

The Trustee's Status Under Section 70 (c) of the Bankruptcy Act - Constance V. Harvey Overruled

James Arthur Kern

Follow this and additional works at: <http://scholarship.law.marquette.edu/mulr>



Part of the [Law Commons](#)

Repository Citation

James Arthur Kern, *The Trustee's Status Under Section 70 (c) of the Bankruptcy Act - Constance V. Harvey Overruled*, 44 Marq. L. Rev. 566 (1961).

Available at: <http://scholarship.law.marquette.edu/mulr/vol44/iss4/9>

This Article is brought to you for free and open access by the Journals at Marquette Law Scholarly Commons. It has been accepted for inclusion in Marquette Law Review by an authorized administrator of Marquette Law Scholarly Commons. For more information, please contact megan.obrien@marquette.edu.

in the opinion accompanying an award, which permits the inference that the arbitrator may have exceeded his authority, is not a reason for refusing to enforce this award."⁴¹ But, primarily, the Supreme Court felt that the Court of Appeals merely differed with the construction of the contract that the arbitrator gave. To allow a vacation on this ground would permit courts to review the merits of every construction of the contract, but this is anathema to the Supreme Court.

The Court's attempt to prevent a review of the merits by a court seems to have resulted in ignoring the view taken by the Court of Appeals and by Justice Whittaker in the dissenting opinion in the *Enterprise Co.* case. They maintained that there existed a question of exceeding given authority rather than one of interpreting the contract differently. The Court of Appeals cited several cases which contained established law that "rights [under a collective bargaining agreement] remain in force only for the life of the contract unless renewed by subsequent contract or preserved by statute."⁴² The arbitrator's authority comes from the contract and since there was no contract governing the time that part of the award covered, it seems that the arbitrator could have been adjudged to have acted outside his given authority.

The Supreme Court seemed to feel that the best way to effectuate the labor arbitration process was to prohibit courts from weighing the merits of a grievance. It was this idea that permeated the decisions of the above three cases and gave rise to their results. In the field of labor arbitration, definite roles are now allocated to the courts and to the arbitrators, roles which are to be played in the advancement of industrial self-government.

ROGER E. WALSH

The Trustee's Status as a Hypothetical Lien Creditor Under Section 70 (c) of the Bankruptcy Act: *Constance v. Harvey Overruled*—In *Lewis v. Manufacturers National Bank of Detroit*,¹ the bankrupt borrowed money from the respondent on November 4, 1957, giving a chattel mortgage on his automobile as security. Under Michigan law, such mortgages were void as against creditors of the mortgagor unless recorded immediately.² Respondent's mortgage was not recorded until four days later on November 8, 1957, but no creditor had extended credit in the interim between the execution and the recordation of the mortgage. However, after the mortgagor filed a voluntary petition in

⁴¹ *Id.* at 598.

⁴² *Enterprise Wheel and Car Corp. v. United Steelworkers*, 269 F. 2d 327, 331 (4th Cir. 1959).

¹ 364 U.S. 603 (1961).

² MICH. COMP. LAWS s.566.140 (1948) as amended by PUBLIC ACT No. 233 (1957). In 1959, by PUBLIC ACT No. 110, a 10-day grace period is now allowed for the recording of chattel mortgages.

bankruptcy 5 months later, the trustee in bankruptcy sought to avoid the mortgage under Section 70(c) of the Bankruptcy Act, which provides in part:

The trustee, as to all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt could have obtained a lien by legal or equitable proceedings at the date of bankruptcy, shall be deemed vested as of such date with all the rights, remedies, and powers of a creditor then holding a lien thereon by such proceedings, whether or not such a creditor actually exists.³

The referee held for the trustee, concluding that under the Michigan statute a simple contract creditor could have avoided the mortgage had he extended credit during the 4 days when the mortgage was "off record," and therefore the trustee could claim the same right, even though no such creditor existed. The District Court overruled the referee, and the Court of Appeals affirmed. Because of the conflict between that decision and the decision of the Second Circuit in *Constance v. Harvey*,⁴ the Supreme Court granted certiorari, and affirmed the Court of Appeals. Thus the Supreme Court has settled an important question as to the rights, remedies, and powers of the trustee as a hypothetical lien creditor under the "strong-arm" clause of the Bankruptcy Act.

The interpretive issue raised in the *Lewis* case first arose in 1954, when the court in *Constance v. Harvey*⁵ announced *sua sponte* that Section 70(c) permitted the trustee, as an "ideal" lien creditor as of the date of bankruptcy, to set aside a chattel mortgage property recorded over a year before the petition was filed, but not recorded within a reasonable time after its execution, as required by New York law.⁶ In New York, as in Michigan, such security transactions not recorded within the required period were subject to attack by interim general creditors without notice. As in the *Lewis* case, there was no such creditor, but the trustee was allowed to assume such a status. While recognizing that the trustee's *lien* arises at the date of bankruptcy, the court erroneously assumed that his status as a hypothetical *general creditor* was not tied to that date, so that he was deemed to have extended credit during the period when it was most advantageous to do so.⁷

The *Constance* theory has caused great consternation among security

³ 66 Stat. 429 (1952), 11 U.S.C. §110(c) (1952).

⁴ 215 F. 2d 571 (2d Cir. 1954), *cert. denied*, 348 U.S. 913 (1955).

⁵ *Ibid.*

⁶ 32 N.Y. CONSOL. LAWS §230 (McKinney, 1940). The statute itself provides no specific time for recording, but the New York courts have interpreted it as requiring recordation within a reasonable time. *Karst v. Gane*, 136 N.Y. 316, 32 N.E. 1073 (1893).

⁷ The *Constance* case was reluctantly followed in *Conti v. Volper*, 229 F. 2d 317 (2d Cir. 1956). It was rejected as unsound in *In re Billings*, 170 F. Supp. 253 (W. D. Mo. 1959) and *In re American Textile Printers Co.*, 1952 F. Supp. 901 (D.C. N.J. 1957).

lenders and bankruptcy authorities for three basic reasons. First, as the court points out in the *Lewis* case, the history of the various versions of Section 70(c) from 1910 down to 1952 when it was cast in its present form indicates one consistent theory, i.e., that the rights of creditors—whether they are existing or hypothetical—to which the trustee succeeds are to be ascertained as of “the date of bankruptcy,” not at an anterior point of time. The predecessor of Section 70(c) was Section 47(a)(2) of the 1910 Act,⁸ which was enacted to correct the decision of *York Manufacturing Co. v. Cassell*,⁹ in which the Supreme Court held that the trustee merely acquired the rights of the bankrupt himself, and therefore could not attack an unfiled conditional sales contract which was valid between the parties. Congress, therefore, gave him the rights of a creditor holding a lien by legal or equitable proceedings upon all property in the custody of the bankruptcy court. Then in *Bailey v. Baker Ice Machine Co.*,¹⁰ the trustee sought to exercise this lien to set aside a conditional sales contract, which by Kansas statute was void as against creditors obtaining a lien upon the property prior to recording. The contract was filed prior to the petition in bankruptcy, however, and the court for the first time held that the trustee’s lien arises as of that date, without any relation back to the period when the contract was not perfected. This decision was codified in the amendment of 1938 by the Chandler Act,¹¹ and has remained in the subsequent amendments of 1950 and 1952,¹² which extended the trustee’s lien to property not in the possession of the bankruptcy court, but in which the bankrupt may have an interest, or may have ostensible ownership. In addition, there were certain changes in phraseology, but the crucial “date of bankruptcy” has remained the point at which the validity of the transaction may be tested under this section of the Act.

Secondly, the purpose of the strong-arm clause is to enable the trustee to set aside secret or otherwise unperfected liens and transfers for the benefit of all the bankrupt’s creditors. In cases where there has been a delay in perfecting the transaction, but no creditor has been injured thereby, the court in the *Lewis* case points out that the position advanced by the trustee would

... enrich unsecured creditors at the expense of secured creditors, creating a windfall merely by reason of the happenstance of bankruptcy. . . . Congress in striking a balance between secured and unsecured creditors has provided for specific periods of repose beyond which transactions of the bankrupt prior to bankruptcy may no longer be upset—except and unless existing creditors can set them aside. Yet if we construe §70(c) as petitioner

⁸ Act of June 25, 1910, §8, 36 Stat. 838.

⁹ 201 U.S. 344 (1906).

¹⁰ 239 U.S. 268 (1915).

¹¹ 52 Stat. 881 (1938).

¹² 64 Stat. 26 (1950), 66 Stat. 430, 11 U.S.C. §110(c) (1952).

does, there would be no period of repose. Security transactions entered into in good faith years before the bankruptcy could be upset if the trustee were ingenious enough to conjure up a hypothetical situation in which a hypothetical creditor might have had such a right. . . .

That is too great a wrench for us to give the bankruptcy system, absent a plain indication from Congress which is lacking here.¹³

Since the priority of the trustee's lien is determined by reference to applicable state law, the result in the *Lewis* decision will be felt most strongly in the minority of states which allow general creditors to attack unperfected security transactions.¹⁴ As a number of writers have pointed out, the rights of a lien creditor naturally encompass the lesser rights of a general unsecured creditor. But to prevent the anomalous result of permitting the trustee to assume greater rights as a general creditor than he would have as a lien creditor, the hypothetical extension of credit and the general levy of legal or equitable process must both occur at the date of bankruptcy.¹⁵

Finally, the *Lewis* decision maintains the proper distinction between Section 70(c), in which the trustee's rights are not dependent upon the existence of an actual creditor, and the derivative rights of the trustee under Section 70(e),¹⁶ by which the trustee may avoid any transfer made or suffered by the bankrupt which an existing creditor having a provable claim in bankruptcy could have avoided under any State or Federal law. The latter Section had been rendered superfluous under the *Constance* theory of Section 70(c), since he was able to "relate back" his status without stepping into the shoes of an existing creditor.

The *Lewis* decision thus represents a significant step forward in achieving the goal of the Bankruptcy Act, in distributing the bankrupt's estate in a manner that will be most equitable to all concerned.

JAMES ARTHUR KERN

¹³ *Supra* note 1, at 609, 610.

¹⁴ See Note, 57 MICH. L. REV. 1227, 1231 (1959) at footnote 16 in which 11 states are listed as having statutes designed to protect general as well as lien creditors against unperfected security transactions of the debtor. In most states, including Wisconsin, such transactions are subject to attack only by a creditor levying attachment or execution. 4 MOORE, COLLIER ON BANKRUPTCY §70.51, at 1424-34 (14th ed. 1959).

¹⁵ See Weintraub, Levin & Beldock, *The Strong-Arm Clause Strikes the Belated Chattel Mortgage*, 25 FORDHAM L. REV. 261 (1956); Marsh, *Constance v. Harvey—The Strong-Arm Clause Re-evaluated*, 43 CALIF. L. REV. 65 (1955); Seligson, *Creditor's Rights*, 31 REF. J. 113, 118 (1957); MacLachlan, *Two Wrongs Make a Right*, 37 TEXAS L. REV. 676 (1959).

¹⁶ 52 Stat. 881 (1938), 11 U.S.C. §110(e) (1952). This is the only section in which the trustee's rights are derivative. Under §60, 64 Stat. 25 (1950), 11 U.S.C. §96 (1952), he may recover certain preferential transfers made by the bankrupt within 4 months of bankruptcy; under §67(a), 66 Stat. 427 (1952), 11 U.S.C. §107(a) (1952), he may invalidate judicial liens obtained against the bankrupt within 4 months of bankruptcy; under §67(a), 66 Stat. 427 (1952), 11 U.S.C. §107(d) (1952) he may set aside other types of fraudulent conveyances made within one year.