60.38 (14th ed. 1956).

99. See Bankruptcy Act § 60a(7), ch. 541, 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96a(7) (1958). This section provides:

> "Any provision in this subdivision to the contrary notwithstanding if the applicable law requires a transfer of property other than real property for or on account of a new and contemporaneous consideration to be perfected by recording, delivery, or otherwise, in order that no lien described in paragraph (2) of this subdivision could become superior to the rights of the transferee therein, or if the applicable law requires a transfer of real property for such a consideration to be so perfected in order that no bona fide purchase from the debtor could create rights in such property superior to the rights of the transferee, the time of transfer shall be determined by the following rules:

transfer may be perfected within twenty-one days or within a shorter period if so fixed by state law and related back to the date of its actual execution.[100] Where there is delayed compliance (but prior to bankruptcy) with the law applicable to the transfer (recording, delivery or otherwise) the transfer is deemed made at the time of compliance.[101] If there is no compliance before bankruptcy, the transfer is deemed to have been made immediately before the filing of the petition.[102] In case there are no applicable local requirements regarding the transfer and it is wholly or in part for a new and contemporaneous consideration, it is deemed made as of the date of its execution to the extent of such consideration.[103] Furthermore, if the transfer secures a future loan which is made, or the transfer becomes security for a future loan, it has the same effect as a transfer for a new and contemporaneous consideration.[104] It has been suggested that the first sentence of paragraph (8) of revised section 60a "was included . . . so as to insure that assignments of accounts receivable will receive the most favorable treatment possible where the state law requires nothing more than the execution of the assignment itself for perfection."[105] The need for the second sentence of paragraph (8) is questionable since "it has always been the rule that a transfer for a genuine future consideration is not preferential."[106]

The significance of the perfection test is that by postponing the effective date of a transfer it postpones consideration of the existence of the elements

"I. Where (A) the applicable law specifies a stated period of time of not more than twenty-one days after the transfer within which recording, delivery, or some other act is required, and compliance therewith is had within such stated period of time; or where (B) the applicable law specifies no such stated period of time or where such stated period of time is more than twenty-one days, and compliance therewith is had within twenty-one days after the transfer, the transfer shall be deemed to be made or suffered at the time of the transfer.

"II. Where compliance with the law applicable to the transfer is not had in accordance with the provisions of subparagraph (1) of this paragraph, the transfer shall be deemed to be made or suffered at the time of compliance therewith, and if such compliance is not had prior to the filing of the petition initiating a proceeding under this title, such transfer shall be deemed to have been made or suffered immediately before the filing of such petition."

100. See comment on § 60a, 1960 COLLIER PAMPHLET EDITION A 95.

101. See note 99 *supra.*

102. *Ibid.*

103. See Bankruptcy Act § 60a(8), ch. 541, 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96a(8) (1958). This section provides: "If no such requirement of applicable law specified in paragraph (7) of this subdivision exists, a transfer wholly or in part, for or on account of a new and contemporaneous consideration shall, to the extent of such consideration and interest thereon and the other obligations of the transferor connected therewith, be deemed to be made or suffered at the time of the transfer. A transfer to secure a future loan, if such a loan is actually made, or a transfer which becomes security for a future loan, shall have the same effect as a transfer for or on account of a new and contemporaneous consideration."

104. *Ibid.*

105. See comment on § 60a, 1960 COLLIER PAMPHLET EDITION A 97.

106. *Ibid.*

of a preference[107] from the time the transfer is actually made to the time the transfer is deemed to have been made.[108] Therefore a transfer supported by a present consideration at the time it is actually made will be supported by an antecedent debt at the time the transfer is deemed to have been made.[109] All the elements of a voidable preference, other than the element of greater percentage,[110] will be determined as of the time of perfection, if perfected before the petition is filed, and if not, as of the date of the filing of the petition.

Of course state law determines when a transfer becomes perfected as against a judicial lien creditor or a bona fide purchaser.[111] Consequently state law determines the time of perfection of a transfer. State law, however, cannot validate a transfer which is a voidable preference under section 60a, b.

In a case arising in New York,[112] the debtor within four months prior to bankruptcy had executed to its attorneys and accountants an assignment of all its claims for refund of customs duties paid under protest to the United States. When the assignment was made and at bankruptcy the claims had not been allowed by the United States and were being prosecuted on behalf of the assignor. On these facts the district court decided that under applicable New York law the assignment was not perfected at the time of its making and therefore must be deemed to have been made immediately before the filing of the petition. The court of appeals agreed with the result but not with the reasoning of the district court. In its view the purported assignment was unenforceable under the Assignment of Claims Act because the customs refund claims had not been allowed. Therefore the assignment was not perfected within the meaning of section 60a(2). The trustee had no difficulty in establishing all of the other elements of voidable preference as of the date of bankruptcy.

In another case,[113] the Fifth Circuit Court of Appeals construing applicable Texas law ruled that the filing of notice of assignment protected only accounts receivable which were in existence when the notice was executed. The receivables in question were not in existence at the date of the filing of the notice. The court decided that since there were available means of perfecting legal liens with respect to the accounts which had not been employed, the equitable liens arising from the assignments would be denied recognition.

The four month period is of course an arbitrary one. Congress could

107. See note 10 *supra.*
108. Corn Exchange Nat'l Bank & Trust Co. v. Klauder, 318 U.S. 434 (1943).
109. *Ibid.*
110. Palmer Clay Prods. Co. v. Brown, 297 U.S. 227 (1936).
111. McKenzie v. Irving Trust Co., 323 U.S. 365 (1945).
112. Matter of Ideal Mercantile Corp., 244 F.2d 828 (2d Cir. 1957), *affirming* 143 F. Supp. 810 (S.D.N.Y. 1956).
113. Republic Nat'l Bank v. Vial, 232 F.2d 785 (5th Cir. 1956).

have lengthened this period to eight or twelve months or more or could have shortened it to one or two months. The four month period has acquired historical significance and it is correlated with the time period for acts of bankruptcy[114] and the time provisions of the act with respect to the nullification of judicial liens.[115] Section 60a, b penalizes the vigilant creditor who by his diligence succeeds in collecting or securing his just claim. At the same time, however, by confining avoidable preferential transfers to those made or deemed to have been made within the four month period, Congress has not dealt too severely with preferential transfers and has also given some stability to continued dealings with an insolvent debtor. In addition, this time provision tends to avoid a race among creditors to obtain payment before bankruptcy occurs. Hence it implements the policy of the act to insure equality of treatment among those similarly situated.

6. Creditor Must Receive Greater Percentage of Debt Than Other Creditors of Same Class

The effect of the transfer must be to enable the creditor to obtain a greater percentage of his debt than some other creditor of the same class. The test of classification is the percentage paid upon the claims out of the bankrupt estate.[116] All creditors in the same class are entitled to receive the same percentage.[117] It is not material that the owners of claims have the right to collect from others than the bankrupt.[118] Finally, in this regard, the determination is made when bankruptcy results and not at the date of payment.[119] It would be extremely difficult for the court to determine whether at the time of the transfer its effect would be to give the transferee a preference over other creditors of the same class, so the Supreme Court adopted the practical approach of determining the effect of the transfer as of the date of bankruptcy.

III. AVOIDANCE OF PREFERENTIAL TRANSFER BY TRUSTEE IN BANKRUPTCY

1. Trustee's Burden of Proof

A preferential transfer is established by proof of the existence of the six elements which have been discussed. The trustee carries the burden

114. Bankruptcy Act § 3b, ch. 541, 30 Stat. 546 (1898), as amended, 11 U.S.C. § 21b (1958).

115. Bankruptcy Act § 67a, ch. 541, 30 Stat. 564 (1898), as amended, 11 U.S.C. § 107a (1958).

116. *In re* Silver, 109 F. Supp. 200 (E.D. Ill. 1953). See also In the Matter of Driscoll, 142 F. Supp. 300 (S.D. Cal. 1956).

117. Swarts v. Fourth Nat'l Bank, 117 Fed. 1 (8th Cir. 1902).

118. *Ibid.*

119. Palmer Clay Prods. v. Brown, *supra* note 110.

of proof[120] and he must establish a preferential transfer by a fair preponderance of the testimony.[121] A preferential transfer under section 60a is sufficient as an act of bankruptcy under section 3a.[122] More, however, is needed if the trustee seeks to set aside the transfer. In that case the burden of proof rests upon the trustee to establish that at the time the transfer was received the creditor or his agent acting with reference thereto had reasonable cause to believe that the debtor was insolvent.[123]

Reasonable cause to believe that the debtor is insolvent does not mean that the trustee must show that the creditor had actual knowledge of insolvency.[124] On the other hand, a mere suspicion or apprehension of insolvency is insufficient.[125] It has been said that the creditor should have a well grounded belief that the debtor is insolvent "based on some fact or facts calculated to produce such a belief in the mind of an ordinarily intelligent man."[126] If the creditor has knowledge of facts sufficient to put a prudent man upon inquiry, the creditor is charged with knowledge of the facts such an inquiry would disclose.[127] Thus, in the last analysis the question of reasonable cause to believe must be resolved in the light of the circumstances peculiar to the particular case, and whether the facts are sufficient to compel the creditor to make an inquiry depends upon the facts.[128]

Certainly less is required if the creditor is an insider—one actively involved in the conduct of the business—than would be required in the case of an outsider.[129] As was said in one case where the principal officer was sued for the amount of a note paid to a bank which he had endorsed: "He was in the active conduct of the business of the corporation. If the corporation was insolvent, indisputably he knew it. He was not merely put on inquiry. He knew it."[130]

The form of the transfer is an important factor in determining reasonable cause to believe.[131] Was the payment made in the regular course of business? Did the debtor anticipate payment of the indebtedness or was the

120. 3 COLLIER, BANKRUPTCY ¶ 60.62 (14th ed. 1956); Allender v. Southeast Tractor & Equip. Co., 178 F. Supp. 413 (M.D. Tenn. 1959).
121. *Ibid.*
122. Bankruptcy Act § 3a, ch. 541, 30 Stat. 546 (1898), as amended, 11 U.S.C. § 21a (1958).
123. 3 COLLIER, BANKRUPTCY ¶ 60.62 (14th ed. 1956).
124. 3 COLLIER, BANKRUPTCY ¶ 60.63 (14th ed. 1956).
125. Grant v. National Bank, 97 U.S. 80 (1877).
126. Mayo v. Pioneer Bank & Trust Co., 190 F. Supp. 151 (W.D. La. 1960).
127. Pender v. Chatham Phenix Nat'l Bank & Trust Co., 58 F.2d 968 (2d Cir. 1932).
128. *In re* Shelley Furniture, Inc., 283 F.2d 540 (7th Cir. 1960); Boston Nat'l Bank v. Early, 17 F.2d 691 (1st Cir. 1927).
129. Irving Trust Co. v. Roth, 48 F.2d 345 (S.D.N.Y. 1930).
130. Irving Trust Co. v. Manufacturers Trust Co., 6 F. Supp. 185, 190 (S.D.N.Y. 1934).
131. 3 COLLIER, BANKRUPTCY ¶ 60.54 (14th ed. 1956).

debt long past due when paid? Did the creditor have or did he know of the existence of dishonored checks or dishonored notes of the debtor?[132] Had the debtor failed to remit on assigned receivables? Did the creditor have knowledge that the debtor was engaged in double financing? Had the debtor ignored repeated demands for payment? Did the creditor institute or threaten to institute suits or did he know of the pendency of suits to collect past due indebtedness?

Was the transfer made in the form of cash distinguished from check? Did the transfer take the form of a transfer of merchandise or other property in satisfaction of the indebtedness and if so, had the property been acquired in the first instance from the creditor?[133] Was it customary for the debtor to pay in cash or in kind? Was the source of funds for the payment unusual or out of the regular course of business? Had the debtor changed its bank or ceased to do business with his bank? Did the transfer in and of itself disable the debtor from continuing the operation of business?[134]

Insolvency is not based upon an inability to meet debts as they become due, so it is urged that a shortage of ready money does not in and of itself evidence insolvency.[135] It has also been found that the dishonoring of some of the debtor's checks is not conclusive on whether the creditor had reasonable cause to believe the debtor to be insolvent.[136] On the other hand, it has been held that knowledge of dishonored checks is evidence which may be considered in determining whether the creditor has had sufficient notice to put him on inquiry.[137] A man who is pressed gives ground for inquiry but it does not follow that he is insolvent because he is not quick to pay.[138]

In a New York case[139] in which it was held that a sale on execution of all of the debtor's assets was a transfer, the court said that the defendant knew that the bankrupts' bank account had been closed and that the bankrupts were not honoring their checks and concluded that dishonoring of checks was a clear indication of financial trouble sufficient to put the defendant on inquiry. Moreover, in the view of the court the sale of the entire physical assets of the bankrupts for an amount insufficient to satisfy

132. Bronner v. Safinna, 25 F. Supp. 791 (S.D.N.Y. 1938); Irving Trust Co. v. Textile Banking Co., 3 F. Supp. 816 (S.D.N.Y. 1932), *aff'd*, 65 F.2d 1018 (2d Cir. 1933); Sams v. First Nat'l Bank, 182 Miss. 777, 181 So. 320 (1938).

133. Abdo v. Townshend, 282 Fed. 476 (4th Cir. 1922); McLaughlin v. Fisk Rubber Co., 288 Fed. 72 (D. Mass. 1923).

134. Bronner v. Safinna, 25 F. Supp. 791 (S.D.N.Y. 1938); Pierre Banking & Trust Co. v. Winkler, 39 S.D. 454, 165 N.W. 2 (1917).

135. Salter v. Guaranty Trust Co., 140 F. Supp. 111 (D. Mass. 1956).

136. Bostian v. Levich, 134 F.2d 284 (8th Cir. 1943).

137. Brown Shoe Co. v. Carns, 65 F.2d 294 (8th Cir. 1933); Grandison v. National Bank of Commerce, 231 Fed. 800 (2d Cir. 1916).

138. Engelkes v. Farmers Co-op. Co., 194 F. Supp. 319 (E.D. Iowa 1961).

139. See note 84 *supra*.

the judgment was in itself enough to give the defendant reasonable cause to believe.

There is a presumption that payments made by the debtor to creditors are valid.[140] Thus the trustee must overcome this presumption by adequate proof. If the inferences to be drawn from the proved facts are as consistent with lack of reasonable cause as they are with reasonable cause, then the trustee has failed to discharge the burden of proving the affirmative.[141]

It can be seen that the question of reasonable cause to believe is a question of ultimate fact. What may be sufficient to satisfy one trier of fact may be insufficient for another. Thus in one New York case,[142] the bankrupt and an affiliate corporation had operated as one business. A store belonging to the affiliate was destroyed by fire and the proceeds of a fire insurance policy were deposited in the bankrupt's bank account in a bank which held notes for loans. The bank set-off the loans against the bank balance. The court found that the transfer of funds was a preference. In a Ninth Circuit case,[143] however, the bankrupt's place of business was closed down as the result of a fire. Two days later the defendant, president and manager of the bankrupt corporation, paid himself from the corporate account a substantial sum owing to him for unpaid salary. The district court ruled that the defendant did not have knowledge or reasonable cause to believe and the court of appeals affirmed. This case can be reconciled with the New York case only upon the theory that here, as the appeals court pointed out, the evidence bearing on knowledge available to the defendant concerning the financial condition of the bankrupt was slender and inconclusive. In a third case[144] arising recently in the New York State Supreme Court, summary judgment was entered by Justice Matthew Levy in favor of the trustee; the action was against an active principal officer of the bankrupt corporation who had issued two corporate checks to himself in payment of antecedent debts shortly prior to bankruptcy. The court thought it plain that a plea by such an officer, "not having extended or widespread business interests, of lack of knowledge of its financial condition—at least in respect of the fact of solvency or insolvency—ought not to be acceptable as a tangible basis for the creation of a triable issue."[145]

Of course if a creditor is put on inquiry he cannot be charged with reasonable cause to believe if such an inquiry would have gained the

140. 3 COLLIER, BANKRUPTCY ¶ 60.62 (14th ed. 1956).
141. 3 COLLIER, BANKRUPTCY ¶ 60.62 (14th ed. 1956); Engelkes v. Farmers Co-op. Co., 194 F. Supp. 319 (E.D. Iowa 1961).
142. Irving Trust Co. v. Continental Bank & Trust Co., 13 F. Supp. 235 (S.D.N.Y. 1935).
143. Williams v. McDonald, 244 F.2d 798 (9th Cir. 1957).
144. Parker v. Unowitz, 204 N.Y.S.2d 521 (Sup.Ct. 1960).
145. *Id.* at 524.

creditor nothing, at least so it has been held by the Ninth Circuit.[146] But the creditor ought not to be permitted to rest upon information furnished by the debtor.[147] Proof of reasonable cause to believe must be directed to the time when the transfer is made or is deemed to have been made. Where the effective date of the transfer is postponed because of non-perfection until just before the filing of the bankruptcy petition,[148] the trustee's burden to establish reasonable cause to believe will not ordinarily be a heavy one.

The trustee cannot recover the value of the property transfererd unless it has been converted.[149] If the property is in substantially its former condition the property, whatever its value, is the extent of the trustee's recovery.[150] It has been held that federal law rather than state law applies in defining conversion under section 60b.[151] Refusal to return the property to the trustee upon demand does not constitute a conversion under the statute.[152] Where the property has been converted the creditor is liable for the amount recovered if sold by him provided that amount is equal to the amount the trustee would have realized therefor.[153] If the property was sold at a sacrifice without justification the creditor may be surcharged therefor.[154]

2. Protection of Bona Fide Purchaser From Preferred Creditor

The right of recovery vests in the trustee and in the receiver when authorized by the court to sue.[155] The recovery can be had only from the person benefiting from the preference.[156] As stated previously, that person may be the transferee or some third party such as an endorser or guarantor.[157] However, "a bona fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value" is completely protected.[158]

146. *In re* Solof, 2 F.2d 130 (9th Cir. 1924).

147. 3 COLLIER, BANKRUPTCY ¶ 60.53, at 997 n.5 (14th ed. 1956).

148. Bankruptcy Act § 60a(2), ch. 541, 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96a(2) (1958).

149. 3 COLLIER, BANKRUPTCY ¶ 60.59 (14th ed. 1956). See also American Exchange Bank v. Goetz, 283 Fed. 900 (7th Cir. 1922).

150. 3 COLLIER, BANKRUPTCY ¶ 60.59. (14th ed. 1956). See also Ernst v. Mechanics' & Metals Nat'l Bank, 201 Fed. 664 (2d Cir. 1912), *aff'd sub nom.* National City Bank v. Hotchkiss, 231 U.S. 50 (1913); Irving Trust Co. v. Conte, 22 F. Supp. 94 (S.D.N.Y. 1937).

151. Perkins v. Remillard, 84 F. Supp. 224 (D. Mass. 1949).

152. *Ibid.*

153. Horowitz v. Huber, 34 F.2d 979 (S.D.N.Y. 1929). See also Walcott v. Commercial Inv. Trust Co., 7 F. Supp. 809 (S.D.N.Y. 1934).

154. Jentzer v. Viscose Co., 82 F.2d 236 (2d Cir. 1936).

155. Bankruptcy Act § 2a(3), ch. 541, 30 Stat. 545 (1898), as amended, 11 U.S.C. § 11a(3) (1958). See also 3 COLLIER, BANKRUPTCY ¶ 60.57 (14th ed. 1956).

156. 3 COLLIER, BANKRUPTCY ¶ 60.58 (14th ed. 1956).

157. Irving Trust Co. v. Manufacturers Trnst Co., 6 F. Supp. 185 (S.D.N.Y. 1934); Irving Trust Co. v. Bank of Manhattan Trust Co., 8 F. Supp. 686 (S.D.N.Y. 1934).

158. See note 11 *supra.*

In that connection, it should be noted that bona fide purchaser is defined in the Act to "include a bona fide encumbrancer or pledgee and the transferee, immediate or mediate of any of them."[159] The bona fide purchaser theory is applied *pro tanto* where the purchaser or lienor gives less than "a present fair equivalent value."[160]

Section 60b contains a special provision which enables the trustee to take advantage of the position of a lienor whose lien has been voided.[161] If the situation warrants, the court may on due notice order that the lien or security title be preserved for the benefit of the estate, in which event the lien or title passes to the trustee.

3. *Proceedings for Recovery of Preference*

Where plenary proceedings are necessary, any state court of competent jurisdiction and any court of bankruptcy have concurrent jurisdiction for the purpose of recovery or avoidance.[162] Thus the trustee has a choice of forums when he is compelled to take plenary action. Plenary proceedings are unnecessary, however, when the property subject to the alleged voidable lien or security title is in the possession of the bankrupt[163] or where the creditor consents to the exercise of summary jurisdiction by the bankruptcy court.[164] It should be noted that section 57g specifically provides that "the claims of creditors who have received or acquired preferences . . . voidable under this Act, shall not be allowed unless such creditors shall surrender such preferences . . . ."[165] In most jurisdictions, the findings of the bankruptcy court under section 57g as to the existence of a preference will be res judicata against the creditor in a subsequent plenary action.[166] In a few jurisdictions an affirmative judgment may be entered

159. Bankruptcy Act § 1(5), ch. 541, 30 Stat. 544 (1898), as amended, 11 U.S.C. § 1(5) (1958).

160. See note 11 *supra.*

161. Bankruptcy Act § 60b, ch. 541, 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96b (1958), so far as relevant, provides: "Where a preference by way of lien or security title is voidable, the court may on due notice order such lien or title to be preserved for the benefit of the estate, in which event such lien or title shall pass to the trustee."

162. Bankruptcy Act § 60b, ch. 541, 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96b (1958), so far as relevant, provides: "For the purpose of any recovery or avoidance under this section, where plenary proceedings are necessary, any State court which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction." See also Bankruptcy Act § 23b, ch. 541, 30 Stat. 552 (1898), as amended, 11 U.S.C. § 46b (1958).

163. Harrison v. Chamberlin, 271 U.S. 191 (1926).

164. MacDonald v. Plymouth County Trust Co., 286 U.S. 263 (1932).

165. Bankruptcy Act § 57g, ch. 541, 30 Stat. 560 (1898), as amended, 11 U.S.C. § 93g (1958).

166. Giffin v. Vought, 175 F.2d 186 (2d Cir. 1949); Breit v. Moore, 220 Fed. 97 (9th Cir. 1915).

in the bankruptcy court against the preferee in disposing of his claim.[167]

A suit to recover for a transfer of money is an action at law with the right to trial by jury, if plenary proceedings are required.[168] But where the relief sought is clearly equitable there is no right to jury trial since the suit is one in equity.[169] The trustee need not allege or prove a demand and refusal to surrender the preference.[170] If a demand is made, however, interest is generally allowed to the trustee from the time thereof[171] and if not from the commencement of suit.[172]

Section 11e[173] fixes a two year statute of limitations and the United States Supreme Court has held[174] this section applicable to a suit to set aside a preferential transfer. The trustee must therefore act promptly to investigate whether a voidable preferential transfer has been made, for if he does not, he will be foreclosed from action against the creditor. It has also been held that the two year limitation applies in summary proceedings.[175]

Finally, it should be noted that section 60c[176] under certain circumstances permits new credit extended to the debtor to be set-off against the amount which would otherwise be recoverable from the preferred creditor. This provision should be distinguished from section 68[177] which allows a set-off in cases of mutual debts and credits. It is important to remember that the right to set-off under section 60c and the right of set-off under section 68 may be asserted in the same action.[178]

167. Continental Cas. Co. v. White, 269 F.2d 213 (4th Cir. 1959); Inter-state Nat'l Bank v. Luther, 221 F.2d 382 (10th Cir. 1955).

168. Schoenthal v. Irving Trust Co., 287 U.S. 92 (1932).

169. Schoenthal v. Irving Trust Co., *supra* note 168; Walker v. Wilkinson, 3 F.2d 867 (5th Cir. 1925).

170. Stephens v. Pittsburgh Plate Glass Co., 36 F.2d 953 (5th Cir. 1930).

171. 3 COLLIER, BANKRUPTCY ¶ 60.63 (14th ed. 1956).

172. *Ibid.*

173. Bankruptcy Act § 11e, ch. 541, 30 Stat. 549 (1898), as amended, 11 U.S.C. § 29e (1958).

174. Herget v. Central Nat'l Bank, 324 U.S. 4 (1945).

175. 1 COLLIER, BANKRUPTCY ¶ 11.13 (14th ed. 1956).

176. Bankruptcy Act § 60c, ch. 541, 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96c (1958).

177. Bankruptcy Act § 68, ch. 541, 30 Stat. 565 (1898), as amended, 11 U.S.C. § 108 (1958).

178. Wertz v. National City Bank, 115 F.2d 65 (7th Cir. 1940).