BANKRUPTCY --- PREFERENCE --- AFTER ACQUIRED PROPERTY PROVISIONS OF THE UNIFORM COMMERCIAL CODE HELD NOT IN CONFLICT WITH SECTION 60 (a) OF THE BANKRUPTCY ACT. In re Portland Newspaper Publishing Co., Inc., 271 F. Supp. 395 (D. Ore. 1967)

Portland Publishing Co., Inc., on the petition filed by its creditors, was adjudicated bankrupt by consent on October 19, 1964. Prior to bankruptcy, Portland, in order to obtain necessary capital, had granted a security interest to Rose City Development Co. in accounts receivable "now existing or hereafter arising, except those heretofore assigned." This security interest was perfected in accordance with Article 9 of the Uniform Commercial Code as enacted in Oregon.[1]

The trustee, however, contended superior title to Rose City as to the proceeds of the receivables since substantially all of the uncollected accounts outstanding at the date of the filing of the petition in bankruptcy had come into existence within the four months prior to bankruptcy and at a time when the bankrupt was known to be insolvent. Thus, the trustee reasoned, any security interest claimed by Rose City against the proceeds of such accounts would constitute a voidable preference under Section 60 (a) of the Bankruptcy Act.

On the other hand, Rose City contended that there was only one transfer regardless of invoice dates; that the transfer occurred before the four month period; and that there was therefore no voidable perference. This argument depended on a treatment of the accounts as one unit or floating mass, so that the transfer occurred when the security agreement was executed and the financing statement filed.

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1. ORS 79.1010 et seq.

The referee, agreeing with the trustee, held that the security interest in those accounts which arose within the four months prior to bankruptcy constituted voidable preferences under Section 60 of the Bankruptcy Act and that to the extent that Section 9-108 of the Uniform Commercial Code attempts to validate such a security interest, it is in conflict with the Bankruptcy Act, which must be given pre-eminence.

On petition for review to the Federal District Court, held, reversed. For purposes of Section 60 of the Bankruptcy Act the transfer occurred, not when the debtor acquired rights in each individual account, but when the security agreement was executed.

Undoubtedly, logical arguments can be offered to show a conflict between Article 9 of the Uniform Commercial Code and Section 60 of the Bankruptcy Act. However, the Code, in Section 1-102, states that its underlying purpose is to simplify, clarify and modernize the law governing commercial transactions; to this end its sections should be liberally construed and applied. The Code is to expand and grow with the development of commercial practices and needs, and in the light of unforseen and new circumstances. Such flexibility is dependent upon good business practices; they alone facilitate good business law.

The Bankruptcy Act, on the other hand, was framed in 1898[2], and most completely amended in 1938[3], when the commercial community had yet to evolve into its present highly complex and sophisticated form. The Code, first adopted

2. 30 Stat. 544 (1898)
3. 52 Stat. 840 (1938)

in 1952, was framed by the country's leading businessmen, drafted by outstanding legal scholars, and has been enacted in forty-nine states. This suggests that in areas of apparent conflict, the Code and the Bankruptcy Act should be read and interpreted together, and, if possible, so as to avoid conflict.

The decisive issue in the present case is the determination of what point in time the transfer of the collateral took place.[4] The referee in Portland decided that the transfer occurred when each account came into existence, and that since 95% of the accounts came into existence within the crucial four-month period, the transfer was a voidable preference. This conclusion has been said to have been reached by "irrefutable logic".[5] Is this so?

A "transfer" is the parting with property or an interest therein and includes the attachment of a lien upon property.[6] A "preference", as defined in Section 60 (a), is a "transfer" of property to or for the benefit of a creditor, for an antecedent debt, while the debtor is insolvent and within four months of bankruptcy, the effect of which will be to enable the creditor to obtain a greater percentage of his debt than some other creditor of the same class.[7] Section 60 (a) (2) looks to applicable state law to determine when the transfer is deemed to have been made,[8] and provides that the transfer is deemed to have been

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4. See, Hanson, "Proceeds" Under the Uniform Commercial Code, 65 COLUM. L. REV. 232 (1965). See also, 65 MICH. L. REV. 1004 (1965); 42 N.Y.U. L. REV. 150 (1967)
5. 65 MICH. L. REV. at 1006
6. Bankruptcy Act §1 (30), 11 U.S.C.A. §1 (30).
7. Bankruptcy Act §60 (a) (1), 11 U.S.C.A. §96 (a) (1).
8. Bankruptcy Act §60 (a) (2), 11 U.S.C.A. §96 (a) (2).

made when, under state law, the interest has become so far perfected that no subsequent creditor can obtain superior rights in it. The state law in this instance is the Uniform Commercial Code as adopted in Oregon.[9]

Under the Code, a security interest attaches when three conditions have been fulfilled; 1) an agreement is made that such an interest is to attach, 2) value is given, and 3) the debtor has rights in the collateral.[10] Unless specifically postponed by the agreement, a security interest attaches at the moment these three elements exist. Section 9-204 (2) (d) states that if the collateral is to be "accounts", they must first come into existence before the debtor may obtain rights in them. If in fact, however, the debtor does have rights in "accounts" as evidenced by an account, or several accounts already in existence, then Section 9-204 (1) can effect a transfer. A security agreement may include as collateral, accounts which at the time of the agreement were not in existence but which were to thereafter arise.[11] The Code further expressly provides that accounts acquired by the debtor after the agreement is executed, in which a security interest arises in favor of the creditor, are to be considered as collateral given for new value and not for an antecedent debt.[12]

At the time Rose City entered into the agreement with the debtor, the collateral used as security advanced was to be "accounts receivable". Since the collateral, "accounts receivable" (as a generic category), was already

9. ORS 79.2040
10. Uniform Commercial Code §9-204 (1)
11. Uniform Commercial Code §9-204 (3)
12. Uniform Commercial Code §9-108.

in existence at the time of the execution of the security instrument, the debtor had rights therein, and the prerequisites of Section 9-204 were satisfied and a security interest attached. Therefore, according to state law the transfer of the property to the creditor occurred as of the date of the security agreement. Thereafter, any account which came into existence is said to be given for new value under Section 9-108 of the Code. Section 9-204 (2) (d) is not applicable as to the new accounts because its function is to explain when Section 9-204 (1) effects a transfer of the collateral; Section 9-204 does not apply to after-acquired accounts, once the transfer has been accomplished, its usefulness is spent.

Under this interpretation all three elements necessary to effect a transfer existed prior to the crucial four months preceding bankruptcy; this was not a situation in which there were no accounts in existence at that time. In that situation the transfer does not take place until the debtor makes his first credit sale, and it is then that the security interest will attach. If this first credit sale takes place within the four months preceding bankruptcy, the security interest will then correctly be treated as a preference. However, if there is even one account receivable available as a subject for an attached and perfected security interest when the agreement is made, and the agreement is made prior to the four months preceding bankruptcy, the security interest must be deemed to have attached at that time. And those accounts which will arise within the four months preceding bankruptcy should not be treated as preferences.

This result is the commercial expectation. It avoids a windfall to unsecured creditors who had no reason to expect this category of collateral would be subject to their claims in the event of bankruptcy. This interpretation does not conflict with the underlying purpose of Section 60 (a) of the Bankruptcy Act;[13] namely, to avoid granting of secret liens which deplete the estate to the detriment of general creditors.

Even if the above analysis is rejected and the transfer is deemed to have been made within the four-month period, the validity of the security interest can be upheld on other grounds. The Bankruptcy Act does not treat as preferences all liens that may arise within four months of bankruptcy, but only those given for an antecedent debt.[14] Therefore, if such a lien is given to a creditor, not for an antecedent debt, but for new value, the Bankruptcy Act does not bar a creditor seeking to enforce such a security interest. This is consistent with Section 9-108 of the Code, which provides that when a security interest arises in favor of a creditor, in property which the debtor acquires after the date on which the financing agreement has been filed, the security interest shall be deemed to have arisen for new value. Thus, if pursuant to a security agreement a creditor is to have a security interest in all the accounts receivables

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13. Professor James A. McLaughlin, author of the 1938 amendment stated in committee hearings: "(W)e are not saying that you cannot make a mortgage on after acquired property. What we do say is that a lien is not regarded as made for the law of preferences . . . until it is so far perfected as to be good against a bona fide purchaser." <u>Hearings Before the Committee on the Judiciary to Study Revision of the Bankruptcy Act</u>, 75 Cong. 1st Sess., Ser. 9 at 123 (1937).
14. Bankruptcy Act § 60 (a) (1), 11 U.S.C.A. § 96 (a) (1).

of the debtor which thereafter may arise, in addition to those then existing, and the debtor has collected the receivables as they became due, and he has physically taken the proceeds of such accounts and turned them over to the secured lender, who in turn advances to the debtor the same amount of money out of his bank account, "re-lending" it to the debtor, the lender has provided new value. But why, under sound business practices, should the debtor and secured creditor be required to go through such a game of book entries? Is not Section 9-108 sufficient protection for creditors? (It might also be noted that this theory in no way depends upon the "relating back" theory, which was struck down in the 1938 amendments to the Bankruptcy Act).[15]

These two theories support the Portland decision as sound business law. The objective of Section 60 (a) is to maintain the status of all the creditors for the four months preceding bankruptcy and to prevent transfers which would disrupt that status. All creditors should know, with some degree of certainty, their relative position with regard to payment of their debt, at all times. More than four months prior to bankruptcy all creditors are aware of filed security interests and the classes of collateral to which they apply. The "substitution" of later accounts receivable is only made in compliance with an agreement which expressly permits the debtor to "substitute" new accounts receivable. Whether or not one thinks of the substitution as being for new value, at all times the secured creditor is known to have a certain "guaranteed" percentage of the bankrupt's assets.

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15. Supra note 13, at 122-125; Corn Exchange Nat. Bank & Trust Co. v. Klauder, 318 U.S. 434, 63 S.Ct. 161, (1943).

Commerce depends upon the willingness of financing institutions to lend money on the strength of such collateral as accounts receivables. By their nature accounts are a constantly changing thing. They are a "collateral unit"; individual items comprising the unit will constantly fluctuate, but creditors are on notice of the unit and are aware of its place among the debtor's assets.

The floating lien provisions of the Code were designed to permit the secured creditor to benefit from an increase in the value of the collateral. Even though this increase may occur within the four-month period, every attempt, such as in Portland, to bridge the theoretical problem and reconcile the Bankruptcy Act to the Uniform Commercial Code is to be applauded.