Preferences Under the Bankruptcy Act

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PREFERENCES UNDER THE BANKRUPTCY ACT

One of the main objects of all bankruptcy legislation is the equal distribution of the assets of an insolvent debtor among his creditors. Experience has shown that the application of the statutes of the various forty-eight States affecting the administration of an insolvent debtor's property has led to many abuses, resulting in rewarding the diligent creditor, satisfying the unscrupulous one, and depriving the just ones from sharing in their debtor's estate.

The enactment by Congress in 1898 of the Bankruptcy Act now in force has tended to wipe out these abuses and, when vigorously enforced, accomplishes an equitable and equal distribution of an insolvent debtor's assets among his just creditors. It is obvious, therefore, that the moment an insolvent debtor has preferred one of his creditors above his other creditors, that then it ought to be possible for bankruptcy proceedings to be instituted, in order that the preferred creditor may restore to the bankrupt's estate that with which he has been preferred, to the end that there may finally be an equal distribution of all of his assets among his creditors.

The present Bankruptcy Act contains adequate provisions to accomplish this purpose. First, it provides for the intervention of bankruptcy proceedings where preferences have been made, and, secondly, it provides for the recovery of the preferences in bankruptcy proceedings after they have been made.


Section 3 provides for five acts which constitute cause for the institution of proceedings in bankruptcy. Two of them, acts 2 and 3, relate to preferences.

Act 2 provides:

"Acts of bankruptcy by a person shall consist of his having

(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."

This contemplates an active preference by the debtor.
Subdivision b of Section 3 provides in part:

"A petition may be filed against a person who is insolvent and who has committed an act of bankruptcy within four months after the commission of such act."

The following elements are therefore necessary in order that a preference may justify the institution of bankruptcy proceedings: (1) A transfer of property, (2) Insolvency, (3) Intent to prefer, and (4) the institution of bankruptcy proceedings within four months after the date of the transfer.

The words "transfer of property" are to be liberally construed. "Property" includes money. Any act by the debtor in connection with his property resulting in a depletion of his estate constitutes a transfer of property. It excludes a transfer of property in exchange for a surrender of securities of equal amount, for in that case the debtor's estate remains of equal value.

The test of insolvency is to be found in Section 1 (15), where insolvency is defined as follows:

"A person shall be deemed insolvent within the provisions of this act wherever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed or 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."

Mere inability of the debtor to meet his obligations as they mature does not render him insolvent, if his assets, taken at a fair valuation, equal his debts.

The transfer of property must be accompanied by the intent to prefer. The intent contemplated here is intent on the part of the debtor, and not intent on the part of the person receiving the transfer of property. Proof of this intent is very often to be implied from the actual result of the transaction. Knowledge by the debtor of insolvency is not essential, but is very often the best proof of an intent to prefer. Indeed, it raises almost a conclusive presumption.

The pendency of legal proceedings against the debtor, the result of which will affect his property, is substantial proof of an

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3Clark v. Icelin, 21 Wall. 360, 22 L. Ed. 568.
intent to prefer, where the transfer of property is made shortly before the termination of the legal proceedings.

The intent of the creditor to whom the preferential transfer is made is not material. He may accept the transfer in good faith, with no knowledge that the debtor is insolvent, yet, if at the time of the transfer the debtor was in fact insolvent and intended by the transfer of that property to prefer that creditor, then an act of bankruptcy has been committed.

In order that a preferential transfer of property may be a ground for the filing of a petition in bankruptcy, the petition must be filed within four months after the date of the transfer. In making the computation, the day of filing is excluded, and the last day included. If the last day is Sunday or a holiday, the time does not expire until the next day. If in order to make the transfer of property valid under a statute of the State where the transfer is made, a recording or registering of the transfer is required or permitted, the four months do not begin to run until the date of the recording or registering. If no recording or registering is necessary the four months begin to run from the day that the creditor took notorious, exclusive or continuous possession of the transferred property, unless the creditors filing the petition have received actual notice of such transfer or assignment, in which event the four months period begins to run from the time of such notice.

The burden of proving all of these elements rests upon the creditors instituting the bankruptcy proceedings, except that where the debtor denies insolvency it becomes his duty to appear in court on the hearing, with his books, papers and accounts, and submit to an examination and give testimony as to all matters relating to the issue of insolvency, and if he fails to so attend and submit to examination the creditors are relieved from proving insolvency, and the burden of proving solvency rests upon the debtor.

A preferential transfer under these circumstances implies neither fraud nor moral turpitude. As pointed out, the state of mind of the creditor receiving the preferential transfer is wholly immaterial. The intent on the part of the debtor must be only to prefer, and involves neither fraud nor bad faith. He may make the preferential transfer while insolvent in the hope that his financial condition will improve and that he will become sol-

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4 In re Dupree, 97 Fed. 28.
5 Dutcher v. Wright, 94 U. S. 533.
vent; yet, if he makes it while insolvent, with intent to prefer, he has committed an act of bankruptcy making him amenable to the Bankruptcy Act, provided the proceedings in bankruptcy are instituted within four months after the date of the transfer.

Act three of the acts of bankruptcy set forth in Section 3 provides:

"Acts of bankruptcy by a person shall consist of his having *

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."

In order to accomplish this preference, the debtor may remain entirely passive. No act on his part is required. Preference as here used is merely a resultant inequality between creditors of the same class. If a debtor is insolvent, and a creditor is, through legal proceedings, in a position to sell the debtor's property and satisfy his debt, it is obvious that inequality among creditors must result, and that it becomes the function of the Bankruptcy Act to intervene and prevent the preference. It is now well-settled that in the commission of this act of bankruptcy, intent, either on the part of the debtor or the creditor, is not an element.⁶

If a judgment has been entered against an insolvent debtor, execution issued and levy made, and the sale of his property is five or less days away, and the debtor has done nothing to have the levy discharged and the sale stopped, then the debtor has committed an act of bankruptcy, and a petition in bankruptcy may be filed against him within the four months' period. It is immaterial as to whether the debtor procured the judgment to be entered and the levy to be made, or a day for the sale to be fixed. Nor is knowledge by the judgment creditor of insolvency necessary. It is of no consequence as to whether the debtor resisted the judgment by a defense or whether he defaulted. If he does not resist the sale within five days before the date of the same, the act of bankruptcy is complete.

Five days before the sale means five days before the day set for the sale.⁷ This construction is made necessary in order that

⁷In re Meyers, 1 Am. B. R. 1.
the bankruptcy proceedings may intervene before the sale, and, through the enforcement of its provisions, the sale stopped. The debtor has all of the fifth day prior to the sale or disposition of it to vacate or discharge the levy and sale. Until some day is definitely fixed for the sale, the time for the commission of this act of bankruptcy does not commence to run.

The legal proceedings whereby the preference is obtained refer to any proceeding or action in a court of law whereby relief in any form against a debtor is sought. They do not include, however, legal proceedings instituted by a lienor to enforce a statutory lien, or by a landlord to distrain for rent; for, in these instances, the creditor instituting the legal proceeding is the only one entitled to the remedy, and the enforcement by him thereof will not give him an advantage or preference over other creditors not having the same remedy. Mere entry of judgment is not sufficient; nor will a levy thereunder suffice. It is necessary that a date be set for the sale or final disposition of the property, and that the debtor shall have done nothing within five days before that date to stop the sale by vacating or discharging the levy. This act of bankruptcy, whereby a creditor obtains a preference through a legal proceeding, likewise does not involve either fraud or moral turpitude.

Both of the acts of bankruptcy discussed aim merely at an opportunity for the intervention of the provisions of the Bankruptcy Act, in order to provide for an equal distribution of the debtor's property among his creditors. A preference has but three elements:— (a) insolvency; (b) the making of a transfer of property by the bankrupt, or suffering by him of a judgment against him; (c) a consequent inequality between creditors of the same class.

The discussion has so far been limited to preferences as acts of bankruptcy. It is not to be concluded, however, that all preferences are voidable under the Bankruptcy Act. The extent to which they are voidable will now be discussed.

2. Preferences Voidable in Bankruptcy.

If it were not for the Bankruptcy Act, preferential transfers, as distinguished from fraudulent transfers, would not, except in cases of transfers made by corporations, be recoverable. Left to the statutes of the various states, preferential transfers could almost invariably be retained by the creditors as the reward of
their diligence. It is only because of the Bankruptcy Act that preferential transfers are under any circumstances recoverable from the preferred creditors, the proceeds brought into the bankrupt estate and distributed equally among all of his creditors.

Again, under the Bankruptcy Act a preferential transfer is not void. It is only voidable, and affirmative action on the part of the trustee of the bankrupt's estate is required to make it void.

Section 60a of the Bankruptcy Act defines a preference 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 petition and before the adjudication, procured or suffered a judgment to be entered against himself in favor of any person, or made a preference of any of his property, and the effect of an enforcement of such judgment or transfer will be to enable any 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 of 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."

It is to be observed that Section 60a is merely explanatory, gives no remedy and does not provide the circumstances under which the preference may be recovered.

Section 60b provides:

"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 judgment or 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 adjudication, the bankrupt is insolvent, and the judgment or transfer operate as 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."
Section 60b prescribes what preferences are voidable and recoverable by the trustee, as well as the forum in which they may be recovered. Reading sections 60a and 60b together, we see that a trustee may recover a preferential transfer of property from a creditor if (1) a preferential transfer was made within four months before the filing of the petition in bankruptcy or after the filing thereof and before adjudication; if (2) the bankrupt was insolvent at the time that the preference was obtained; and if (3) the person receiving the preference or benefited thereby or his agent acting therein had reasonable cause to believe that a preference was affected.

There is therefore a wide distinction between a preference constituting an act of bankruptcy and a preference recoverable from a creditor by a trustee. A preference to constitute an act of bankruptcy must involve as an element the state of mind of the bankrupt—there must be an intent on the part of the bankrupt to prefer. The state of mind of the preferred creditor, as pointed out, is immaterial. A preference, to be recoverable by a trustee, however, involves the state of mind of the preferred creditor—there must be on his part reasonable cause to believe that a preference was effected.

The preference here discussed includes both the transfer of property and the sufferance of a judgment.

The date of the filing of the original petition in bankruptcy is the period from which the four months is to be counted; an amendment to the petition does not extend the time. The method of computing the time is similar to that for computing the time of preferences as acts of bankruptcy. The method adopted to transfer the property is immaterial; if it resulted in a depletion of the bankrupt’s property then there has been a transfer of property. Property includes money. It is of no consequence that the transfer was made in good faith. If it was made within the prescribed period and resulted in a depletion of the assets, and if the person receiving the transfer, or the person benefited thereby or his agent had reasonable cause to believe that a preference was intended, then it is recoverable at the instance of the trustee.

Payment of an antecedent debt within the four months period is recoverable by the trustee, if the bankrupt was at the time of the payment insolvent and if the creditor had reasonable cause to believe that he was thereby obtaining a preference.
Specific intent on the part of the bankrupt to give a preference is not essential. What is essential is that the creditor shall have had reasonable cause to believe that a preference was effected. Of course, it would be difficult to prove that the creditor had reasonable cause to believe that a preference was intended unless there was some evidence that the bankrupt intended to make the preference. Intent on the part of the bankrupt is therefore necessary only as evidence of a reasonable cause to believe on the part of the creditor that a preference was effected.

A transfer may be made to a third person, but if a creditor is thereby benefited there is a preference.

Insolvency at the time of the giving of the preference is an essential element; but proof of knowledge thereof, either on the part of the bankrupt or the creditor, is not necessary. However, there must be proof that the creditor had reasonable cause to believe that a preference was intended, and since insolvency is an element of the preference it becomes necessary as a practical matter very often, in order to show that the creditor had reasonable cause to believe that a preference was intended to prove that the creditor had knowledge of insolvency. It is for this reason that as a matter of evidence it also becomes necessary to prove intent to prefer on the part of the bankrupt.

Whether or not a creditor had reasonable cause to believe that a preference was effected is a question of fact, to be determined, like all other questions of fact, by a jury. The circumstances under which a transfer of property was made, the method by which the transfer was made, as well as proof that the creditor had been pressing the bankrupt for money and that the payment was made under pressure, will determine whether the creditor had reasonable cause to believe that he intended a preference.

Though actual knowledge that a preference was intended is not necessary, yet mere guess or suspicion is insufficient. The requirement is that the surrounding circumstances should be such as would lead an ordinary prudent business man to conclude that a preference was intended. The sale or transfer of an entire stock of goods, or the circumstance that the creditor receiving the transfer was a relative of the bankrupt will very often lead to a finding that the creditor had reasonable cause to believe that

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a preference was intended. Likewise the payment of a debt not due is a probative circumstance. Reasonable cause to believe that a preference was intended, on the part of an agent representing a creditor and receiving the payment will be imputed to the creditor.

When all these elements exist the preference may be recovered from the creditor; but the right to recover belongs to the trustee exclusively, because it is a right created by the Bankruptcy Act and inures to the trustee as the representative of all creditors, to be enjoyed by them equally.

Prior to 1903 suits by trustees to avoid preferences could be brought only in the State Courts, but by an amendment in that year such suits may be brought either in the State Courts or in the Federal District Court.

The right of the trustee to recover a preference rests upon the quasi-contractual obligation of the creditor to return the preference to the trustee, and courts having jurisdiction to try cases on contracts implied by law have jurisdiction of such actions. The Municipal Court of the City of New York has jurisdiction of an action by a trustee to recover a preference. The trustee may recover either the property or its value, and a recovery should include interest from the date of the preference.

Where a creditor, after receiving a voidable preference, has in good faith given the debtor further credit without security, he is permitted, under section 60c, to set off the amount of his credit against the amount recoverable from him, provided the new credit has become a part of the debtor's estate. It is not necessary that the new credit shall be a part of the bankrupt's assets at the time that the bankruptcy proceedings are instituted.

Transfers of property made by a bankrupt to his attorney for services to be rendered will be re-examined by the court on the application of the trustee, to determine the reasonable amount of his compensation. The excess will be regarded as a preference recoverable by the trustee.

Section 67f contains a drastic provision for the avoidance of preferences. It declares that all levies, judgments, attachments or other liens obtained through legal proceedings against a person who is insolvent, within four months prior to the filing of a petition in bankruptcy against him, are null and void, and that property affected by the lien is discharged and released. If necessary for an equal distribution of the assets, the trustee is subrogated to the lien and permitted to enforce it on behalf
of all of the creditors. The trustee, however, must institute appropriate proceedings to avail himself of the rights given to him by section 67f.

Thus we see that the Bankruptcy Act of 1898, as amended, embodies a comprehensive scheme for the avoidance of preferences, in order that an administration of an insolvent’s estate in bankruptcy may result in an equal distribution of his assets among creditors of the same class. The benefits which creditors have obtained from the operation of the Bankruptcy Act are not to be judged alone by the specific instances in which a vigorous enforcement of its provisions has resulted in the restoration to bankrupts’ estates of property preferentially transferred to creditors, but also by the deterring influence which the drastic provisions of the Bankruptcy Act have had upon creditors who otherwise would have taken advantage over their fellow-creditors.

Though the present Bankruptcy Act has been effective, it is by no means perfect. But the readiness with which Congress has yielded to the demands of business men and of lawyers for amendments to the Act, made necessary by the teachings of experience, has inspired both the business man and the practitioner with the belief and hope that in time we may expect a model act, which will accomplish what all just creditors want, namely, an equal distribution of their insolvent debtor’s property among all his creditors.

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