Marquette Law Review

Volume 9
Issue 2 *February 1925*

Article 2

Preferences Withing the Meaning of the National Bankruptcy Act

Reginald I. Kenney

PREFERENCES WITHIN THE MEANING OF THE NATIONAL BANKRUPTCY ACT

REGINALD I. KENNEY*

THIS article relates to preferences within the purview of the National Bankruptcy Act and does not attempt to include a discussion of preferences under state insolvency laws except to call attention to the fact that there is a provision in the Wisconsin statutes rendering preferences void under certain circumstances.[1]

At common law there was no inhibition against the preference of one creditor over others by an insolvent debtor, the theory of the law being that "the race was with the diligent." Commercial development, however, required the adoption of a more equitable rule of distribution of the insolvent's estate among his creditors and hence the common law was modified by statute, and the present provisions of the National Bankruptcy Act relating to preferences are an outgrowth and development of such theory of equitable distribution.

The National Bankruptcy Act of 1867, Section 35; U. S. Revised Statutes, Section 5128, prohibited preferences, but the wording of the preference statutes of the Act of 1876 is so entirely different from the provisions of the Act of 1898 that authorities construing the provisions of the Act of 1867 relating to preferences should be carefully scrutinized. The present National Bankruptcy Act went into effect July 1, 1898, and we find therein four provisions dealing with preferences. The first two sections, *3a–2* and *3a–3*, deal with preferences as an act of bankruptcy; the third section, *57g*, relates to the rights of a creditor to file a claim against the estate of the bankrupt where such creditor has been the recipient of a preference, and the fourth section, *60*, defines what a preference is, prescribes the penalties as to the creditor receiving it and names the courts in which suit may be brought. These several sections of the Bankruptcy Act deserve separate consideration.

PREFERENCES AS ACTS OF BANKRUPTCY

The two provisions of the act relating to preferences as a ground for filing of an involuntary petition in bankruptcy against a debtor are as follows:

Sec. 3. *Acts of Bankruptcy.*

(a) Acts of bankruptcy by a person shall consist of his having . . .

* Member of Milwaukee Bar.

[1] See *Section 128.08, Revised Statutes of Wisconsin.*

(3) suffered or permitted, while insolvent, any creditor to obtain a preference through legal proceedings, and not having at least five days before a sale or final disposition of any property affected by such preference vacated or discharged such preference. . . .

(a) Scope and Meaning of Section 3a–2

(2) transferred, while insolvent, any portion of his property to one or more of his creditors *with intent to prefer* such creditors over his other creditors: or

It will be noted that under Section 3a–2 quoted above, that there must be (1) a transfer by the debtor while insolvent (2) of any portion of his property (3) to one or more of his creditors (4) with intent to prefer such creditor or creditors over other creditors. There is no preference within the meaning of this section if the debtor does not make a transfer of property. Hence, if a creditor converts property of the debtor or if such creditor receives such property impressed with a trust and retains such property in violation of the trust, there is no transfer.[2] There must likewise be a transfer to a creditor. If the debtor while insolvent transfers property to one other than a creditor then the transfer may be avoided under other sections of the Bankruptcy Act relating to transfers in fraud of the Act.[3]

The word "insolvent" has a well defined meaning. The test of insolvency is not the ability or inability to pay or discharge his debts, but whether the assets of the debtor at a fair valuation in a going business are less than the liabilities.[4] The same definition has been given to the word "insolvent" within the meaning of the Wisconsin Insolvency Laws by *Sec. 128.09 Revised Statutes of 1923*. The inability to pay bills as they mature in the ordinary course of business is an important circumstance to consider in determining whether the debtor is insolvent or not.[5]

The "transfer" meant by the act must be one which depletes the estate which would otherwise be available to unsecured creditors. Hence, the payment of a secured debt does not constitute a preference where the security returned to the debtor by the creditor is equal in value to the amount of the debt.[6]

The question of intent on the part of the debtor under Section 3a–2 is of great consequence. That it is the debtor's intent and not the credi-

[2] *Western Tie and Timber Co. v. Brown*, 196 U. S., 502.

[3] See Sec. 67e and 70e.

[4] *In re Andrews, Circuit Court of Appeals*, C. C. A. 1, 144 Fed., 992.
Carson Pirie Scott v. Chicago T. and T. Co., 182 U. S. 438.

[5] See *Martin v. Hulen, C. C. A. 8;* 149 Fed., 982.

[6] *Clark v. Iselin, 21 Wall.* U. S. 360; 22 Le. ED.

tor's intent is material under this section. Under Section 60, hereinafter discussed, the intent of the creditor is of importance and the intent of the debtor is of no consequence. The burden of proving the "intent to prefer" is upon the person who alleges it. But such intent does not have to be established by direct evidence and in fact, in most cases it is impossible to establish it except by circumstantial evidence, because it is an almost impossible case where one is able to find a debtor who is willing to admit that he had an intent to prefer one creditor at the expense of the others,[7] and experience demonstrates that in most cases of preference, the debtor has as a rule some very good reason for creating such preference and will most generally defend his conduct. Payments made in the usual and ordinary course of business, however, even if they result in an inequality among creditors, will not of themselves be sufficient to establish an intent to prefer if the debtor in fact believes that he is solvent,[8] but as the law contemplates that every man is deemed to be aware of the natural and probable consequences of his acts, the intent to prefer will be established where payments are made out of the ordinary course of business, are unusual in amount, or have some unusual circumstances in connection with them, provided such payments produced the inequality which the act condemns.[9]

As a practical matter, the best way of establishing that there was no intent to prefer is to show that the payments or transfers made were handled in the usual and ordinary course of business and hence, it follows that very strong evidence of such intent is given by the doing of an act which is contrary to the usual course of business, for instance, where a debtor gives a mortgage on all of his property, consisting of chattels, with a provision in the mortgage that the mortgagee might possess himself of such property and make a sale thereof at any time that such creditor felt himself unsecure.[10]

While the section under consideration does not provide that such preference must be accomplished within four months of the bankruptcy, nevertheless the authorities have so construed the section and in view of the provision of Section 60 of the act, which will hereinafter be discussed, such construction is inherently sound.[11]

(b) Scope and Meaning of Section 3a–3

To constitute an act of bankruptcy within the meaning of this section, the debtor must have suffered or permitted a creditor to obtain a prefer-

[7] See dissenting opinion in *Stuart v. Farmer's Bank*, 137 Wis. 66, at page 77.
[8] *Goodlander R. L. Co. v. Atwood C. C. A. 4;* 152 Fed., 978.
[9] *Macon Grocery Co. v. Beach*, 156 Fed., 1009.
[10] *Jackman v. Bank of Eau Claire*, 125 Wis., 465.
[11] See *Colliers*, page 90.

ence over other creditors through *legal proceedings,* and such proceedings include any proceeding in any court, whether legal or equitable, whereby the property of a debtor is seized and diverted from the claims of his general creditors,[12] and include attachment, garnishment, receivership and supplementary proceedings and liens obtained by execution. The *result* and not the intent is material under this section,[13] and includes passive action on the part of the debtor as well as active.[14]

It is not the levy of attachment lien, but the failure on the part of the debtor to have the same vacated or discharged before a sale or final disposition of the property which constitutes the act of bankruptcy.[15] Therefore, the right accrues five days before the sale of the property if the levy is not lifted,[16] so that in the cases where a lien is obtained on the debtor's property *pendente lite,* as in attachment and garnishment proceedings, etc., subject to the entry of judgment in favor of the creditor against the debtor, a right to file an involuntary petition in bankruptcy against the debtor is obtained if the debtor fails within four months after the attaching of the lien, to discharge the same or to file a voluntary petition in bankruptcy, because the lien dates not from the date of the judgment but from the time of the levy.

Voidable Preferences

Section 60 of the Bankruptcy Act is as follows:

(a) A person shall be deemed to have given a preference if, being insolvent, he has, within four months before the filing of the petition, or after the filing of the petition and before the adjudication, procured or suffered a judgment to be entered against himself in favor of any person, or made a transfer of any of his property, and the effect of the enforcement of such judgment or transfer will be to enable any one of his creditors to obtain a greater percentage of his debt than any other of such creditors of the same class. Where the preference consists in a transfer, such period of four months shall not expire until four months after the date of the recording or registering of the transfer, if by law such recording or registering is required.

(b) If a bankrupt shall have procured or suffered a judgment to be entered against him in favor of any person or have made a transfer of any of his property, and if, at the time of the transfer, or of the entry of the judgment, or of the recording or registering of the transfer if by law, recording or registering thereof is required, and being within four months before the filing of the petition in bankruptcy or after the filing thereof and before the adjudication, the bankrupt be insolvent and the judgment or transfer then operate as

[12] *In re Rome Planing Mills,* 3 A. B. R., 123; 96 Fed. 812.
[13] *Bradley Timber Co. v. White,* C. C. A. 5, 121 Fed. 779.
[14] *Bogen, et al, v. Protter,* C. C. A. 6; 129 Fed. 533.
[15] *Matter of Rung Furniture Co.,* C. C. A. 2; 135 Fed. 526.
[16] *In Re National Hotel and Cafe Co.,* 138 Fed., 947.

a preference, and the person receiving it or to be benefited thereby, or his agent acting therein, shall then have reasonable cause to believe that the enforcement of such judgment or transfer would effect a preference, it shall be voidable by the trustee and he may recover the property or its value from such person. And for the purpose of such recovery, any court of bankruptcy, as hereinbefore defined, and any state court which would have had jurisdiction if bankruptcy had not intervened, shall have concurrent jurisdiction.

(c) If a creditor has been preferred, and afterwards in good faith gives the debtor further credit without security of any kind for property which becomes a part of the debtor's estates, the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy may be set off against the amount which would otherwise be recoverable from him.

Elements of a Preference

There is no preference within the meaning of Section 60 unless (1) it be accomplished within four months of the filing of the petition (2) by a debtor who is actually insolvent in that his liabilities must exceed the fair value of his assets as a going concern, or (3) a debtor procure or suffer a judgment to be entered against him in favor of any person or have made a transfer of his property (4) and the effect of the enforcement of such judgment or transfer will be to enable such judgment creditor or transferee to obtain a greater percentage of his debt than other creditors of the same class, (5) under such circumstances that such creditor shall then have reasonable cause to believe that the enforcement of such judgment or transfer would effect a preference.

(a) Time as an Element of a Preference

The transfer must be made or the judgment suffered or procured within four months prior to the filing of the petition in bankruptcy against the debtor. The period ordinarily begins to run from the moment the judgment or transfer takes effect as a lien,[17] but if recording or filing of the instrument is required by the local law, the transfer takes effect from the date of such filing or recording.

The significance of this provision of the act is appreciated in considering the cases in which the state law required the filing of mortgages.

Where a transfer, either of real or personal property, is required to be filed in order to be valid only as against innocent purchasers for value without notice, the failure to file or record such instrument does not present any question of preference even if the instrument is filed within the four months period, because the Supreme Court of the United States has held in *Carey v. Donohue,* 240 U. S., 430, that the

[17] *Sawyer v. Turpin,* 91 U. S., 114.

phrase "recorded or filed" meant such filing or recording as was necessary under the state law to render the transfer valid as to *unsecured creditors,* and that hence, where the local law required the instrument to be filed in order to be valid as to all parties other than those to the transfer, the filing of such instrument within four months of the bankruptcy, unless for a present consideration, constitutes a preference, providing all of the other elements are present. For example, if more than four months prior to the filing of a petition in bankruptcy, a debtor incurs a liability to a creditor and in consideration of his indebtedness to such creditor and as a part of the same transaction gives a chattel mortgage to such transferee as security for the payment of such debt and if the law requires the mortgage to be filed in order to be valid as to creditors represented by the trustee, the failure of the transferee to file the chattel mortgage until within the four months' period brings such transfer within the scope of Section 60.[18]

In re Antigo Screen Door Co., 123 Fed., 249, C. C. A. 7 seems to support the theory that where the mortgaged lien can be made valid by the transfer of possession and that "filing" is not "required," and hence, it would follow that where the mortgage is validated by the transfer of possession, even though within the four months' period, there is no preference. The correctness of this doctrine is extremely doubtful and it is safer to err on the side of caution and to see to the proper filing of the chattel mortgage so as to obviate all question of preference claims as well as the equally serious claims of fraudulent withholding from record of a mortgage, which withholding, if established to be fraudulent, may likewise deprive the transferee of his security.[19]

A transfer is made within four months of the bankruptcy within the meaning of the act even if given pursuant to a promise or agreement made prior to the four months' period, the theory being that up to the time of the transfer the creditor had no interest in any property of the debtor and that upon such transfer the estate for the benefit of general creditors is depleted.[20]

It is important to distinguish between an agreement to give security and the actual transfering of such security. This question is raised frequently in respect to transfers of choses-in-action, accounts receivable and book accounts, and the rule may be stated thus: There must be a present transfer of title or of a lien for a valuable consideration of the debtor's interest in the account or in the choses-in-action, which need not be in writing nor need any express words be used, but the intention

[18] *Martin v. Bank,* 245 U. S. 513.
Brigman v. Covington, 219 Fed., 500, C. C. A. 4.
[19] *Rogers v. Page,* C. C. A. 6; 140 Fed., 596.
[20] *In re Great Western Mfg. Co.,* C. C. A. 8; 152 Fed. 123.

to declare or deliver a present interest must be clear and the debtor's right of control or retention of the choses-in-action or a right to receive the proceeds thereof must be completely surrendered, and even if at the time the debt is created, there be a promise to give, the giving thereof results in a preference if there is any interval of time between the creation of the debt and the transfer of security.[21]

Another instance of materiality of time is found in the case of payment made by check. The time of the presentment of the check to the bank for payment and not the time of giving of the check determines whether there is a preferential transfer, especially under statutes such as 118.60 Wis. Statutes, where the giving of a check does not constitute an assignment of the debtor's interest in the funds.[22]

(b) The Debtor Must Be Actually Insolvent

The same rule applies respecting the determination of the meaning of insolvency as used in Section 60, as we found was the rule under Section 3a–2.

(c) There Must Be a Transfer of Property

Anything of value which the debtor gives to a creditor in payment of a debt or as security, therefor including money, is property within the meaning of the preference statute,

(*Goetz v. Zeif,* note), but the transfer must be voluntary on the part of the debtor, (*Western T. and T. Co. v. Brown,* note).

(d) The Estate Must Be Depleted

There is no preference unless there are creditors of the debtor who are prejudiced thereby, and they are not prejudiced unless the estate in which they might share has been depleted, and the share that they might receive from the debtor's estate decreased; in other words, if the debtor made a settlement with all of his unsecured creditors at a certain percentage on the dollar, there is no preference because each one shares ratably. By "creditors of the same class" is meant substantially the same classification of creditors as are entitled to priority of payment under the National Bankruptcy Act.[23]

The section last named designates the order in which the debts of the bankrupt shall be paid.

What is meant by the phrase "equality among creditors of the same class" can well be demonstrated by an example as follows: If the debtor

[21] *Goetz v. Zeif,* 181 Wis., 628.

[22] *Goetz v. Zeif, supra. In re Wolf and Levy Co.,* D. C. Tenn.; 122 Fed., 127.

[23] *Colliers,* 895. *Swarts v. First National Bank,* 117 Fed. 1, C. C. A. 8. Section 64 of the Bankruptcy Act.

pays taxes due to the United States and to the state government, a wage earner cannot claim that there has been a preference thereby for the reason that wages are subordinate to the payment of the taxes. (See Section 64–A.) Likewise unsecured creditors cannot complain of the payment of wages by the debtor providing the amount paid is not in excess of the statutory limit of three hundred dollars because such wages are entitled to priority of payment out of the assets of the estate over unsecured creditors. Section 64–B.) So likewise, the payment of a debt which has been previously secured does not create a preference if the security which comes back to the estate is equal to the amount of the payment, nor where securities of property of equal value are exchanged for new securities. *Sawyer v. Turpin,* note.

All unsecured creditors are in the same class, and secured creditors are in the same class with unsecured creditors to the extent that the debt exceeds the value of the security.[24]

Among other creditors who may be the recipients of a preference are endorsers or sureties who procure the payment of the note or debt with reasonable knowledge or cause to believe that such payment will result in a preference,[25]

As stated before, only creditors may be preferred and the rights of persons other than creditors receiving property from the Bankrupt are determined by other provisions of the Bankruptcy Act, notably Section 67-e and 70-e.

(e) The Creditor Must Have Reasonable Cause to Believe that the Enforcement of the Transfer or Judgment Will Effect a Preference

This means that the creditor must have reasonable cause to believe that the debtor is insolvent and that the transfer results in the giving to him of a larger share of his debt than he would otherwise receive.

The burden of proving that the creditor has reasonable cause to believe that the debtor is insolvent is of course upon the Trustee.[26] Actual knowledge of the debtor's insolvency is not necessary, but there must be proof of such facts from which a reasonably prudent man would draw such conclusion.[27]

This test likewise excludes mere suspicion on the part of the creditor,[28] but in examining this element of a preference there are many

[24] Remington, Sec. 1387.

[25] See *Colliers,* page 899. *Reber v. Schulman,* 25 A. B. R., 475; 183 Fed., 564; C. C. A. 3.

[26] *Clifford v. Morrill,* 230 Fed., 190.

[27] *Hussey v. Richardson, et al, Dry Goods Co.,* C. C. A. 8; 148 Fed., 598.

[28] *Off v. Hakes,* 142 Fed., 364; C. C. A. 7.

facts and circumstances other than those which might be acquired by direct statement of the debtor to the creditor, or by the examination of the debtor's books, which may have a bearing: such as facts showing the relation of the parties, their intimacy, the usual or unusual nature of the transfer, the opportunity of the creditor for knowledge, the participation of the creditor, if any, in the business of the debtor, the fairness or unfairness of the transferee as to the disclosure of relevant facts within his knowledge and the character of the transfer as to whether it constitutes a large or a small portion of the debtor's estate, and the conduct of the parties in respect thereto.[29]

Some of the federal courts have held that where the transferee is put in possession of facts sufficient to put a reasonably prudent man upon inquiry, the transferee is chargeable with the discovery of such facts as reasonable investigation would disclose.[30]

The Supreme Court of Wisconsin in the case of *Stuart v. Farmer's Bank,* 137 Wis., 66, refused to adopt the rule of the federal courts referred to in the last paragraph, but it is extremely doubtful whether our court in view of its recent decision in the case of (*Goetz v. Zeif,* note,) would follow the Stuart case if it were to consider the same question again.

There are other facts which may be considered in arriving at the creditor's knowledge, including the debtor's known reputation for honesty or lack of it, his indulgence in practices condemned by good morals such as forgery and falsification of books, which if brought to the attention of the creditors have a material bearing, at least so far as the creditors' right to rely upon the debtor's statements.[31]

(f) The Trustee's Recovery

The Act provides, Section 60–B, as to a preferential transfer that,

It shall be voidable by the Trustee and he may recover the property or its value from such person.

It would seem that the election to recover either the property or its value rests with the trustee but this does not necessarily follow. Where the property has been transferred by the debtor to the transferee in payment of a debt, then the trustee may recover the value of the property transferred,[32] but such is not the case where property has been transferred by the debtor merely as security for the payment of a debt.[33]

---

[29] *Goetz v. Zeif, supra.*

[30] *In re Eggert,* 102 Fed., 735; C. C. A. 7. *Chicago Car Equipment Co.,* 211 Fed., 638; C. C. A. 7. *In re States Printing Co.,* 238 Fed., 775; C. C. A. 7.

[31] *Watchmaker v. Barnes,* 259 Fed., 783, C. C. A. 1.

[32] *Stearns Salt and Lbr. Co. v. Hammond,* C. C. A. 6; 217 Fed., 559.

[33] *American Exchange Bank v. Goetz,* C. C. A. 7; 283 Fed., 900.

In the latter situation the trustee can only recover the property. The trustee must take some affirmative act to avoid a preference either by demand or the commencement of a suit, which is the equivalent of a demand.[34]

If there is a shrinkage in the value of goods delivered as security from and after the time of the demand, it is probable that the courts will hold the transferee liable for the difference between the value at the time of the demand, and the value at the time of the judgment. This matter has been before the Supreme Court of the United States but was not decided.[35]

(g) Courts in Which Suits May Be Brought

Suits to recover preferences may be brought in any state court having jurisdiction of the person of the defendant or any court of bankruptcy.

Where the interposition of a court of equity is necessary to avoid a transfer, such as a deed of real estate or mortgage, or for an accounting, it would seem the case would properly be brought on the equity side of the court; but where the relief is merely for money damages, an action at law is proper. This distinction is of importance only in courts maintaining the distinction between practice in equity and at law, as in the United States Court. It has been held, however, in the case of *Off v. Hakes,* 142 Fed., 364; C. C. A. 7, that even if the recovery is for money only, suit may be brought on the equity side.

(h) New Credits

Under Section 60–c a creditor who has received a recoverable preference but who gives a new credit (1) in good faith (2) without security and (3) resulting in property which becomes a part of the debtor's estate, may offset so much of the new credit as remains unpaid at the time of the bankruptcy against the amount of the preference received and the creditor need not show that the property was a part of the debtor's estate at the time of the bankruptcy.[36]

CLAIMS OF CREDITORS WHO HAVE RECEIVED A PREFERENCE

Section 57–g of the Bankruptcy Act is as follows:

The claims of creditors who *have received preferences voidable* under section sixty, subdivision (b), or to whom conveyances, transfers, assignments, or incumbrances, void or voidable under section sixty-seven, subdivision e, have been made or given, shall not be allowed unless such creditors shall surrender such preferences, conveyances, transfers, assignments, or incumbrances.

[34] *American Exchange Bank supra; Kaufman v. Tredway,* 195 U. S. 271.
[35] *Hotchkiss v. National City Bank,* 231 U. S. 50.
[36] *Kaufman v. Tredway supra.*

Under this provision of the law, a creditor who has received a preference may not receive a dividend upon any claim until the preference is surrendered.

The preference within the meaning of this section is identically the same as that referred to in Section 60-b. The burden is likewise upon the trustee to prove that a preference has been accomplished, and when the preference has been surrendered, even as a result of legal proceedings, the claim may be filed and allowed by the bankruptcy court even after the expiration of the year limited in which to file claims.[37]

The court held in the last named case that a creditor might file his claim even though the time in which to file claims against the estate had expired, where such creditor was obliged by a proceeding in equity to surrender the preference. It is extending the rule to great lengths to permit such a situation and it is doubtful whether the rule will be extended any further than to cases in equity brought for the recovery of preferences in the same courts in which the bankruptcy proceedings are pending, and the transferee's claims set forth in his pleadings before the expiration of the year.

The law of preference is generally misunderstood by business men, who erroneously suppose that there is no preference unless they have actual knowledge of the insolvency of the debtor, and very frequently the attorney who seeks to defend an alleged preference is led into error by the assurance of his client that he did not know of the insolvency of the debtor, but the attorney should carefully examine all of the attendant and surrounding facts and circumstances connected with the transaction and should then seek to determine whether a reasonably prudent man would have had reasonable cause to believe that the debtor was insolvent. If he will do this he will more clearly and more closely approximate the true legal status of the matter and may save himself considerable embarrassment at the trial where it will undoubtedly be revealed that his client had possession of many facts, no one perhaps in itself sufficient to charge him with knowledge, but when all are pieced together may justify a finding that a reasonable prudent man would have believed the debtor insolvent, and that the creditor was receiving a larger share of his debt than other creditors of the same class.

[37] *Keppel v. Tiffen Savings Bank*, 197 U. S. 362. *Page v. Rogers*, 211 U. S. 575. *American Exchange Bank v. Goetz, supra.*