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BANKRUPTCY LIEN INVALIDATION: ROLE OF RECORDATION

DAVID G. EPSTEIN*

Congress is currently considering new bankruptcy legislation. To date, its focus has been on two bills, one prepared by the National Commission on Bankruptcy Laws,¹ the other by the National Conference of Bankruptcy Judges.² Both bills call for substantial changes in present bankruptcy practices. Affirmative action on some combination of the two now seems likely. It appears that Congress soon will, for the first time in 77 years, comprehensively revise bankruptcy law. Accordingly, this is an appropriate time to examine closely basic bankruptcy concepts and policies. This article will deal with one very specific topic: *the effect of recordation on lien invalidation under present bankruptcy law and under the proposed acts.*

I. PRESENT LAW

"[B]ankruptcy is one of those words, like 'war', that you have heard all your life and think that you understand until you actually become involved with the process the word is intended to identify."³ Bankruptcy is a federal creditors' remedy and debtors' relief provision. There are presently several forms of bankruptcy proceedings.⁴ The overwhelming majority of bankruptcy proceedings are "straight bankruptcy" and most laymen and all too many lawyers use the terms "bankruptcy"

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1. H.R. 31, 94th Cong., 1st Sess. The companion bill in the Senate in S. 236. This will be referred to hereafter as the Commission's Bill in the text and (Commission) in the footnotes.

2. H.R. 32, 94th Cong., 1st Sess. The companion bill in the Senate is S.235. This will be referred to hereafter as the Judges' Bill in the text and as (Judges) in footnotes.

3. J.WEIDMAN, *FOURTH STREET EAST* 219 (1970).

4. See generally D. EPSTEIN, *DEBTOR-CREDITOR LAW IN A NUTSHELL* (1973).

and "straight bankruptcy" interchangeably. Straight bankruptcy is in the nature of a liquidation proceeding and involves the collection and distribution to creditors of all the bankrupt's nonexempt property by the bankruptcy trustee in the manner provided in the Bankruptcy Act. As part of the proceedings, the bankrupt is discharged from all of his "provable" debts absent the application of one of the exclusions from discharge set out in section 14⁵ of the Act or exceptions from discharge set out in section 17.

Straight bankruptcy proceedings may be instituted voluntarily by the debtor or involuntarily by creditor action. Voluntary bankruptcies outnumber involuntary bankruptcies by more than one hundred to one. Voluntary straight bankruptcy is available to most individuals and businesses.⁶ The solvency of the petitioner is immaterial, as is the amount of his liabilities, so long as he has debts.

While any person eligible under section 4a may, with few requirements, file a voluntary petition and be automatically adjudicated bankrupt, the situation in an involuntary proceeding is somewhat more complicated.⁷ Adjudication upon an involuntary petition is dependent upon satisfaction of the following conditions:

- (1) The debtor owes debts of \$1,000 or more;
- (2) The debtor is not within one of the three classes of persons eligible for voluntary bankruptcy protected by section 4b from an involuntary petition;
- (3) The petition is filed or joined by a sufficient number of qualified creditors;⁸
- (4) The bankrupt has committed one of the six acts of bankruptcy enumerated in section 3a;
- (5) The petition must be filed within four months of the commission of the act of bankruptcy;

5. The Bankruptcy Act is found in Title 11 of the United States Code. Section numbers in Title 11 do not correspond to the more commonly used section numbers of the Act. All references in this article are to Bankruptcy Act section numbers.

6. See Bankruptcy Act § 4.

7. *Id.* § 4b.

8. See Bankruptcy Act § 59.

(6) The debtor is properly served with the petition and defaults or is adjudicated bankrupt after a trial.

After adjudication, the procedure in an involuntary straight bankruptcy proceeding is the same as in voluntary proceedings. The bankruptcy judge calls a first meeting of creditors and sends notice to all creditors scheduled by the bankrupt. An important feature of the first meeting of creditors is the selection of the trustee. The trustee is the representative of the creditors, and the Bankruptcy Act provides for selection of a trustee by creditors. While the bankruptcy judge supervises the task of collection and distribution of the bankrupt's estate, the actual job of collection and distribution is the trustee's.

A valid lien is particularly important to a creditor when the debtor is bankrupt.⁹ All creditors do not participate equally in the distribution. A creditor with a valid lien is paid first to the extent of the value of the property subject to the lien. Then, creditors entitled to priority under section 64 of the Bankruptcy Act are paid. Then, a pro rate distribution is made to the general creditors.

The following hypothetical illustrates the practical significance of a valid lien in straight bankruptcy. *B* files a voluntary bankruptcy petition. At the time of the petition, *B* owes \$3,000 to *S* who has a valid lien on property of *B* worth \$3,000. *B* owns \$5,000 of other nonexempt property but owes other creditors \$9,000. Assuming that \$1,000 of \$9,000 of other claims is entitled to section 64 priority, a *general* creditor with a \$3,000 claim will only receive \$1,500. $\frac{5,000-1,000 \times 3,000}{9,000-1,000}$ 3,000]. *S*'s \$3,000 claim, however, will be completely satisfied; *S* will receive the value of the property subject to the lien.

The debtor rehabilitation provisions of the Bankruptcy Act differ from straight bankruptcy in that the debtor looks to rehabilitation and reorganization, rather than liquidation, and the creditors look to future earnings of the bankrupt, rather than property held by the bankrupt at the time of the institution of the bankruptcy proceeding to satisfy their claims. There

9. "The ultimate test of the protection afforded a secured creditor is: will it hold up against the trustee in bankruptcy." J. MURRAY & T. WHITE, COMMERCIAL TRANSACTIONS PROBLEM TEACHING MATERIALS 179 (1973).

are several different types of debtor relief cases, each governed by separate and distinct chapters of the Bankruptcy Act: reorganization of railroads under section 77; municipal debt composition under Chapter IX; corporate reorganizations under Chapter X; business arrangements under Chapter XII; and wage earner plans under Chapter XIII. In the rehabilitation proceedings as in straight bankruptcy, the rights and remedies of a creditor with a valid lien are substantially greater than those of an unsecured creditor.¹⁰

As the preceding paragraphs imply, some liens that are valid outside of bankruptcy are not valid in bankruptcy. While invalidation of liens benefits primarily the creditors without liens, general creditors are not permitted to challenge the validity of liens themselves. The trustee in bankruptcy, however, as representative of the creditors is given a variety of powers to avoid or supersede prebankruptcy "transfers," as defined in section 1(30), that give rise to liens.

This does not mean that the trustee will be able to avoid every lien so that in bankruptcy all creditors will be general creditors and thus be treated equally. Perhaps the Act could have so provided; perhaps the Act should have so provided. But, it did not. Instead it provides the trustee with certain powers under sections 60, 67a, 67c, 67d, 70c and 70e to attack the liens of creditors. Recordation plays an *important* part in at least three of these provisions: sections 70c, 60, and 67d.¹¹

A. Section 70c

Section 70c provides in pertinent part: "the trustee shall have as of the date of bankruptcy the rights and powers of: . . . a creditor who upon the date of bankruptcy obtained a lien by legal or equitable proceedings upon all property . . . whether

10. See generally F. Kennedy, *Secured Creditors: The Impact of Bankruptcy on Their Interests*, in ICLE, BASIC BANKRUPTCY ALTERNATIVES, PROCEEDINGS AND DISCHARGES 155, 172-183 (1971).

11. It would seem that recordation also plays an important part in lien invalidation under § 70e. See generally D. EPSTEIN, *DEBTOR-CREDITOR RELATIONS* 445-47 (1973); Countryman, *The Use of State Law in Bankruptcy Cases*, 47 N.Y.U.L.REV. 631, 656-63 (1972). Professor Kennedy strongly disagrees; see Kennedy, *The Trustee in Bankruptcy as a Secured Creditor Under the Uniform Commercial Code*, 65 MICH.L.REV. 1419 (1967). The Commission's Bill reflects Professor Kennedy's position, § 4-604(b). Because of this and because present § 70c is virtually never invoked in a recordation situation, this article will not discuss § 70e.

or not such a creditor exists." Section 70c does not describe the rights and powers of this hypothetical judicial lien creditor. Rather, to determine the rights and powers of such a creditor it is necessary to look to non-bankruptcy state law. The state law generally "looked to" is the applicable recording statute. Every state has statutory recording requirements for transfers of realty and security transfers of personalty.

The following hypothetical illustrates the application of section 70c. On January 1, 1975, *B* gives *M* a mortgage on *B*'s non-exempt real property. Before *M* can record the mortgage, *B* on February 2, 1975, files a voluntary bankruptcy. Under applicable state law, a mortgage is not effective against judgment lien creditors until recorded. Since *M* had not recorded the mortgage, as of the date of bankruptcy, a creditor who obtained a judicial lien on the date of bankruptcy could invalidate *M*'s mortgage. Section 70c gives the bankruptcy trustee the status, *i.e.*, the rights and powers, of a creditor who obtains a judicial lien as of the date of bankruptcy. Accordingly, the trustee could invalidate *M*'s mortgage under 70c.

Statutory recording requirements for transfers of realty vary greatly from state to state. The variables include (1) the type of document to be filed, (2) place of filing, (3) geographical extent of the filing unit, and (4) persons protected by the filing requirement.¹² For purposes of bankruptcy law, it is the final variable that is the most significant. For the bankruptcy trustee to be able to void an unrecorded transfer of realty under section 70c, the protection of the applicable recording statute must extend to judicial lien creditors. For the bankruptcy trustee to be able to void an unrecorded transfer of realty under section 70e, an actual, existing creditor must be within the coverage of the applicable recording statute.

In approximately one third of the states, real property recording statutes expressly limit their protection to *bona fide* purchasers.¹³ The courts in such states have uniformly excluded creditors from the protection of the act. In most other states, the recording statutes purport to protect all third parties from unrecorded transfers of realty. In some jurisdictions

12. See generally Aigler, *The Operation of the Recording Acts*, 22 MICH.L.REV. 405 (1922).

13. See generally G.OSBORNE, MORTGAGES, § 210 (2d ed. 1970)

with such a statute, however, courts have limited "third persons" to *bona fide* purchasers.¹⁴ Where the real property recording statute protects only purchasers, the trustee will not be able to avoid an unrecorded transfer of realty under 70c. Section 70c does not give the trustee the status of a purchaser.

Thus, the effect in bankruptcy of a failure to record a real property mortgage will vary from state to state. In states with real property recording statutes that protect lien creditors the mortgage will be invalid under 70c; in states with real property recording statutes that protect only *bona fide* purchasers the mortgage will *not* be vulnerable to a section 70c attack.

Recording statutes governing security transfers of personalty do not present the same uniformity problem. In every state except Louisiana security transfers of personalty are governed by Article 9 of the Uniform Commercial Code.¹⁵ However, a famous (or perhaps "infamous") circuit court decision has resulted in one section 70c for the Ninth Circuit and another for the rest of the United States. The case is *Pacific Finance Corp. v. Edwards*.¹⁶ There X, on November 12, 1959, recorded a conditional sales contract executed on October 10th. Subsequently, a bankruptcy petition was filed. The applicable recording statute provided that a conditional sales contract was void as to subsequent creditors if not recorded within ten days of execution. Under these facts, it would seem that the trustee in bankruptcy could invalidate X's consensual lien. The lien would be invalid as to any subsequent creditor and under 70c the trustee has the status of a subsequent creditor—*i. e.*, a creditor who extended credit to the bankrupt as of the date of the filing of the bankruptcy petition. The Ninth Circuit found otherwise: it held that the avoidance under section 70c is dependent upon the existence of an actual subsequent creditor and that since there were no such actual creditors the trustee could not successfully invoke section 70c.

14. See generally Note, *Status of Judgment Creditors Under the Recording Acts*, 32 NOTRE DAME LAW. 471 (1971).

15. Under Article 9 of the Uniform Commercial Code, filing, *i. e.*, recordation, is the most common method of perfecting, *i. e.*, giving public notice of the lien. It is not, however, the only method. Some security interests are perfected by the secured party taking possession of the collateral; some are automatically perfected. See UCC 9-302; see generally Ruud, *The Perfection of Security Interests Under Article 9 of the Uniform Commercial Code - How? Where? When? How Often?* 44 TEXAS L. R. 724 (1966).

16. 304 F.2d 224 (9th Cir. 1962).

Section 70c has long provided that the trustee has the status of a creditor with a judicial lien "whether or not such a creditor exists." A number of commentators have focused on this language in criticizing *Pacific Finance*.¹⁷ The *Pacific Finance* court reconciled this language with its holding by stressing the word "such." The opinion takes the position that section 70c does not require the existence of an actual subsequent creditor with a judicial lien—of *such* a creditor—but that it does require the existence of an actual subsequent creditor—of *a* creditor. In other words, the *Pacific Finance* view is that the trustee under 70c cannot hypothesize the existence of a subsequent creditor, but if, under the applicable recording statute only subsequent lien creditors can invalidate the lien in question and there is an actual subsequent general creditor, the trustee can hypothesize the necessary lien.

The present status of *Pacific Finance* is somewhat unclear. It remains the law in the Ninth Circuit. No other circuit has expressly accepted or directly rejected *Pacific Finance*.

The state to state variations in application are not the only troublesome aspect of present section 70c. Generally, section 70c can invalidate a lien only where there has been a failure to record. Absent a recording statute similar to the one involved in the *Pacific Finance* case — a recording statute that provides that a transfer not filed within a specific time period is ineffective — section 70c cannot be used to attack delays in filing.

Reconsider the hypothetical on page 74. Assume that *M* delayed in recording her mortgage until December 12, 1975. If *B* did not file for bankruptcy until December 13, 1975, *M*'s mortgage will be valid. Does this make sense?

In the original version of the hypothetical, a delay in recordation of little more than a month resulted in invalidation of *M*'s mortgage; in the amended fact statement, a delay of recordation of almost a year did not affect *M*'s rights. Shouldn't the validity of *M*'s mortgage turn on how long *M* delayed in recording rather than on whether *M* recorded before the bankruptcy petition was filed? At the very least, it seems that a delay in recordation should be a significant factor in determining the

17. *E.g.*, King, *Pacific Finance Corp. v. Edwards: Another Misreading of Section 70c of the Bankruptcy Act*, 69 COLUM. L. REV. 232 (1963).

validity of a lien in bankruptcy. While recordation delay, as contrasted with recordation failure, is not significant under section 70c, it is in section 60 and section 67d.

B. Section 60

At first glance, section 60 of the Bankruptcy Act does not seem to have any connection with recordation requirements. Professor Charles Seligson, the leading expert on bankruptcy law, explained the rationale of section 60 as follows:

“A cornerstone of the bankruptcy structure is the principle that equal treatment for those similarly situated must be achieved. It would be highly inequitable to disregard what transpires prior to the filing of the bankruptcy petition; to do so would encourage a race among creditors, engender favoritism by the debtor, and result in inequality of distribution. At bankruptcy, the bankrupt would be left, as Collier says, with only tag ends and remnants of unencumbered assets. Therefore, Congress arbitrarily prescribed the four-month period preceding the filing of the bankruptcy petition as the period in which preferential transfers shall be prohibited. However, in order to give some measure of security to those dealing with the bankrupt who are unaware, actually or constructively, of the bankrupt’s insolvency, Congress has provided that preferential transfers may not be avoided unless the creditor receiving the preference had reasonable cause to believe that the bankrupt was insolvent.”¹⁸

Seligson’s statement suggests that section 60 is quite different from section 70c: 70c promotes perfection of security interests; section 60 promotes equality of distribution. However, a closer examination of section 60, particularly 60a(2), reveals a considerable overlap between the purposes and particulars of sections 60 and 70c—reveals that recordation affects the trustee’s avoidance powers under section 60 as well as under section 70c.

There are eight elements of a section 60 preference—elements easily discernible from reading section 60a(1):

18. Seligson, *The Code and the Bankruptcy Act*, 42 N.Y.U.L. REV. 292 (1967).

- (1) a transfer [broadly defined in section 1(30) to include both absolute transfers and security transfers];
- (2) of the bankrupt's non-exempt property;
- (3) made or suffered by the bankrupt;
- (4) within four months of the filing of a bankruptcy petition;
- (5) to or for the benefit of a creditor;
- (6) for or on account of an antecedent debt;
- (7) while the debtor was insolvent;
- (8) the effect of which must be to enable the transferee to obtain a greater percentage of his debt than some other creditors of the same class.

The first, second, third and fifth requirements of section 60a(1) seem easy to apply. The eighth element of a preference under 60a(1) presents the most difficulty in understanding and application. It requires determination of (1) what is a "class" of creditors; (2) whether other creditors are in the same class as the transferee; and (3) whether the transfer enables the transferee to obtain a greater percentage of his debt than these other creditors. For purposes of this article, it is assumed that the eighth element is satisfied by any transfer of security except a transfer of security to a creditor who is already completely secured.¹⁹

19. The most commonly cited judicial discussion of the concept of class in § 60 is that appearing in *Swarts v. Fourth Nat'l Bank*, 117 F. 1, 6-7 (8th Cir. 1902). The court stated that:

"While, it is true that the bankrupt act does not define the word 'class,' nor in terms state what creditors are in the same class, it creates some classes and specifies others, and it seems to us that the meaning of the word 'class' in the act should, if possible, be derived from the statute itself. Section 64 . . . creates . . . classes of creditors . . . entitled to priority. Sections 56b, 57e and 57h provide for the treatment and disposition of claims secured by property and of claims which have priority. The creditors who hold these various claims and the general creditors of the estate constitute the classes of creditors of which the bankrupt act treats. Now if any one of these various classes is taken by itself and examined, it will be seen that each one of the creditors in the same class always receives the same percentage upon his claim, out of the

The following hypothetical illustrates the application of these eight elements of section 60a(1) in a lien invalidation context. On January 1, 1975, *D* borrows \$1,000 from *S*. *S* does not then obtain any security for her loan. On May 5, 1975, *S* learns that *D* is in financial difficulty and demands payment or assurance of payment. Accordingly, *D* gives *S* a lien on machinery. On June 6, 1975, *D* files a voluntary bankruptcy petition. The May 5, 1975, transfer of a lien by *D* to *S* would be a section 60 preference. There was (1) a transfer (2) of the bankrupt's non-exempt property (3) by the bankrupt (4) within 4 months of bankruptcy (5) to a creditor (6) for an antecedent debt (7) while the debtor was insolvent (8) which preferred the transferee over others in the transferee's class. Section 60b provides that the trustee can invalidate a preference if the transferee has "at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent."

In applying the fourth, sixth and seventh requirements of section 60a(1) and 60b, it is necessary to know the date of the transfer in question. The date of the transfer is not always easy to determine. Section 60a(2) provides that a transfer shall be deemed to have been made or suffered only when perfected as against certain specified other parties. If the transfer is of realty, the relevant "other parties" are subsequent *bona fide* purchasers; if the transfer is one of personalty, the "other parties" are subsequent judicial lien creditors.

Certain transfers are perfected against "other parties" as soon as made. Cash payments to a creditor or actual deliveries of tangible personal property are deemed to have been made *when they were actually made* because they are then perfected as against subsequent liens obtained by judicial proceedings. Other transfers such as real property conveyances, mortgages, and security transfers of personal property are ordinarily not perfected as against "other parties" until some further step such as filing or recording has been taken. In other words, state

estate of the bankrupt, that every other creditor of his class receives. . . . The test of classification is the percentage paid upon the claims out of the estate of the bankrupt."

See generally Note, *Class—The Forgotten Element of Section 60a (1) of the Bankruptcy Act*, 11 ARIZ. L. REV. 362 (1969). In this focus, it would seem that a transfer of a lien to an unsecured creditor will have a preferential effect unless the bankruptcy estate is sufficiently large as to permit 100% payments to all creditors.

recording statutes determine when lien transfers are deemed made. Thus, recordation is an important part of section 60 lien invalidation.

The following hypothetical points up the importance of recordation in section 60 contests. *B*, a Texas debtor, borrows \$100,000 from *S*, an Arkansas lender, on February 7, 1975, giving *S* a security interest in equipment in Texas. *S* does not perfect this security interest until March 6, 1975. *B* files a voluntary bankruptcy petition on July 1, 1975. At first, it might seem that section 60 is not applicable—that the security transfer from *B* to *S* was *not* for an antecedent indebtedness and did *not* occur within four months of the bankruptcy. For purposes of section 60, however, the transfer will be deemed made on March 6, 1975, not February 7, 1975. Under Section 9-301(1)(b) of the Uniform Commercial Code, *S*'s security interest would not be perfected as against subsequent judicial lien creditors until that date. Accordingly, by reason of section 60a(2), the transfer will not be deemed made until that date. Thus, the transfer would be within four months of the filing of the bankruptcy petition. Thus, the transfer would be for an antecedent indebtedness, *i.e.*, the \$100,000 loaned on February 7, 1975, almost a month prior to the time that the transfer was deemed made.

The above hypothetical illustrates the section 60 significance of timely perfection of liens. A delay in perfection can result in a transfer actually made for present consideration being deemed made for an antecedent indebtedness and thus a section 60 preference. From the language of 60a(2), it would seem that any delay in perfection—regardless of how slight—could have this effect. Section 60a(7), however, tempers section 60a(2).

Section 60a(7) is essentially a grace period provision. It provides that a transfer is regarded as having occurred on the actual date of the transfer if the transferee perfects it in the manner required by state law (1) within twenty-one days or (2) sooner, if the state law requires. The grace period afforded by section 60a(7) to transfers in fact made for new consideration is twenty-one days, unless state law provides a shorter grace period; the twenty-one day period is the maximum allowable even if the state law allows more.

Section 60a(7) is applicable only if the transfer of security is *in fact* made "on account of a new and contemporaneous consideration." In other words, the lien must be given at the time that the debt is incurred. To illustrate, section 60a(7) would be applicable to a security interest given on February 7, 1975, to secure a debt incurred on February 7, 1975. It would, however, not be applicable if the February 7, 1975, transfer of a security interest was to secure a debt incurred prior to February 7, 1974.

In summary, the date of recordation can be an important factor in determining whether a lien is invalid as a section 60 preference. Two different types of transfers of liens would seem to be section 60 preferences: (1) a lien actually given for an antecedent debt and (2) a lien actually given for new consideration that is not timely recorded.

C. Section 67d

Section 67d, like section 60, does not appear to have any connection with recordation. Section 67d is a fraudulent conveyance provision. It is very similar to the Uniform Fraudulent Conveyances Act (hereafter referred to as the UFCA).²⁰

Section 67d(1) is a definitional provision and corresponds to sections 1, 2 and 3 of the UFCA. Section 67d(2) telescopes into one exceedingly long and complex sentence sections 4 through 7 of the UFCA; if the debtor within one year of bankruptcy made a transfer without fair consideration while insolvent, or if he is rendered insolvent thereby, or if the transfer is made with intent to hinder, delay, or defraud existing or future creditors, or is made without fair consideration while the debtor is engaged in business and is left thereby without reasonable capital to conduct the business, without regard to intent, or is made without fair consideration by a debtor who expects to incur obligations beyond his ability to pay as they mature, such transfer is fraudulent. Section 67d(4) is similar to the partnership provisions of section 8 of the UFCA. Section 67d(5) affords *bona fide* purchasers the same protection as UFCA section 9.

20. The Uniform Fraudulent Conveyance Act, adopted in twenty-three states, is set out volume 7 of the Uniform Laws Annotated.

While fraudulent conveyances are generally absolute transfers, the creation of a lien can be a fraudulent conveyance.²¹ For example *D*, unable to pay his debts and concerned that his creditors will institute legal proceedings to seize his property, gives, *F*, his father a mortgage on all of his property. Shortly thereafter, the creditors of *D* file an involuntary bankruptcy petition. The bankruptcy trustee would be able to invalidate the transfer of the mortgage from *D* to *F* as a fraudulent conveyance. When *D* made the transfer, *D* was insolvent and did not receive fair consideration. When *D* made the transfer, *D* intended to hinder, delay or defraud his creditors.

The time of transfer is of course important in section 67d. The solvency of the debtor is measured as of the time of the transfer. The transfer must have occurred within 1 year of the filing of the bankruptcy petition.²² In section 67d, as in section 60, the important time is not the date that the transfer actually occurred but rather the date that the transfer is deemed to have occurred.

Section 67d(5) fixes the time that a transfer is deemed made: when the transfer has been so far perfected that no *bona fide* purchaser from the debtor can thereafter acquire any rights superior to those of the transferee in the property. Section 67d(5) also provides that if the transfer is not perfected before the filing of the bankruptcy petition, it will be deemed to have been made just before the bankruptcy petition.

The time of perfection as against a *bona fide* purchaser is important not only for limitation purposes but also as the time for determining whether the transfer was fraudulent under either 67d(2), (3), or (4). If, for example, the trustee is contending that a transfer was fraudulent under either 67d(2) (a) or 67d(4) which requires proof of insolvency of the transferor, the trustee can satisfy the insolvency requirement by showing insolvency of the transferor debtor at the time the transfer became valid as against a *bona fide* purchaser. Thus, again, a lien can be invalidated by the bankruptcy trustee because of recordation.

21. See, e.g., *Zellerbach Paper Co. v. Valley Nat'l Bank*, 13 Ariz. App. 431, 477 P.2d 550 (1970); *In re Rasmussen's Estate*, 238 Wis. 334, 298 N.W. 172 (1941).

22. Bankruptcy Act § 67d(2).

Kindom Uranium Corp. v. Vance,²³ is the classic illustration of the application of section 67d(5). There the debtor made a gift of real estate to her brother. At the time of the gift, the debtor had no financial problems. The debtor, however, subsequently became involved in an automobile accident which resulted in litigation against her. During the litigation, debtor's brother finally recorded the deed pursuant to state law. Thereafter, the person injured by debtor recovered a \$15,000 judgment which debtor was unable to pay. The debtor filed a voluntary bankruptcy petition. Thereafter, the bankruptcy trustee invalidated the gift of real estate to her brother under section 67d.

Note that the recordation or rather the delay in recordation was crucial to the bankruptcy trustee's section 67d case. At the time that the gift was actually made, the debtor was solvent. There are no legal problems with people who are solvent making gifts. It happens every Christmas and Chanukah. Gifts are fraudulent conveyances only when made by insolvents.

While the debtor in *Kindom* was solvent when the gift was actually made, she was not solvent when the gift was "deemed" made. Since the transfer was not by state law perfected against *bona fide* purchasers until recordation, the trustee was allowed to invoke section 67d although the actual transfer occurred almost two years before bankruptcy. And, since the transfer was deemed made during the lawsuit, it was held fraudulent under section 67d(2)(c) as one made without fair consideration "by a debtor who intends to incur or believes that he will incur debts beyond his ability to pay as they mature. In so holding, the court stated:

"Since the time of the transfer was [deemed to be] during the trial of a claim against her, large in amount as tested by her income, and since she was already indebted to her brother [for \$900] and [was] responsible for supporting herself and her daughter, the deduction is inescapable that at that time she contemplated incurring liabilities which she could not discharge as they matured."²⁴

23. 269 F.2d 104 (10th Cir. 1959).

24. 269 F.2d at 107.

Section 67d can thus be summarized in much the same way as section 60 was. Two separate and distinct kinds of transfers are affected by section 67d: (1) true fraudulent conveyances, *e.g.*, gifts by insolvents, transfers made with an intent to defraud creditors and (2) "technical" fraudulent conveyances, *i.e.*, transfers "valid" when actually "made" that are not timely recorded.

II. COMMISSION'S BILL AND JUDGES' BILL

Both the Commission's Bill and the Judges' Bill represent a substantial departure from present bankruptcy law and practice.²⁵ While the most drastic changes are in the general areas of bankruptcy administration, consumer relief and business rehabilitation, changes have been proposed in the various lien invalidation provisions. These changes do not, however, change the basic role of recordation in bankruptcy lien invalidation.

A. Section 4-604(a)

Section 4-604(a) of both the Commission's Bill and the Judges' Bill correspond to section 70c of the present Bankruptcy Act. The two versions of section 4-604(a) are virtually identical to each other. The two versions of section 4-604(a) are virtually identical to section 70c.

The trustee has the "rights and powers of a judicial lien creditor" as of the date of bankruptcy. Such rights and powers are determined by state law, primarily state recording statutes. If such statutes protect lien creditors, the bankruptcy trustee will be able to invalidate liens that are not recorded as of the date of bankruptcy. However, even if such statutes do protect lien creditors, the bankruptcy trustee will *generally* not be able to invalidate liens recorded prior to bankruptcy, but after a considerable delay.

B. Section 4-607

Section 4-607 in both bills is designed to replace section

25. There have already been several law review articles that survey the two bills. See *e.g.*, Lee, *A Critical Comparison of the Commission Bill and the Judges' Bill for the Amendment of the Bankruptcy Act*, 49 AM.BANKR.L.J.1 (1975); Walker, *An Introduction to the Proposed Bankruptcy Act of 1973: From Revision to Revolution*, 41 TENN.L.REV. 635 (1975).

60 of the Bankruptcy Act. Both proposals substantially change the present law of preferences. Both bills define a preference as a transfer made while the debtor was insolvent to pay or secure an antecedent debt. The Commission's Bill shortens the four month period of the present Act to three months for preferences to creditors other than "insiders."²⁶ The Judges' Bill retains the traditional four month period.²⁷ Under both bills, preferential transfers to "insiders" — *e.g.*, a member of the debtor's immediate family, officer, director, partner, or managing agent of the debtor — within *one year* of the filing of the petition can be avoided.²⁸

The most difficult problems of proof under the present version of section 60 are (1) insolvency at the time of transfer and (2) reasonable cause by the transferee to believe that the debtor was insolvent at the time of the transfer.²⁹ Both bills ameliorate these problems of proof. Under both bills, insolvency of the debtor is presumed for the initial preference period (*i.e.*, three months under the Commission's Bill, four months under the Judges' Bill).³⁰ Similarly for this period, both bills eliminate the requirement of proof of reasonable cause to believe.³¹ The Judges' Bill also shifts the burden on insolvency and eliminates reasonable cause to believe as to preferential transfers to insiders during the earliest eight (8) months one year prior to bankruptcy;³² the Commission's Bill does not.

These proposed changes in proof of insolvency and "reasonable cause to believe" will make it much easier for bankruptcy trustees to invalidate transfers as preferences. Although the above-discussed changes do not mention recordation, they indirectly affect the role of recordation in bankruptcy lien invalidation. They increase the likelihood that a delay in recordation will result in a lien being invalidated as a preferential transfer.

26. § 4-607(a)(1) (Commission)

27. § 4-607(a)(1)(Judges)

28. § 4-607(a)(2)

29. Report of the Commission on the Bankruptcy Laws of the United States, Part I 204 (July 1973).

30. § 4-607(f)(Commission); § 4-607(g)(Judges)

31. § 4-607(a)(1); *see generally* Note, *Voidable Preferences: An Analysis of the Proposed Revisions of Section 60b of the Bankruptcy Act*, 1974 Wisc. L.Rev. 481.

32. § 4-607(a)(2)(Judges)

For example, on January 1, 1975, X borrows \$1,000 from Y and gives Y a mortgage on Green Acre. On February 2, 1975, Y records the mortgage in the manner prescribed by state law. On March 3, 1975, X files a voluntary bankruptcy petition. Under section 60, the trustee will have to establish (1) X was insolvent on February 2, 1975, and (2) Y had reasonable cause to believe that X was insolvent on February 2, 1975. Under section 4-607 of the Commission's Bill or the Judges' Bill, the trustee will not have to prove either.³³

There are some provisions in both bills that more directly speak to recordation.

"A transfer of real property other than fixtures, but including the interest of a seller or purchaser under a contract for the sale of real property, is perfected when the transferee has acquired an interest in the property which is superior to the rights a subsequent bona fide purchaser of the property from the transferor could subsequently acquire by his purchase. A transfer of fixtures or of property other than real property is perfected when the transferee has acquired an interest in the property which is superior to the rights a subsequent judicial lien creditor could acquire in the property transferred.

"A transfer occurs when it takes effect between the parties if perfected at that time or within ten days thereafter. If perfected after the ten days, the transfer occurs when perfection occurs. Unless perfected within ten days, a transfer not perfected before the filing of the petition dates from a time immediately preceding such filing. A transfer does not take effect before the transferor has acquired rights in the property."³⁴

The first quoted paragraph corresponds to section 60a(2) of the present act: using the *bona fide* purchaser standard for transfers of real property and the judicial lien creditor test for transfers of personalty. The second paragraph set out above replaces section 60a(7). It substitutes a fixed ten-day grace period for the twenty-one day maximum grace period of section 60a(7).

33. To be precise, the trustee will have to establish insolvency but there is a statutory presumption of insolvency.

34. § 4-607(g)(6)&(7)(Commission); § 4-607(i)(Judges)

Again, the effect of the proposals can best be understood by illustration. On January 1, 1975, *D* borrows \$1,000 from *S* and gives *S* a security interest on her car.³⁵ *S* neglects to record its security interest until January 20, 1975. Under section 60(a)(7)'s 21-day grace period, the transfer of the security interest will be deemed to have occurred on January 1, 1975. No antecedent debt. No preference.

Under section 4-607's 10-day grace period, the transfer of the security interest will be deemed to have occurred on January 20, 1975. The Commission's Bill defines "antecedent debt" as "a debt incurred more than five days before a transfer paying or securing a debt."³⁶ Accordingly, applying the Commission version of section 4-607 to the hypothetical, there would be "antecedent debt" and the 19-day delay in recordation would result in invalidation of the security interest as a preference. The Judges' Bill defines "antecedent debt" as "a debt incurred more than *thirty days* before a transfer paying or securing a debt."³⁷ Applying the Judges' section 4-607 to the hypothetical, no antecedent debt and thus no preference.

In this focus, the proposed bills do not change the role of recordation in invalidation of liens as preferences. All that is to be changed is the time period that a creditor can delay recordation without risking lien invalidation.³⁸

C. *Section 4-608 of the Commission's Bill and Section 4-609 of the Judges' Bill*

Section 4-608 of the Commission's Bill and section 4-609 of the Judges' Bill are the primary fraudulent conveyance provisions in the proposed acts. Notwithstanding the difference in numbering, the two are basically similar to each other.³⁹ The

35. In most states, recordation of a lien on an automobile is accomplished by notation of the lien on the certificate of title. See UCC 9-302(3); see generally Murphey, *Cars, Creditors and the Code*, 1970 WASH.U.L.Q. 135.

36. § 4-607(g)(1)(Commission)

37. § 4-607(h)(1)(Judges)

38. Reading § 4-607(i) together with § 4-607(h)(1), it seems that the Judges' Bill is providing for what amounts to a 30-day grace period. If there is a 29-day delay in recordation, the transfer will be deemed to have occurred on the date of recordation rather than the date of the actual transfer. Nevertheless, the trustee would not be able to invalidate the transfer because of the 30-day gap permitted by the definition of antecedent debt.

39. See generally Countryman, *Some Good and Some Bad Features of the Proposed New Bankruptcy Act*, UCC L.J. 213, 228-29 (1975).

two proposals are also basically similar to section 67d of the existing Act. While there are differences between the two provisions and present law, the role of recordation remains the same.

“A transfer occurs at the time when it becomes so far perfected that no bona fide purchaser from the debtor other than a buyer in the ordinary course of business could thereafter have acquired any rights in the property transferred superior to the rights of the transferee therein, but if the transfer is not so perfected prior to the date of the petition under this title, it occurs immediately before the date of the petition.”

Accordingly, under the proposed legislation as under the present law, a transfer that is not a fraudulent conveyance, viewed as of the date it is actually made, can be invalidated as a fraudulent conveyance because of a delay in recordation and a change in the debtor's financial situation.

III. AN ALTERNATIVE PROPOSAL

Under both the present bankruptcy act and the two proposals that Congress is currently considering, recordation is a factor in lien invalidation. Under both the present bankruptcy act and the two proposals, the failure to record will result in loss of lien status if the applicable recording statute protects lien creditors. That is the effect of section 70c and proposed section 4-604. The result is less clear if the applicable recording statute only protects *bona fide* purchasers. Invalidation then hinges on the trustee's satisfying the various requirements of the preference or fraudulent conveyance provision. Similarly, invalidation of a lien because of a delay in recordation turns on proof of a preference or a fraudulent conveyance.

It is submitted that a failure to record or a delay in recording should be a factor in determining the validity of a lien. Such inaction on the part of a lien creditor can prejudice other creditors. If creditor X does not record its lien, creditor Y might not know that the debtor's property is encumbered; relying on the mistaken belief that the debtor holds his or her property free from liens, Y might extend credit or refrain from obtaining a lien or instituting collection proceedings.

Just as there is a bankruptcy policy against preferences and fraudulent conveyances there should be a bankruptcy pol-

icy against recordation delays and failures. And, this policy should be manifested in the same fashion as the policy against preferences and fraudulent conveyances: **a separate section of the Bankruptcy Act setting specific recordation standards.** Instead of the present and proposed piecemeal treatment of recordation problems, the Bankruptcy Act should simply provide that consensual liens that are not recorded or otherwise perfected within ten days⁴⁰ of their creation shall be invalid in bankruptcy.⁴¹

The following chart shows the impact of this proposal.

40. There is nothing "magical" about ten days. This number was selected because it was used by the Commission in § 4-607(h)(2) and because it appears throughout the time requirements of the Uniform Commercial Code. *See, e.g.*, 2-702(2); 9-301(2).

41. Others earlier recognized the problems presented by the piecemeal treatment of recordation in the present Bankruptcy Act. For example, in 1970, Professor Robert Morris of the University of Minnesota called for changing the law of preferences so that delay in recordation would not result in technical preferences. *See Morris, Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens*, 54 MINN.L.REV. 737 (1970). *See also* § 4-608 (Commission), note 9.

FACTS	PRESENT ACT	COMMISSION'S BILL	PROPOSAL
I. 1/1, mortgage 2/1, bankruptcy No recordation; recordation statute protects lien creditors	invalid under 70(c)	invalid under 4-604	invalid
II. Same as I except that recordation statute protects only bona fide purchasers	invalid under section 60 if (1) debtor insolvent at time of transfer and (2) transferee had reasonable cause to believe that debtor was insolvent	invalid under 4-607	invalid
III. 1/1 mortgage 2/2 recordation 3/3 bankruptcy	Same as II	invalid under 4-607	invalid
IV. 1/1 mortgage 1/15 recordation 2/2 bankruptcy Recordation statute silent as to grace period	invalid under 67(d) if viewing the facts as of 1/115, the transfer constituted a fraudulent conveyance - unlikely	invalid under 4-607	invalid
V. 1/1 mortgage 2/2 recordation 7/7 bankruptcy	Same as IV	invalid under 4-608 if viewing the facts as of 2/2, the transfer constituted a fraudulent conveyance - unlikely	invalid

Note that the proposal represents a substantial change from present bankruptcy law and practice. It is not, however, materially different in substance from the Commission's Bill. It is merely a more simple and more direct method of accomplishing, in a single section that speaks to recordation, what the Commission's proposal does in several sections that barely mention recordation.