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# Assignments of Accounts Receivable as Preferences in Bankruptcy

## I

### INTRODUCTION

In connection with the so-called Chandler Act Amendments of 1938 in bankruptcy, the section defining a preference was the subject of substantial change.<sup>1</sup> The effect has been to place the law in doubt and confusion.

The matter is particularly important to a bank since its practice of lending on accounts receivable may have been transformed, in some jurisdictions, from what was formerly a fairly well secured loan to a somewhat capricious one to be protected only by higher interest rates and carrying charges in order that the losses of one account may be made up by the profits on others. This follows out of the wording of Section 60 that a preference is a transfer of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt made or suffered by the debtor while insolvent and within four months before the filing by or against him of the petition in bankruptcy, and especially out of the wording that a transfer shall be deemed to have been made at the time when it became so far perfected that no bona fide purchaser from the debtor and no creditor could thereafter have acquired any right in the property so transferred superior to the right of the transferee therein, further, that if such transfer is not so perfected prior to the filing of the petition in bankruptcy, it shall be deemed to have been made immediately before bankruptcy.<sup>2</sup> In other words, there is risk, depending in some measure on applicable state law, of the lending bank finding what it thought to be a valid security invalidated as a preference at the suit of a subsequently appointed bankruptcy trustee of the borrower with the result that the lender shares in the liquidation of its debtor only along with the general unsecured creditors.<sup>3</sup>

Whether the loan was "perfected" within four months of the bankruptcy petition, or outside the magic four months period preceding bank-

<sup>1</sup>52 STAT. 869, 870 (1938), 11 U.S.C.A. §96 (a) and (b).

<sup>2</sup>52 STAT. 869 (1938), 11 U.S.C.A. §96 (a).

<sup>3</sup>52 STAT. 870 (1938), 11 U.S.C.A. §96 (b).

ruptcy becomes the ultimate question and this depends primarily on whether the pledgee's position is secure as against bona fide purchasers or creditors under the applicable state law. The assignment may have been made outside the four months period; it will still be vulnerable to attack if perfected within four months of the bankruptcy petition.

There are three rules. Some American jurisdictions apply the English rule which found interpretation in the leading case of *Dearle v. Hall*, decided in 1828.<sup>4</sup> The English court reasoned that there can be no delivery of a chose in action, and that in lieu thereof, the assignee must give notice to the debtor of the assignment to him, and that if a second assignee notifies the debtor first, the second assignee is preferred to the first assignee.

Section 60 of the Chandler Act states in effect that a transfer of an interest is not complete until neither a subsequent creditor nor a subsequent bona fide purchaser can acquire a better right than the right of the original assignee. So, applying the English rule, as it exists in many of our states today, to our present bankruptcy law, we find that a bank, to make a loan on accounts receivable of a local business house, would have to notify each of the account debtors to protect itself from a subsequent claimant's giving notice and gaining priority.

During the course of the nineteenth century, various American state courts developed a rule of their own, the so-called American rule, in respect to the assignment of accounts. It was originally a minority rule adhered to by only seven states—Kentucky, Massachusetts, Minnesota, New York, Oregon, Texas and West Virginia.<sup>5</sup> However, in 1924, *Salem Trust Co. v. Manufacturers Finance Company* was decided by the Supreme Court of the United States, changing the rule of the federal courts from the English rule to the American rule.<sup>6</sup> The court made two rulings as to assignments of accounts receivable:

1. "There is no decision of this court which sustains the contention that as between successive assignees of the same chose in action, mere priority of notice gives priority of right. It seems to us that the better reasons are against such a rule. By the first assignment, the rights of the assignor pass to the assignee. The creditor has a right to dispose of his own property as he chooses, and to require the debt to be paid as he directs, without the assent of the debtor."

<sup>4</sup>Appeal in *Dearle v. Hall* (1827), 3 Russ. 47, 38 English Reports (Chancery) 492.

<sup>5</sup>Annotation 31 A.L.R. 879 (1924); 110 A.L.R. 774 (1937).

<sup>6</sup>*Salem Trust Co. v. Mfrs. Finance Co.* (C.C.A. Mass. 1924) 280 F. 803, 260 U. S. 714, 43 S. Ct. 89, 67 L. Ed. 477; rev 264 U. S. 182, 44 S. Ct. 266, 68 L. Ed. 628, 31 A.L.R. 867.

2. "We hold that mere priority of notice to the debtor by a second assignee, who lent his money to the assignor without making any inquiry of the debtor, is not sufficient to subordinate the first assignment to the second."

This was the beginning of the trend away from the English rule, and the result is that today the English rule is the minority rule in the United States.<sup>7</sup>

Unfortunately, the question arose under the American rule as to what would happen if the debtor paid the second assignee instead of the first assignee. To be sure, the debtor would be protected by such payment in good faith, but a split of authority developed over the right to the proceeds of payment. The Massachusetts rule developed that if the debtor paid the second assignee, the second assignee could keep the payment.<sup>8</sup> This is the rule of Section 173 (b) (i) of the Restatement of Contracts.<sup>9</sup> The New York rule, on the other hand, as developed in the New York courts, was to the effect that, even though the debtor paid the second assignee in good faith, the first assignee had a good cause of action against the second assignee to recover the amount.<sup>10</sup>

Applying these two rules, could a bank safely loan money on accounts receivable? Under the Massachusetts rule, it could not. Under such a rule, a second assignee could, under the provision of Section 60, cut off the interest of the first assignee; but, under the New York rule, the bank could make a safe loan because, even though a second assignee were to intervene and be paid by the debtor, the first assignee would have a good cause of action against the second assignee to recover the payment the second assignee had received on the account.

Until 1938, there was a feeling that the federal courts were not obliged to follow state law as to the validity of assignments of accounts receivable, since this was held to be "general law," but in that year Judge Story's one hundred year old decision in *Swift v. Tyson* was reversed by *Erie R. Co. v. Tompkins*, which held that the federal courts must follow the applicable state law in the state in which the court was sitting.<sup>11</sup> The

<sup>7</sup>REPORT OF SPECIAL COMMITTEE ON UNIFORM ACT ON ASSIGNMENT OF ACCOUNTS RECEIVABLE BY NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS (1944), p. 5; Koessler, *Assignments of Accounts Receivable* 33 CALIF. L. REV. 40 (1945).

<sup>8</sup>*Rabinowitz v. People's National Bank* (1920) 235 Mass. 102, 126 N.E. 289.

<sup>9</sup>RESTATEMENT, CONTRACTS, §173.

<sup>10</sup>*Superior Brassier Co. v. Zimetbaum* (1925) 214 App. Div. 525, 212 N. Y. Supp. 473.

<sup>11</sup>*Erie R. Co. v. Tompkins* (1938) 304 U. S. 64, 82 L. Ed. 1188, 58 S. Ct. 817, 114 A.L.R. 1487.

effect of this decision on Section 60 is to place within the jurisdiction of the forty-eight states the power to determine whether there has been a completed transfer so that no subsequent interested party can establish a valid prior claim to the assigned property.

## II

### DECISIONS UNDER SECTION SIXTY OF THE CHANDLER ACT AMENDMENT IN BANKRUPTCY

Leading decisions since the Chandler Act Amendment of 1938 follow. The most important case appealed to the U. S. Supreme Court was decided in 1943, *Corn Exchange National Bank v. Klauer*.<sup>12</sup> The trustee in bankruptcy was allowed to recover an assignment because of the Pennsylvania law which, following the English rule, allowed a second assignee, by prior notification of the debtor, to gain priority over the first assignee, because, as the court interpreted Section 60, it meant as we saw in the English case of *Dearle v. Hall*, that assignments are intangible choses in action and, since they can not be delivered in the ordinary sense, they can best be reduced to possession by notification to the debtor, and the first assignee to do so completes the transfer in his favor.

Thereafter, the *Vardaman Shoe Company* case was decided in the Missouri Federal District Court in 1943.<sup>13</sup> The court held that even where state law did not require an assignee of accounts to give notice thereof so as to defeat a subsequent good faith assignee, if such a subsequent assignee could improve his position by acts such as payment or satisfaction of the obligor's duty, or the obtaining of a judgment against the obligor, or the securing of a new contract by means of novation, or the delivery of a tangible token or writing, surrender of which is required by the obligor's contract for its enforcement, then the transfer of an assignment was not "perfected" within the meaning of Section 60 since the trustee is put in the shoes of a hypothetical subsequent assignee by that section. Thus, we have the Massachusetts rule and the so-called "four horsemen" of the Contracts Restatement.<sup>14</sup>

However, *In re Rosen et al.*, a New Jersey case decided in 1946, the court found that the assignment of book accounts was bona fide and fully consummated when executed, since in New Jersey an assignment of accounts is valid without notice and a subsequent bona fide assignee

<sup>12</sup>(1943) 318 U. S. 434, 63 S. Ct. 679, 87 L. Ed. 884, 144 A.L.R. 1189.

<sup>13</sup>*In re Vardaman Shoe Co.* (Dist. Ct., E.D. Mo. 1943) 52 F. Supp. 562.

<sup>14</sup>RESTATEMENT, CONTRACTS §173.

would take nothing.<sup>15</sup> New Jersey was following the New York version of the American rule, and therefore the assignments were valid as against the trustee. The court points out in the next to the last paragraph of its opinion that in the *Corn Exchange Bank* case emphasis is placed on the intent of Congress to discourage secret transfers and not to strike down the law protecting prior assignees in non-notification jurisdictions. The opinion clearly indicates that the "standards" to be applied must be found in the "applicable state law."

On June 13, 1947, the district court in New Jersey was again heard from in *In re Nizolek Furniture & Carpet Co., Inc.*<sup>16</sup> The court upheld the assignment of accounts receivable against the claim of the trustee, stating that the trustee to establish a preference under Section 60 would have to prove a transfer:

1. To benefit the creditor particularly;
2. That it was for an antecedent debt;
3. That it was made by the assignor while insolvent;
4. Within four months of bankruptcy;
5. That its effect would be to give the assignee more than his share of the assets; and

that in order to recover under Section 60, the trustee would have to prove that the creditor receiving the preference had at the time of the transfer reasonable cause to believe the debtor to be insolvent. Thus, an assignment requiring no notice under state law was perfected when the loan was first made, was then for contemporaneous consideration rather than for an antecedent debt, and the fact that a hypothetical subsequent bona fide assignee could prevail by obtaining a judgment was not material for purposes of "perfection" under Section 60.

In *Adams v. City National Bank & Trust Co. of Macon*,<sup>17</sup> the court emphasizing that a transfer must be "for or on account of an antecedent debt," said,

"This refers to the whole transaction, and not simply to the step to be taken to make it binding as to subsequent creditors and purchasers for a valuable consideration."

Thus, we see the source of difficulty for the lending bank. Partly, it lies in differing views as to "perfection" of the assignment, some courts

<sup>15</sup>*In re Rosen* (D. N.J. 1946) 66 F. Supp. 174.

<sup>16</sup>71 F. Supp. 1012.

<sup>17</sup>(1940) 115 F. (2) 453; Certiorari denied 312 U. S. 699.

holding it perfected when the contract is made and so a loan for contemporaneous consideration at that time, others holding it perfected by something done at a later date within four months of bankruptcy and that it is then a transfer for an antecedent debt. But mainly, the difficulty lies in the states pursuing the English rule calling for notification of the debtor of the assignment in order to complete the transfer; also, in states pursuing the Massachusetts rule, theoretically a second assignee could gain a better right than a bank as first assignee if the debtor should perchance in good faith make payment to the second assignee.

The New York version of the American rule seemingly gives adequate protection to the lending bank. This is because of the ability of the first assignee to recover from the second assignee any payments the debtor may make to him. As will be recalled, the New York rule and the Massachusetts rule are the two branches of the American rule that first in time is first in right—no notification being necessary. However, under the Chandler Act, unless notification is given by the bank of its assignment, the security of an assignment of accounts receivable would be safe only in those jurisdictions using the New York version of the American rule.

### III

#### THE MONTANA RULE

In *General Electric Co. v. Black*,<sup>18</sup> the plaintiff claimed under an 1894 assignment; the defendant answered a previous 1890 assignment by its creditor and that the defendant had subsequently paid the first assignee. Holding for the defendant, the court said:

“This plaintiff company which claims the account was assigned to it in 1894, long after its assignor had parted with its title to the account, acquired no title therein by its alleged assignment.”

This is an adoption of the American rule that the first assignment controls, but whether the New York or Massachusetts version thereof is Montana law is not clear from the Montana authority.

### IV

#### REACTION OF STATES TO INTERPRETATION OF SECTION SIXTY

It would seem that the Congress has gone too far in the language of Section 60. While a major purpose was to strike at secret liens, the

<sup>18</sup>(1897) 19 Mont. 110, 47 P. 639.

effect has been a high degree of uncertainty and confusion, and no doubt considerable hesitation by lenders in making loans of undoubted validity.

To obviate these decisions invalidating the security, the states could require actual delivery of the assigned accounts to the pledgee bank, but this is not desired. The lending finance company may not have a collection department. If it must go into the work of collecting on the assigned accounts, it must increase the charges to the borrower. The assignor will not wish his customers to know he is in a weak financial condition. Perhaps, they could not rely on him to carry out their contracts with him. The assignor's idea is that the less notorious the transaction the less chance of the borrower's competitors taking advantage of it. Delivery is therefore impractical. Four types of statutes are, however, being enacted in the states. They are:

1. Non-notification statutes (New York rule) making the assignment valid at date of its creation with no notice of any kind required. This is sometimes called a validating statute.
2. Recording or filing of the assignment.
3. Book-marking—marking the accounts receivable in the book-keeping system of the borrower so that a subsequent assignee or creditor would see that they had been assigned.
4. A combination allowing book-marking, filing or giving notice to the debtor.

To avoid conflicting laws and to meet the demand for action to protect the interest of the banks making loans on accounts receivable, a majority of the Committee of the National Conference of Commissioners on Uniform State Laws prepared a draft uniform law to be adopted by the states.<sup>19</sup> A study of this proposed statute indicates that this law is a suggested version of the New York rule. The property interest in the assignment becomes fixed at the date of the assignment; no notice of any kind is required; no recording is necessary; the debtor is protected from being obliged to make double payments; and the prior assignee has a superior claim to all subsequent assignees. In addition, the Commissioners on Uniform State Laws gave five reasons for using the American rule in the Uniform Act:

1. Recording destroys fluidity of credit;
2. No reason to record assignment of accounts receivable and not bonds, notes, etc.;

<sup>19</sup>REPORT OF SPECIAL COMMITTEE ON UNIFORM ACT ON ASSIGNMENT OF ACCOUNTS RECEIVABLE, (1944) p. 11 (Exhibit 1).



3. Recording statutes are not acceptable to many states;
4. Right of privacy invaded unduly by requiring recording of assignments; and
5. A greater likelihood of uniformity.<sup>20</sup>

A minority of the Committee drafted an alternative which allowed filing of notice of assignments to be optional.<sup>21</sup> This suggested law differed from that of the majority of the Committee in that while recording was not necessary; still, if an assignee did record, he immediately gained a prior right.

Since the report of the National Conference of Commissioners on Uniform State Laws in 1944, twenty-two states have enacted laws to protect the interest of the assignee in accounts receivable. These laws are not uniform, though many incorporate with variations the principles of the Uniform Act. Probably most interesting is the adoption in 1945 of the New York rule by Massachusetts, which is indicative of the swing away from the Massachusetts Act.<sup>22</sup> This act is modeled after the proposed Uniform Act.

An examination of the recent legislation will show that, while the Uniform Act has had its effect, the effect has not been uniform. Some of the legislation was passed prior to the proposed Uniform Act; and also, even where it was apparent that the legislature was obviously impressed with the Uniform Act, it has modified it in various respects.

As a sole remedial procedure, this will probably not be adequate. It takes many years to obtain acquiescence of all jurisdictions in a uniform law. For example, the Negotiable Instruments Law, which is the only uniform law to be adopted in fifty-three jurisdictions of the United States, was first promulgated in 1896.<sup>23</sup> It was adopted by the last of the fifty-three jurisdictions thirty-four years later in Puerto Rico.<sup>24</sup>

Of the other uniform acts, the Uniform Warehouse Receipts Act, created in 1906, was adopted in fifty-one of the various jurisdictions by 1944, with South Carolina being the only state not adopting it;<sup>25</sup> but,

<sup>20</sup>REPORT OF SPECIAL COMMITTEE ON UNIFORM ACT ON ASSIGNMENT OF ACCOUNTS RECEIVABLE (1944), p. 7.

<sup>21</sup>REPORT OF SPECIAL COMMITTEE ON UNIFORM ACT ON ASSIGNMENT OF ACCOUNTS RECEIVABLE (1944), p. 15 (Exhibit 2).

<sup>22</sup>Ch. 107a, §§1-6 ANNOTATED LAWS OF MASS. (1946).

<sup>23</sup>HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSION ON UNIFORM STATE LAWS AND PROCEEDINGS (1944), pp. 340-341.

<sup>24</sup>UNIFORM LAWS ANNOTATED, NEGOTIABLE INSTRUMENTS, Part 1, p. XIII, Table III.

on the other hand, the Uniform Statute of Limitations Act of 1939 has absolutely no adopters.<sup>26</sup>

The reasons for the Uniform Accounts Receivable Act are that:

1. It would make the law uniform in all the states;
2. It would seem to be more in accord with the existing line of thought for handling combined federal-state legal situations; that is, the federal courts will follow the state law where it exists.<sup>27</sup> This would be applicable where bankruptcy law would be applied, the assignment's completion being determined by state law;
3. It would seem to be more in the province of the states to regulate assignments, and have the assignments so determined that the law applying to them would not have one effect generally and another effect when the bankruptcy law is applied;
4. Also, it would provide a base for common treatment of this and other security devices by amendment of the National Bankruptcy Act, since the present Bankruptcy Act makes questionable conveyances under the Uniform Trust Receipts Act, the Uniform Fraudulent Conveyance Act, Conditional Sales for Resale, Factoring Agreements, and Blanket Chattel Mortgages.

The Uniform Fraudulent Conveyance Act provides in part that every conveyance by an insolvent without fair consideration is fraudulent and that a creditor may have the conveyance set aside as to all but a bona fide purchaser.<sup>28</sup> In other words, if the assignment has not by some kind of notice or statute become fixed in the assignee, it can be set aside. Again the Uniform Trust Receipts Act provides that a trust receipt without filing is good against all creditors for thirty days after delivery of the goods or the papers to the trustee, but a bona fide purchaser will be protected.<sup>29</sup> Suppose the Bankruptcy Act of today is brought to bear on such a situation. Theoretically, a bona fide purchaser could acquire a right superior to the right of the security transferee, and so the thirty day non-filing period could place the assignee in a very unfortunate position as to a trust receipt.

<sup>26</sup>See note 23, *supra*.

<sup>26</sup>See note 23, *supra*,

<sup>27</sup>*Erie R. Co. v. Tompkins* (1938) 304 U. S. 64, 82 L. Ed. 1188, 58 S. Ct. 817.

<sup>28</sup>Ch. 126, §§1-14, LAWS OF MONTANA 1945 (Uniform Fraudulent Conveyance Act).

<sup>29</sup>Ch. 147, §§1-19, LAWS OF MONTANA 1945 (Uniform Trust Receipts Act).

## V

SUGGESTED AMENDMENT TO THE BANKRUPTCY LAW  
ADVOCATED BY THE AMERICAN BAR ASSOCIATION

Since uniform laws will probably not prove an effective sole remedial procedure, we turn to amendment of the bankruptcy statute. The American Bar Association has advocated an amendment along the following lines.<sup>30</sup> In its proposal, Paragraph 1 remains as in Section 60a of the Chandler Act Amendment of 1938. Paragraph 2 is changed so that the fixing of the interest in the assignment is to be determined by regard for whether or not an ordinary lien creditor can later acquire a better right than the pledgee, rather than by regarding this from the standpoint of the bona fide purchaser. For the potential bona fide purchaser test is to be substituted the potential creditor test.

Thus, we eliminate the criticism directed at the so-called "bona fide purchaser" test—some writers saying that the effect of 60a was to place the trustee in bankruptcy in the place of a bona fide purchaser, which he obviously was not. It is to be noted that "property" and "real property" are distinguished in this section. The effect of this is to place the assignment of real property interests in another category to be determined by the old bona fide purchaser rule. Moreover, the old troublesome clause, ". . . and, if such transfer is not so perfected prior to filing of the petition in bankruptcy . . ., it shall be deemed to have been made immediately before bankruptcy," is left out. Paragraph 3 of the proposed act specifically sets forth that the assignment for good consideration will be considered made at the time of transfer; thus, the assignment is perfected and no subsequent creditor could acquire a superior interest. This supports the New York rule that a prior assignee has a better right than a second assignee, whether notice is given or not. Paragraph 3 Part 1 also takes care of the present conflict raised by the thirty-day non-filing period allowed by the Uniform Trust Receipts Act. Under this Part 1, the transfer, if perfected in the thirty-day period, is considered to have been perfected at the time of transfer.

Thus, this further amendment of the Bankruptcy Act seems to be the more immediately feasible approach to eliminating the difficulty raised by Section 60 of the Chandler Act. While it will not make the perfection of accounts receivable uniform in all jurisdictions, it will establish the perfection necessary to avoid the assignments being set aside in case of bankruptcy, and the banks may govern themselves accordingly.

<sup>30</sup>H.R. 2412, 80TH CONGRESS, 1ST SESSION (1947).

Questions may yet remain. Some have criticized the proposed American Bar Association Amendment because it may go too far in allowing the return of the secret equitable lien of the sort upheld in *Sexton v. Kessler*.<sup>31</sup> It has been proposed that there be inserted in Subsection 2 of the bill a proviso reading:

"For the purposes of this section, such a creditor shall be deemed to have an interest superior to that of any equitable lienor."<sup>32</sup>

A second criticism relates to that part which ties bankruptcy preferences to state law, and the question is asked:

"Is the constitutional mandate that Congress has power to pass a uniform act on the subject of bankruptcy met when bankruptcy preferences are tested by forty-eight varying and at times inconsistent laws? And so it has been proposed that subsection 2 be amended by adding at the end thereof the following proviso: 'provided, further, that for the purposes of this section, applicable law shall be construed to mean the statutes of a state and the common law of a state providing such common law accords with general law'.<sup>33</sup>

This would be a return to *Swift v. Tyson* in the preference section of the Bankruptcy Act.

The matter is before Congress, and it is believed that a change from the hypothetical bona fide purchaser rule to the hypothetical creditor rule would prove beneficial in determining preferences in bankruptcy.

The better way undoubtedly would be to have a Uniform State Law as to Assignments of Accounts Receivable, modeled on and compatible with the proposed amendment in bankruptcy. This would be in line with the work being done by the Commissioners on Uniform State Laws on a Uniform Commercial Code. It would simplify the matter and avoid confusion between the two laws where state law may apply to non-bankruptcy liquidation of a debtor up to a certain point followed thereafter by liquidation in bankruptcy. It is also believed that the result should be similar whether a debtor is liquidated under non-bankruptcy state law or under the Federal Bankruptcy Act. Debtors often have property in different jurisdictions and make assignments across state lines; uniform operation of liquidation law is therefore highly desirable.

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<sup>31</sup>(1912) 225 U. S. 90, 32 S. Ct. 657.

<sup>32</sup>Keefe, Kelly Jr., & Lewis, *Sick Sixty*, 33 CORNELL L.Q. 99 (1947).

<sup>33</sup>See note 32, *supra*,