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The Status of Unrecorded Liens in Bankruptcy

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THE STATUS OF UNRECORDED LIENS IN BANKRUPTCY.

One of the questions which frequently occurs in the present rising tide of bankruptcy cases is that of the relation of state recording statutes to the bankruptcy law. The point more frequently arises with reference to personal property and the rights of the holder of a chattel mortgage or conditional sale contract under any of the multiple forms which such instruments modernly take.

Under Section 70 of the Law of 1898 the title to all property (substantially speaking) of the bankrupt passes to the trustee. In addition to this the trustee acquires any rights which could have been exercised by a general creditor had bankruptcy not intervened, and to that category the right of jection to the validity of mortgages and liens asserted against any of the property of the bankrupt estate is referable. This right of subrogation, or, it might even more frankly be called *appropriation*, has application to liens which are void under any state law in the same degree as it does to liens which are voided by the bankruptcy law itself. Very soon after the passage of the bankruptcy law the courts began to experience difficulty in the application of these fundamental principles. Of course, there is a clear right, and the trustee is possessed of the undoubted standing to enforce this right, where the facts of the case satisfy the conditions of a voidable preference under the bankruptcy law. But where the position of the trustee is dependent upon the authority of a state statute of fraudulent conveyances or a recording or registering statute, passed for the benefit of creditors, there arises at once a procedural difficulty of great perplexity. In many of the States a distinction is made in the statute law between *prior* and *subsequent* creditors, and in others some form of distinction or favoritism is indulged along this line in the decided

cases even where the statute is general in terms. The courts have generally been disposed to recognize the superior equity of creditors who have actually been deceived by the appearance of ownership of property held in possession by their debtor and upon the faith and credit of which they have placed their trust. There is a natural sympathy for this class of creditors reflected in the policy of the law in many jurisdictions in which creditors not so circumstanced do not share. The trustee who is the representative of general creditors would be called upon in such case to function for the benefit of all creditors by seizing upon the rights of this favored class and administering it for the partial benefit of another class which of itself had no right. This manifest contradiction has led to much confusion in thinking. In some of the States, as in Missouri, an unrecorded chattel mortgage or conditional contract of sale is void at the instance of creditors, but in order to raise the question, which resolves itself into one of priority of liens, the creditor must have levied his attachment or execution upon the affected property before the recordation of the instrument. In such cases the question became quite acute as to the quality of the trustee's title and standing where the debtor went into bankruptcy with an unrecorded lien upon his property and no process levied by any creditor. In nearly every case the holder of the lien records it immediately upon hearing of his debtor's financial debility. Some times the recordation is effected just prior, and, in many instances, just subsequent, to bankruptcy. The difficulty is obviated and all procedural rules satisfied where a levy is existing at the time of bankruptcy, for in such case the trustee merely takes over the levy, which has, because of the bankruptcy, become abortive in the hands of the creditor, and under authority of Section 67 prosecutes it for the benefit of the estate.

But in instances where no attachment or levy has been made prior to bankruptcy, the extent of the right and quality of title of the trustee was a constantly recurring issue and one which was decided differently in different jurisdictions.

Much of this difficulty and inharmony of decision was relieved by the Amendment of 1910 by which the status of a creditor having a lien levied was arbitrarily given to the trustee. (Sec. 47, Bankruptcy Act Amendment 1910.) It was largely taken for granted by the bar of the country that it was the intention of Congress by its amendment to give this status to the trustee during the four months prior to bankruptcy, which was the period of limitation fixed by Sections 60 and 67, although the Act was silent upon this phase, and under this theory of construction the position of the trustee as against the holders of secret and unrecorded liens was greatly strengthened. The Supreme Court of the United States decided in due time, however, that the new status of trustees in bankruptcy related only to the date of bankruptcy and not to the four months' period preceding.[1]

It is not of infrequent occurrence that a creditors' meeting may be called or by some other form of notice the creditors become aware that bankruptcy of their debtor is a possibility, and it so happens that those creditors who are holding liens which through negligence or for other reasons have been withheld from record, are thus reminded and in a spirit of last chance activity rush their liens to record. Within a few days perhaps bankruptcy ensues and the question at once becomes acute as to whether the recordation of the lien before bankruptcy removes the defect which undoubtedly would have proven fatal after bankruptcy.

The statute of Missouri makes no difference in classes of creditors in dealing with the subject of the recordation of chattel mortgages, but makes them void where unrecorded, as to everybody. The earlier cases in the courts of appeal of Missouri hold, however, that before the issue can be raised by creditors, a lien must have been levied by some creditor before the mortgage was recorded. Otherwise the recording of the mortgage validated it before the question of its validity had

1. Bailey v. Baker Ice Mach. Co., 239 U. S. 268.

been challenged by any proceeding in court. Subsequently, however, a policy and principle grew up in the decisions of the courts of appeal in Missouri, whereby this rule of procedure was relaxed as to subsequent creditors, for the reason that they having extended their credit upon faith of the apparent ownership and title to the property in question, have secured a right grounded in equity which is superior to that of prior creditors and which enables such special class of creditors to oppose the validity of a mortgage, notwithstanding the fact that it had been recorded before such creditor instituted any proceeding or levied any lien. This principle seems to be the settled policy of the law of Missouri and will scarcely admit of question at this time.

In the case of Stewart v. Asbury,[2] Judge Farrington, speaking for the Springfield Court of Appeals, lays this down as the undoubted doctrine of the courts of appeal of this State. After a more than usually thorough consideration of the authorities upon the subject, he has used this language:

"It has long been the law of this State that a creditor who extends his credit to his debtor at a time when there is a chattel mortgage or conditional contract creating a secret lien on property in the hands of the debtor ostensibly his, cannot be defeated by the mortgagee or vendor taking possession thereof under the mortgage or conditional contract, or filing the same for record."

If, therefore, the creditors of an estate were all *subsequent* creditors, there would be no question but that the trustee who accedes to their rights would be enabled to successfully contend that a secret lien even where it was recorded prior to bankruptcy, was void under the law of the State of Missouri.

It was held in the case of Martin v. Commercial Nat'l. Bank,[3] that the trustee must hold the position of some creditors

2. 199 Mo. App., l. c. 126.
3. 245 U. S. 513 (40 A. B. R. 765).

who would have been in position themselves to actually challenge the transfer, and in the leading case of Carey v. Donohue,[4] that the trustee must be in the position of some person for whose benefit the state law of registration and recordation of mortgages was enacted, before he could secure the operation of the state law for the benefit of an estate in bankruptcy. In the latter case the statute of Ohio there drawn in question, was made for the benefit of subsequent purchasers, which is a class of persons having no interest in a bankruptcy case and not represented by the trustee. The decision in the Carey case harmonized much confusion existing in the decisions of various circuits and yet it would seem that this confusion after all was traceable to the divergent phraseology of the State statutes under consideration rather than to any wide difference in principle. It is true that the Eighth Circuit, and probably one or two others, had made the character of the instrument the test as to whether it was *required* to be recorded or not, without regard to the persons in whose favor such requirement was imposed. To this extent, the Supreme Court in the Carey case has modified the opinion in the First National Bank v. Connett,[5] and in the Mattley v. Giesler,[6] cases, but not in other respects.

Of course, if the trustee can enforce only such rights as creditors could themselves enforce if bankruptcy had not occurred, then the trustee is limited in cases where a tardy recordation has taken place, to the enforcement of the rights of *subsequent* creditors alone. This was the procedure followed in Missouri, and it naturally follows, for their benefit alone. This was the procedure followed in re Bothe,[7] which went up from the Eastern Division of the Eastern District of Missouri in which the trustee was allowed to enforce the rights of subsequent creditors, for the benefit of subsequent creditors, to the

4. 240 U. S. 430.
5. 142 Fed. 33.
6. 187 Fed. 970.
7. 173 Fed. 597.

exclusion of others, and the fund affected was ordered distributed among a particular class composed of subsequent creditors and the lien claimant. General creditors were excluded from participation.

Since the decision of the In re Bothe case, and since the decision of the case of Carey v. Donohue above referred to, the question has again been adverted to, and the proposition here under consideration has received further illumination from a decision written by Judge Hook in this, the Eighth Circuit, in the case of Bunch v. Maloney.[8] Judge Hook was one of the judges who assented to the decision in the Bothe case in 1909, and his decision in a case involving the same question, in 1916, marks the progress of his thinking and the development of the law in the meantime. In deciding that the distinction between prior and subsequent creditors in state practice is a mere rule of procedure which need not be followed in bankruptcy, he uses the following language:

"The reasonable conclusion is that, where the applicable registry statute provides generally that an unfiled or unrecorded transfer shall be void as to 'creditors', or employs words of similar import, as in Arkansas, the trustee in bankruptcy, as the representative of general creditors, may invoke the remedy of Section 60b, regardless of the local construction of the statute making a procedural distinction between creditors with a lien and those without."

This language appeals to us as reasonable. Should one or more of the *prior* creditors levy an attachment or execution prior to the recordation of the mortgages whose validity is disputed, but within the four months before bankruptcy, such creditor could not himself pursue his advantage because his lien would, under Section 67, be void. In such case, however, the trustee would have the right under Section 67b to cause himself to be substituted as party plaintiff and prosecute such lien to final judgment, and having secured a favorable

8. 233 Fed. 967.

judgment sustaining the lien as against the subsequently recorded mortgage, he would take the chattel and administer it *for the benefit of the estate.* Indeed, his right of subrogation and substitution entirely depends upon a statute which permits such right to be exercised only for the benefit of the estate. Now to limit the scope of the representative capacity of the trustee to subsequent creditors alone, would amount to a determination that the title of a trustee to the property of a bankrupt is derived by inheritance or succession of title rather than created, defined and limited by the bankruptcy law. The rights of the trustee do not come by any process of succession or inheritance from the bankrupt or creditors, but are derived from the provisions of the bankruptcy law which create those rights, for the benefit of the estate and general creditors whom he is destined to represent and to serve. No rights are given to the trustee and no title is vested in the trustee by any provision of the bankruptcy law except with this end and aim in view, that the estate, which is distributable to the general unsecured creditors, may be benefited. The right which the recording statute of Missouri created as against unrecorded mortgages, is given to all creditors alike, and no distinction is made between prior and subsequent creditors in respect of this right. It is true that a procedural distinction has grown up in the process of the exercise of this substantive right, which has prevented in many cases prior creditors from exercising the right whereas subsequent creditors were permitted to exercise it. At the door of bankruptcy, however, all procedural questions of purely local derivation should be left behind. The bankruptcy court is the forum; the bankruptcy law provides the procedure, and it remains alone to inquire what rights the trustee has acquired under the State law as well as under the bankruptcy law, in the interest and for the benefit of the bankrupt estate. The decision of Judge Hook, from which we have just quoted, amounts to a construction and application of the Carey v. Donohue opinion and establishes a rule which is compelling in this circuit. The

statute of Arkansas under consideration in that case is not different in principle from the statute of Missouri. This is the feeling that Judge Van Valkenburgh evidently holds about the matter for he said, In re Bennett:[9]

"The subsequent creditor is already armed with all that is necessary for his protection and the trustee is fully empowered to preserve and assert his rights for the benefit, not alone of such subsequent creditors, but through them for the benefit of the entire estate."

And in the concluding paragraph of that decision, he indulges in this expression:

"Of course, it must follow that in accordance with the doctrine announced in L. A. Becker v. Gill,[10] the claim of the petitioner herein must be allowed as a general claim and that the fund involved must be distributed ratably among all creditors of the same class."

The Ninth Circuit has apparently swung into line also upon this proposition, and Judge Hunt, speaking for the Court in a case coming up from California, endorses the doctrine of the Bunch case and applies it to the facts under consideration quite as a matter of course, in the case of Nat'l. Bank v. Moore.[11]

In conclusion, two propositions emerge from the foregoing discussion: First, mortgages in Missouri which are withheld from record beyond a "reasonable" time and not recorded until after bankruptcy, are void at the instance of the trustee; second, such mortgages recorded within four months prior to bankruptcy and during insolvency are void as to the trustee even where no action has been initiated by creditors if it can be shown that any subsequent credit was extended.

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9. 264 Fed. 537.
10. 206 Fed. 36.
11. 247 Fed. 913.