# "CLASS"—THE FORGOTTEN ELEMENT OF SECTION 60(a)(1) OF THE BANKRUPTCY ACT

*[T]he bankruptcy statute is such a patchwork in its structure . . . that it is difficult to understand . . . . [I]t is often incongruous and so incompatible that the judicial mind is in a state of consternation at the confusion and conflict of opinion about it . . . .*[1]

When a debtor realizes that he is steadily sinking further into debt and is unable to meet his obligations as they become due, he usually begins devising means to extricate himself from his financial difficulties in such a manner as to treat each of his creditors with equality.[2] However, an insolvent debtor[3] may, either intentionally or inadvertently, treat one creditor more generously than the others by transferring all or part of his property to one or more of his creditors, thereby placing such creditors in a better position than all or some of the other creditors. In so doing, the debtor may run afoul of one of the most important provisions of the Federal Bankruptcy Act,[4] namely, section 60,[5] which, *inter alia*, gives the trustee in bankruptcy, under certain specified conditions, power to set aside transfers by which creditors are preferred and to bring the property back into the bankrupt's estate so that it may be distributed, along with the debtor's other assets, among those creditors who have provable claims under the Act. A "preference" as defined by section 60(a)(1)[6] is made voidable by subsection (b) "if the creditor receiving it or to be benefited thereby" had reasonable cause to believe that the debtor was insolvent at the time the transfer was made. The cases identify some six elements of a preference within the language of section 60(a)(1):[7]

[1] a transfer . . . of any of the property of a debtor[8] [2] to or

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1 *In re* Wolf, 122 F. 127, 133-34 (W.D. Tenn. 1903).

2 *See* C. Nadler, The Law of Bankruptcy § 4 (2d ed. 1968).

3 It should be noted that a debtor is considered insolvent under § 1(19) of the Bankruptcy Act, 11 U.S.C. § 1(19) (1964),

> whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, 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.

4 11 U.S.C. § 1 (1964) [hereinafter referred to as the Bankruptcy Act or the Act].

5 11 U.S.C. § 96 (1964).

6 11 U.S.C. § 96(a)(1) (1964). *See* notes 7-13 *infra* and accompanying text. The term "preference" was first used in American bankruptcy law in the Act of 1800, and since that Act was copied from then existing English law, it did not include a definition of a "preference" nor in fact were preferential payments interdicted. *In re* Hall, 4 Am. Bankr. R. 671, 683-84 (W.D.N.Y. 1900); 3 W. Collier, Bankruptcy ¶ 60.05 (14th ed. 1968).

7 Bracketed material and footnotes added. For a general discussion of the constituent elements of a preference see Aulick v. Largent, 295 F.2d 41 (4th Cir. 1961); Dean v. Planters Nat'l Bank, 176 F. Supp. 909 (D. Ark. 1959).

8 A transfer, to make a preference voidable, must deplete the debtor's estate

> for the benefit of a creditor[9] [3] for or on account of an antecedent debt,[10] [4] made or suffered by such debtor while insolvent[11] [5] and within four months before the filing by or against him of the petition initiating a proceeding under this Act,[12] [6] the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.[13]

As can be seen from the footnote material, the first five elements have received extensive judicial treatment. This comment will deal with the sixth element, which presents one of the seemingly more difficult, yet rarely discussed questions raised by section 60, *i.e.*, whether the debtor has made such a transfer as will enable the creditor to obtain a greater percentage of his debt than another *creditor of the same class*. The problem lies in determining just what constitutes a "creditor of the same class." In other words, how is the trustee to determine that creditors are of the same class so that he may move to set aside a transfer which comes within the purview of section 60? What factors should the referees and courts consider in making such a determination? Since the Bankruptcy Act is federal legislation and federal courts have exclusive jurisdiction over proceedings under the Act,[14] there should be general agreement as to the answers to these questions. Unfortunately, this is not the case. Some courts have acknowledged that "nowhere in the Act is the word 'class' defined," but have avoided the problem by deciding the case before them without further discussion of whether the "creditor of the same class" requirement has been satisfied.[15] Others, including the Supreme Court of the United States, merely conclude that *A* and *B* are in fact creditors of the same class without explaining how or why they

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and diminish the assets available for distribution to creditors. For an interesting discussion concerning the application of the transfer element see Corn Exch. Nat'l Bank & Trust Co. v. Klauder, 318 U.S. 434 (1943). *See also* Glessner v. Massey-Ferguson, Inc., 353 F.2d 986, 990-92 (9th Cir.), *cert. denied*, 384 U.S. 970 (1966); COLLIER, *supra* note 6, ¶ 60.07.

[9] The benefit element is given excellent treatment in Dean v. Davis, 242 U.S. 438 (1917). *See* COLLIER, *supra* note 6, ¶ 60.16 for a discussion of the creditor aspect.

[10] *E.g.*, Ernst v. Mechanics' & Metals Nat'l Bank, 201 F. 664 (2d Cir. 1912), *aff'd sub nom.* National City Bank v. Hotchkiss, 231 U.S. 50 (1913), aptly covers the antecedent debt element of a preference. *See also* Glessner v. Massey-Ferguson, Inc., 353 F.2d 986, 992 (9th Cir.), *cert. denied*, 384 U.S. 970 (1966); COLLIER, *supra* note 6, ¶ 60.19.

[11] *E.g.*, General Elec. Credit Corp. v. Davis, 224 F.2d 322 (4th Cir. 1955); COLLIER, *supra* note 6, ¶ 60.30.

[12] For a discussion of the time element see New York Credit Men's Ass'n v. Domestic Broadtail Producers, 61 F. Supp. 102 (S.D.N.Y. 1945); COLLIER, *supra* note 6, ¶ 60.32.

[13] The leading case regarding the class element is, as noted throughout this article, Swarts v. Fourth Nat'l Bank, 117 F. 1 (8th Cir. 1902). *See also* COLLIER, *supra* note 6, ¶ 60.34.

[14] 11 U.S.C. § 11a (1964). *See* Pepper v. Litton, 308 U.S. 295 (1939).

[15] *See, e.g.*, Glessner v. Massey-Ferguson, Inc., 353 F.2d 986, 992 (9th Cir.), *cert. denied*, 384 U.S. 970 (1966); *In re* Star Spring Bed Co., 257 F. 176, 181 (D.N.J. 1919), *aff'd*, 265 F. 133 (3d Cir. 1920); Swarts v. Fourth Nat'l Bank, 117 F. 1, 6 (8th Cir. 1902); *In re* Harpke, 116 F. 295, 297 (7th Cir. 1902).

arrived at that conclusion.[16]

In light of the glaring paucity of authoritative discussion in this area, the objectives of this comment are four-fold: first, to examine the historical background of the Bankruptcy Act generally and of section 60 (a)(1) specifically; second, to analyze suggested definitions together with relevant commentaries by various courts and authorities; third, to consider the possible effect of political factors on the lack of legislative clarification; and fourth, hopefully to provide some assistance in resolving the uncertainty which surrounds the meaning of the word "class" as used in section 60(a).

## HISTORICAL BACKGROUND

According to one authority, the law of preferences must be rated as the single greatest contribution of the Bankruptcy Act to the field of commercial law because of its effect in discouraging preferential arrangements with insolvent debtors.[17] The theme of the entire Act, as well as the primary purpose of section 60(a)(1),[18] is said to be the securing of equality in distribution of the insolvent's assets among his creditors.[19] The present Bankruptcy Act[20] is the fourth major federal enactment in the area.[21] While it has been amended and revised extensively,[22] it has managed to survive nearly three-quarters of a century—more than four times longer than the combined existence of its three predecessors.[23] Although section 60(a)(1) has been revised on four occasions,[24] it remains substantially as originally enacted in 1898. Each time it has retained without clarification or comment the troublesome phrase "creditor of the same class." This phrase was not part of any of the earlier bankruptcy acts, albeit the Act of 1841 did contain a provision whereby any transfer, payment, conveyance, etc., which gave *any* creditor a preference or prior-

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[16] *See, e.g.*, Palmer Clay Prod. Co. v. Brown, 297 U.S. 227 (1936); *cf.* Glessner v. Massey-Ferguson, Inc., 353 F.2d 986 (9th Cir.), *cert. denied*, 384 U.S. 970 (1966); *In re* Smith, 205 F. Supp. 30 (E.D. Pa. 1962).

[17] J. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY § 247, at 284 (1956).

[18] *See In re* Bloch, 142 F. 674, 676 (2d Cir. 1905).

[19] *E.g.*, Kothe v. R.C. Taylor Trust, 280 U.S. 224, 227 (1930).

[20] Act of July 1, 1898, ch. 541, 30 Stat. 544.

[21] The previous federal bankruptcy statutes were the Act of April 4, 1800, ch. 19, 2 Stat. 19 (repealed 1803); Act of Aug. 19, 1841, ch. 9, 5 Stat. 440 (repealed 1843); and Act of March 2, 1867, ch. 176, 14 Stat. 517 (repealed 1878). Each of these acts followed a major or minor depression, but was repealed after a short existence, reportedly due to popular dissatisfaction with various aspects of the legislation.

[22] The Act of 1898 was amended in important particulars in 1903, 1906, 1910, 1917, 1922, 1926, 1933 and 1934 before being comprehensively revised by the Chandler Act (Act of June 22, 1938, ch. 575, 52 Stat. 869).

[23] The first three bankruptcy acts were in effect for a total of 16 years. The current act is now in its 71st year.

[24] The section was amended by the Act of Feb. 5, 1903, ch. 487, § 13, 32 Stat. 799; the Act of May 27, 1926, ch. 406, § 14, 44 Stat. 666; the Act of June 22, 1938, ch. 575, § 60, 52 Stat. 869; and the Act of March 18, 1950, ch. 70, § 1, 64 Stat. 24.

ity over general creditors was deemed void.[25] A similar provision of the Act of 1867 voided any such transaction which gave a preference to any creditor or person having a claim against the debtor.[26] However, there is no indication as to why Congress adopted the particular phraseology of the Act of 1898.

## JUDICIAL INTERPRETATIONS OF 60(a)(1)

The first recorded decision to consider section 60(a)(1) appears to be *Mather v. Coe*,[27] a district court case decided in February, 1899—nearly eight months after the act became effective and four months after petitions in involuntary bankruptcy could first be filed.[28] The court there, as in most of the early cases which followed,[29] treated *all* creditors without distinction, as being in the same class, thereby making it unnecessary to define the word "class."

The earliest attempts to define what was meant by the word "class" as used in section 60(a)(1) were made in 1902 by the Seventh Circuit in *In re Harpke*[30] and by the Eighth Circuit in *Swarts v. Fourth National Bank*.[31]

In *Harpke*, the trustee sought to recover an alleged preference made by payment within three weeks of bankruptcy of a note by an endorser thereof with funds provided by the insolvent principal. The first to

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[25] Section 2 of the Act of Aug. 19, 1841, ch. 9, 5 Stat. 442, provided:

> [A]ll future payments, securities, conveyances, or transfers of property, or agreements made or given by any bankrupt, in contemplation of bankruptcy, and for the purpose of giving any creditor, endorser, surety, or other person, *any preference or priority over the general creditors* of such bankrupts . . . shall be deemed utterly void . . . . (emphasis added).

[26] Section 35 of the Act of March 2, 1867, ch. 176, 14 Stat. 534, which replaced Section 2 of the Act of 1841 (*see* note 25 *supra*), similarly provided that

> if any person, being insolvent, or in contemplation of insolvency . . . with a view to give a *preference to any creditor or person having a claim against him* . . . makes any payment, pledge, assignment, transfer, or conveyance of any part of his property . . . the same shall be void, and the assignee [trustee] may recover the property . . . . (emphasis added).

The Act of 1867, which was adopted largely from the Massachusetts Insolvency Law of 1838, required a specific intent by the debtor to give a preference. However, such intent was not emphasized in decisions under the Act. COLLIER, *supra* note 6, ¶ 60.05.

[27] 92 F. 333 (N.D. Ohio 1899), *rev'd on other grounds*, 109 F. 550 (6th Cir. 1901).

[28] The Act was approved on July 1, 1898, and the concluding section of the Act stated, *inter alia*:

> [N]o petition for voluntary bankruptcy shall be filed within one month of the passage thereof, and no petition for involuntary bankruptcy shall be filed within four months of the passage thereof. 30 Stat. 566.

It was held in *In re* Bruss-Ritter Co., 90 F. 651 (E.D. Wis. 1898), that operation of the Act in suspending state insolvency laws and depriving the state courts of jurisdiction under the Act, was to be dated from the day of its approval, Nov. 1, 1898, and not from the day when petitions could first be filed in involuntary cases.

[29] *E.g.*, *In re* Fixen, 102 F. 295 (9th Cir. 1900); *In re* Conhaim, 97 F. 923 (D. Wash. 1899).

[30] 116 F. 295 (7th Cir. 1902).

[31] 117 F. 1 (8th Cir. 1902).

point out that "[n]owhere in the act is 'class' defined,"[32] the court in *Harpke* went on to state that the distinction between classes of creditors was not necessarily marked by a line running between secured and unsecured creditors; rather, "the distinction consists in the added source out of which the claim may be collected and the added probability of its payment."[33] Noting that the dictionary definition of "class" was a number of persons ranked together for some common purpose or possessing some attribute in common, the court held that a creditor holding a note secured by an endorser was *not* of the same class as one holding a note not so secured.[34] The effect of the court's ruling would appear to be that there could be as many different classes of creditors as there were different forms or types of security. A creditor whose relationship with the bankrupt differed in any manner with that of another creditor would constitute a different class, and the bankrupt could pay the debt of one, if he so chose, without having given him a preference over another creditor.

In *Swarts,* the defendant-creditor bank held a $60,000 claim against the bankrupt dry goods company, evidenced by a series of promissory notes, all of which were endorsed by third parties so as to place the endorsers in the position of accommodation makers to the bank. Some $35,000 of the notes were endorsed by two individuals who were also insolvent; the remaining $25,000 in notes were endorsed by the same individuals and another firm, which was solvent. Within four months of the filing of an involuntary bankruptcy proceeding against it, the dry goods company had paid the bank $14,600 on the latter notes. Subsequent to the adjudication of bankruptcy, the endorser-firm paid the bank the remaining $10,400 on the latter notes and then proved the payment as a claim against the bankrupt's estate. The bank, relying on *Harpke,* contended its claim for the remaining $35,000 worth of notes endorsed by a separate group of endorsers put it in a different class as to those notes, and it was permitted to prove such claim. However, after the referee subsequently granted the trustee's motion to expunge the bank's claim unless it returned the $14,600, the district court reversed the referee's ruling. The Eighth Circuit then reversed the lower court and held that the entire $60,000 constituted one claim. Thus, the transfer of the $14,600 within the interdicted period had permitted the bank to receive a greater percentage of its debt than other debtors of the same class, and it was forbidden by statute[35] to prove any part of its claim until it surrendered

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[32] 116 F. at 297; *see* cases cited note 15 *supra.*

[33] 116 F. at 297.

[34] *Id.* The court stated that "[i]n no sense can it be said that a note collectible only from the principal makers, is of the same class as a note that bears, in addition, the guaranty of a respectable endorser."

[35] 11 U.S.C. § 93(g) (1964) provides that

> The claims of creditors who have received or acquired preferences, liens, conveyances, transfers, assignments or encumbrances, void or voidable under this Act, shall not be allowed unless such creditors shall surrender [them] . . . .

this preference.

The court criticized and rejected the holding of *Harpke*, concluding that the logical effect of the classification adopted therein would lead

> to the creation of new and numerous classes of creditors not specified in the . . . act; because . . . the definition of the term 'class' as used in the bankrupt act should be derived from that statute itself; and because *the true test of the classification of creditors under that act is the percentage which, in the absence of preferences, their claims are entitled to draw out of the estate of the bankrupt*, and the holder of an unindorsed note is entitled to the same percentage from the estate as the holder of an indorsed note.[36] (emphasis added).

While recognizing that the Act neither defined the word "class" nor stated in specific terms what creditors are in the same class, the *Swarts* court stated that the Act did create some classes and specified others. The court specifically cited section 64, which creates certain classes of creditors for priority of distribution;[37] section 56(b), which provides that secured creditors and those who have priority shall not vote at creditors' meetings and their claims are not counted as to number or amount, except to the extent that the amounts of their claims exceed the value of their security;[38] section 57(d) which provides for the temporary allowance of claims of secured and priority creditors to enable them to participate at creditors' meetings held prior to the determination of the value of their securities or priorities;[39] and section 57(h), which relates to the determination of the value of securities held by secured creditors for purposes of final allowance and payment of dividends.[40] Asserting that the Bankruptcy Act was drawn from the station of the bankrupt and not that of the creditor, the court went on to state that

> [i]t is the relation of their claims to the estate of the bankrupt, the percentages their claims are entitled to draw out of the estate of the bankrupt, and these alone, that dictate the relations of the creditors to the estate, and fix their classification and

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[36] 117 F. at 7-8.

[37] 11 U.S.C. § 104 (1964) provides that certain classes of debts shall be paid in advance of the payment of dividends to creditors, and establishes an order of priority as between such debts. First in order of priority are the various costs and expenses of administration of the bankrupt's estate; second are wages and commissions, not to exceed $600 to each claimant, which have been earned within three months before the date of commencement of the bankruptcy proceeding; third are costs and expenses paid by creditors in defeating an arrangement, wage-earner plan or the bankrupt's discharge, or in securing a criminal conviction for bankruptcy offenses; fourth in priority are taxes legally due and owing by the bankrupt to the United States or any state or subdivision thereof; and finally, the fifth class of priority covers debts owing to any person, including the United States, who by the laws of the United States is entitled to prioriy, and also to rent owing to a landlord who is entitled to priority by applicable state law.

[38] 11 U.S.C. § 92(b) (1964).

[39] 11 U.S.C. § 93(e) (1964). However, the temporary allowance is only to the extent that the value of such creditors' claims exceed the value of their securities or priorities.

[40] 11 U.S.C. § 93(h) (1964).

their preferences.[41]

It appears that the *Swarts* court was pointing out that there were, in effect, two major classes of creditors affected by the Act—statutory priority claimants, of which there were five subclasses,[42] and the general or unsecured creditors. Thus, upon adjudication of bankruptcy, while any secured creditors of the bankrupt would, of course, be paid to the extent they were able to realize payment on their security (becoming general or unsecured creditors as to any deficiency), the remainder of the estate would then be distributed, first, to the five subclasses of priority creditors in the order provided, and finally, to the general or unsecured creditors. It should be made clear that in each category listed, each creditor therein is to be paid the same proportion, *i.e.*, *no* "greater percentage of his debt than some other creditor of the same class."

As a hypothetical, suppose the bankrupt's assets for final distribution under the Act total $1,000 and his liabilities total $1,500 as follows: taxes, $500 to the federal government, $250 to the state, $50 to the county; wages owed, $200; unsecured or general creditors, total of $500. Costs of administering the estate come to $150 and, having first priority under section 64, are paid in full, leaving $850. Next, the bankrupt's handyman has filed a claim for $200 wages due; no other wage claims are filed, so that claim—second on the statutory priority list—is also paid in full, leaving $650 to be distributed. Since the taxes due (which have fourth priority) totaled $800, the remaining $650 would be paid to the governmental units in proportion (*i.e.*, 650/800 or 13/16ths) to the amount due them. In other words, the federal government would receive $406.25 (of its $500 debt); the state would get $203.13 (of its $250 due); and the county, $40.62 (of the $50 owed it). Thus, each of these creditors would have received the same percentage of its debt as the other members of the same class. In this example, the general or unsecured creditors would not have recovered any dividend whatsoever on their debts because the bankrupt's estate was exhausted in paying the priority debts.

Thus, under the *Swarts* test of classification, all creditors, whether secured, priority or unsecured, who receive the same percentage of their claims, are creditors of the same class.

A year after *Swarts*, the problem was considered by the Sixth Circuit in *Livingstone v. Heineman*.[43] There the defendant was a surety on two series of notes—for $8,200 and $800 respectively—made by the bankrupt and held by a bank. Just prior to filing his petition, the bankrupt paid the bank $600 on one note in the first series and $266.66 on two others in the second group. The $600 payment was conceded to be a

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[41] 117 F. at 7.
[42] *See* note 37 *supra*.
[43] 120 F. 786 (6th Cir. 1903).

preference, and upon surrendering that amount to the trustee, the surety was allowed to prove his claims against the bankrupt's estate[44] for the $7,600 balance on the first series of notes, which he had paid off within a period of time beginning shortly before and ending immediately after adjudication of bankruptcy. The district court had held that the surety's claims were not affected by the preferential payments because they were properly proved and allowed in his own name, rather than as subrogee of the bank. The court of appeals, in reversing, however, held that (1) the two series of notes together constituted only one claim by the *bank*, no part of which could be allowed without restoration to the estate of both preferential payments, and (2) the surety *was* subrogated to the bank's rights; therefore, if the surety were allowed to treat each series of notes as a separate claim, withholding the smaller claim while refusing to surrender the proportionally larger preferential payment, he would receive a greater percentage than other claims of the same class. The court, adopting the *Swarts* percentage test, further concluded that

> there are two general classes—first, those who have priority and are to be paid in full; and, second, general or unsecured creditors, among whom the balance remaining after paying the creditors of the first class, is to be distributed equally, in proportion to the amount of their respective claims.[45]

A similar result was reached by the New Jersey District Court in 1919 in *In re Star Spring Bed Co.*,[46] and was affirmed by the Third Circuit Court of Appeals. There the insolvent company, indebted to a bank for $58,200, entered into an after-banking hours transaction with the bank the day before being adjudicated bankrupt, whereby the company assigned to the bank certain amounts receivable aggregating $28,000 to secure a $20,000 note. The referee, following *Harpke*, ruled that the transaction did not constitute a preference since the bank was the only secured creditor and thus was in a class by itself. The district court reversed, adopting the *Swarts* percentage-classification test and holding that, in a broad sense, there are only two classes of creditors:

> those who have priorities [under Section 64] and are paid in full, and general creditors, including secured and unsecured. . . . Creditors entitled to receive out of the bankrupt estate the same percentage of their claims are therefore in the same class, regardless of whether they may collect any deficiency from others.[47]

In the past five decades there has been a perceptible lack of judicial

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[44] Section 57(g) does not deal with the proof of claims, but rather with their *allowance*. In other words, the existence of the preference itself does not hinder allowance of the claim so much as does the failure to surrender it. "Restoration, not punishment, is the object of this law." *In re* George M. Hill Co., 130 F. 315, 321 (7th Cir. 1904); COLLIER, *supra* note 6, ¶ 57.19, at 279-80.

[45] 120 F. at 788-89.

[46] 257 F. 176 (D.N.J. 1919), *aff'd*, 265 F. 133 (3d Cir. 1920).

[47] *Id.* at 181. For a discussion of the section 64 priorities see note 37 *supra*.

comment concerning the concept of "class." During that period, there has been no significant effort to formulate a definition that would be uniformly acceptable to the courts. In those cases in which the question has been presented, the courts have appeared content to follow the *Swarts* "percentage-classification" test.[48] In the most recent case of import, *Glessner v. Massey-Ferguson, Inc.*,[49] which has often been cited for its discussion of the "class" problem,[50] the court adroitly avoids a definition. There the Ninth Circuit held that repossession by a vendor of property subject to a conditional sales agreement (such conduct being tantamount to recording under then existing Arizona law), within four months preceding filing of the petition in bankruptcy, constituted a preference voidable by the trustee under section 60(b). The court found that the creditor's initial failure to record the agreement as required by state law rendered the subsequent repossession a transfer of the debtor's interest "for or on account of an antecedent debt," which debt was created at the time of the making of the conditional sales agreement. The creditor in *Glessner* had contended that the sixth element of section 60 (a)(1) had not been satisfied since the "class" in that case included only creditors holding claims arising from conditional sales contracts, and not unsecured creditors of the bankrupt. The court rejected this argument as an erroneous assumption which, if accepted, would defeat the two-fold purpose of section 60, *i.e.*, to enable the trustee to strike down "secret liens" and to require prompt perfection of security interests in order to provide timely and adequate notice to other creditors.[51] In this neat, yet elusive manner, the Ninth Circuit in effect avoided direct confrontation with the problem.

## COMMENTATORS' VIEWPOINTS

None of the recognized authorities in the field of bankruptcy law (Collier,[52] Remington,[53] MacLachlan[54] and Nadler[55]) suggest a workable test for determining what creditors are in the same class. This is not to say that these commentators have not recognized the problem. Indeed, *Remington* devotes an entire section of his treatise to a discussion of the problem;[56] unfortunately, however, his treatment leaves the question unanswered. After first stating that section 60(a) refers to the section 64 grouping of creditors into classes for purposes of relative priority on distri-

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[48] *See, e.g., In re* Forney, 299 F.2d 503 (7th Cir. 1962); Walker v. Wilkinson, 296 F. 850 (5th Cir. 1924); Jentzer v. Viscose Co., 13 F. Supp. 540 (S.D.N.Y. 1934)
[49] 353 F.2d 986 (9th Cir.), *cert denied*, 384 U.S. 970 (1966).
[50] *See, e.g.,* COLLIER, *supra* note 6, ¶ 60.34.
[51] 353 F.2d at 992.
[52] COLLIER, *supra* note 6.
[53] H. REMINGTON, A TREATISE ON THE BANKRUPTCY LAW OF THE UNITED STATES (6th ed. 1957).
[54] MACLACHLAN, *supra* note 17.
[55] NADLER, *supra* note 2.
[56] 4 H. REMINGTON, *supra* note 53, § 1701.

bution of the debtor's estate, he notes that

> [t]hose classes of creditors who are, seriatim, entitled to priority in payment out of the estate are each distinct unto themselves. Others are all general creditors, entitled to share alike in the balance remaining, whether or not they hold security for the amount due them and could collect from other sources.[57]

Extensive quotations from the *Star Spring Bed Co.* and *Swarts* decisions are then presented in support of this statement, but nothing new is added or proposed toward resolving the question.

*Collier*, while discussing what he considers a definitional shortcoming of section 60(a)(1) (see discussion *infra*), nonetheless concludes by advocating the *Swarts* classification test:

> Creditors who, in the absence of preferences, are entitled to receive the same percentage upon their claims out of the estate of the bankrupt, are members of the same class. Those who are entitled to different percentages are of different classes.[58]

Although *MacLachlan's* treatment of the subject is substantially less extensive than that of *Remington*, he in effect reaches the same conclusion in expressing the view that the word "class," as used in the Bankruptcy Act, refers to priorities under section 64:

> Classification primarily, at least, turns on priorities. Prima facie, all general creditors belong to the same class, and each of the five priorities set up in section 64(a) is conterminous with a class of creditors.[59]

*Nadler*, while adopting the *Swarts* percentage-classification test, erroneously asserts that "the Supreme Court has clearly established what is meant" by a creditor obtaining a greater percentage of his debt than another creditor of the same class.[60] He goes on to state that the Act divides creditors into *three* classes:

> (a) those who are entitled to priority, and (b) those who are secured, and (c) those that are general and unsecured . . . .[61] (footnotes omitted).

The morass surrounding this question has become cloudier because each

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[57] *Id.* at 316.

[58] COLLIER, *supra* note 6, ¶ 60.34, at 905, *citing* Swarts v. Fourth Nat'l Bank, 117 F. 1, 8 (1902).

[59] MACLACHLAN, *supra* note 17, § 256.

[60] NADLER, *supra* note 2, § 648, *citing* Palmer Clay Prods. Co. v. Brown, 297 U.S. 227 (1936). Actually the *Palmer* case resolved the question as to the *time* at which the preferential transfer is to be considered effected for purposes of determining whether the transferee has been favored over other creditors of the same class; it did *not* define "class" nor even discuss the question. Mr. Justice Brandeis, speaking for the Court, stated that

> Whether a creditor has received a preference is to be determined, not by what the situation would have been if the debtor's assets had been liquidated and distributed among his creditors at the time the alleged preferential payment was made, but by the actual effect of the payment as determined *when bankruptcy results.* 297 U.S. at 229. (emphasis added).

[61] NADLER, *supra* note 2, § 648.

of these commentators cite the same cases as authority and some are in turn cited by other writers as authority for their comments on the subject.[62] Thus, rather than attempt to independently analyze the meaning of the word "class," legal writers have been content to rely on each other.

Ironically, nearly all of the authors of textbooks on creditors' remedies and related areas[63] pose to their readers the question which is the subject of examination in this comment. Yet, with one possible exception where the author coincidentally cites the *Swarts* definition of the word,[64] the student is left to determine for himself the meaning of "class" as used in section 60(a)(1).

## POSSIBLE EFFECT OF POLITICAL FACTORS

The simplest and most obvious solution to the problem, of course, would be for Congress to define or categorize the word "class" as it has done with regard to other key words and phrases used in the Act.[65] Admittedly, it may be unrealistic to expect a classification for every conceivable creditor; yet Congress has previously enacted definitions to ensure clarification of specific sections of the Act, even though the original draftsmen considered the issue too narrow for legislative definition.[66] Such a congressional categorization of creditors into various classes would no doubt tend to favor secured creditors if for no other reason than that it could be expected that those creditors with some sort of security for their debts would be given an order of priority in payment over those having no security.

[62] *E.g.*, D. COWANS, BANKRUPTCY LAW AND PRACTICE § 748, at 393 n.35 (1963).

[63] *E.g.*, J. HANNA & J. MACLACHLAN, CASES AND MATERIALS ON CREDITORS' RIGHTS 724-25 (5th ed. 1957); W. HOGAN & W. WARREN, CASES AND MATERIALS ON CREDITORS' RIGHTS AND SECURED TRANSACTIONS UNDER THE U.C.C. 399 (1967); S. RIESENFELD, CASES AND MATERIALS ON CREDITORS' REMEDIES AND DEBTORS' PROTECTION 538 (1967).

[64] RIESENFELD, *supra* note 63.

[65] 11 U.S.C. § 1 (1964). An opportune forum for initiation of such congressional action could be provided by a Senate resolution (S.J. RES. 100), now pending before the House of Representatives, which provides for the creation of a Commission on the Bankruptcy Laws of the United States. The commission would study, analyze and evaluate the Bankruptcy Act, recommending changes and revisions therein to reflect and meet demands of the present technical, financial and commercial activities. The commission would be composed of two members each of the Senate and House of Representatives, three referees in bankruptcy, and three businessmen knowledgeable in the field of bankruptcy. The commission would be required to issue a report of its activities and recommendations within two years of its creation. 2 BANKR. L. REP. No. 120, at 1 (Sept. 24, 1968).

[66] *See* W. LAUBE, SIGNIFICANT RECENT BANKRUPTCY DEVELOPMENTS § 2.24 (1967), commenting on the 1966 addition of 1(29a) to the Bankruptcy Act, 11 U.S.C. § 1(29a), *as added*, (Supp. II, 1967), defining the statutory lien. Because the term was not previously defined in the Act, the definitive purpose of the amendment was explained in H.R. REP. No. 686, 89th Cong., 1st Sess. 2 (1965) as being to specifically embody the meaning which Congress originally intended in the act . . . ." It is submitted that a similar need exists with regard to the word "class." *See also* J. SUTHERLAND, STATUTORY CONSTRUCTION § 4816 (3d ed. 1943), wherein it is noted that the legislature can "eliminate uncertainties in the legislative intent and in the meaning of words by amending prior acts and by inserting construction and definition sections in the law."

As a practical matter, however, it would appear that a major factor contributing to the lack of affirmative definition of the word "class" in the Act itself can be traced to the considerable influence which *unsecured* creditors exert upon Congress. This influence is present both in the form of powerful lobbyist groups, such as the National Association of Referees in Bankruptcy, and of the large number of average citizens who quite often cannot be bothered with such things as security for loans. It would appear that the referees' lobby would be particularly resistant to any attempt by Congress to legislatively define creditor classifications since, as pointed out previously, such action inevitably would result in new categories of creditors to be ranked ahead of the general unsecured creditors in distribution of the bankrupt's assets. The underlying basis for such opposition is the fact that bankruptcy courts traditionally have been unfavorable to secured creditors, primarily because the "referee's experience tends to make them acutely aware of the small percentages commonly left for general creditors."[67] Thus, it can be expected that any legislative attempt to better the position of the secured creditors at the expense of general creditors will meet with stiff opposition.

## OTHER FACTORS TO CONSIDER

Except for the *Swarts* line of cases, courts generally have neglected to discuss the so-called "class" requirement of section 60(a)(1). In fact, the question has been treated in detail in only a few isolated cases over the past 70 years. Perhaps it has been ignored by the courts and participants in most of the thousands of bankruptcy proceedings which take place in this country each year[68] simply because of the lack of sufficient guidelines needed to make a knowledgable determination of whether creditors are within the same class. Perhaps courts throughout the country agree that the *Swarts* classification test is the proper approach and have been content to tacitly follow it. On the other hand, there may be dissatisfaction with the *Swarts* doctrine but, because of the lack of judicial or legislative direction, courts have merely avoided the question. Perhaps a more candid approach to the problem would be to divert attention from the judiciary and re-direct it toward the attorney for the creditor against whom a preference has been asserted, for it appears that, except for a few isolated cases, the issue has not been raised during the proceedings to determine whether a preference in fact exists. If the ques-

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[67] MACLACHLAN, *supra* note 17, § 205, at 226. The author further notes that the referee's role as advisor to the trustee may make him more collection-minded, *i.e.*, with a tendency to look more critically at claims of secured creditors. *See also* Treister, *Bankruptcy Jurisdiction: Is It Too Summary?*, 39 S. CAL. L. REV. 78 (1966).

[68] In the fiscal year ending June 30, 1968, a total of 197,811 bankruptcy proceedings were filed, according to a report by the Administrative Office of the United States Courts, Division of Bankruptcy Administration. 2 BANKR. L. REP. No. 122 at 2 (Oct. 23, 1968).

tion is not raised—which may reflect the practicing bar's recognition of bankruptcy courts' unfavorable attitude toward secured creditors[69]—the court may assume that the "class" element is not in issue, and determination of this vital element then becomes merely a matter of stating that *A* and *B* are creditors of the same class.

Regardless of the explanation, the fact remains that there is today, some 71 years after the phrase first became part of the Bankruptcy Act, no clear answer to the question of what is a "class" within the meaning of section 60(a)(1). As pointed out earlier, the simplest and most logical solution would be for Congress to supply the definition,[70] which would of course be binding on the courts. However, in view of the probable effect of political factors (discussed *supra*), it would appear that no such action on the part of Congress will be forthcoming.

If it is assumed *arguendo* that the *Swarts* percentage-classification test is indeed the proper one to be applied, it behooves counsel for the alleged preferred creditor to raise the question by challenging the classification in all cases where there is any doubt as to whether the test has been satisfied. In addition, in those cases where the question is raised, the courts and referees should delineate in their opinions the manner in which they arrive at the conclusion that *A* and *B* are in fact creditors of the same class. Illustrative of such a discussion is that of the Court of Appeals for the Eighth Circuit in the recent case of *Kenneally v. First National Bank*.[71] The bankrupt firm, owing the defendant bank $11,436 on a $12,000 note secured by certain accounts receivable and in need of additional funds for operating expenses, negotiated a new loan two months prior to filing a voluntary bankruptcy petition. The bank advanced additional cash, cancelled the original note and took a new note for $16,000 from the firm, which in turn assigned additional accounts receivable and a factor's lien as security therefor. In the two months following this transaction and prior to adjudication of bankruptcy, the firm made payments of $9,095 on the new note. The referee in bankruptcy rejected the validity of the security instruments because of improper execution, in that they had been signed by only one officer of the firm instead of the two required by a corporate resolution filed with the bank. However, because of the circumstances surrounding the making of the notes, the referee found that the trustee was equitably estopped to deny the validity of the security instruments, and he therefore allowed the bank's claim for the $6,904 due on the note as a secured claim. The Minnesota district court affirmed the referee's finding, but the Eighth Circuit reversed, holding, *inter alia*, that (1) the bank had reasonable cause to believe that the firm was insolvent at the time of making the

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69 *See* note 67 and accompanying text *supra*.
70 *See* note 65 and accompanying text *supra*.
71 400 F.2d 838 (8th Cir. 1968).

payments, and (2) the trustee had sufficiently established that the bank would receive from the payments a greater percentage of its debt than other creditors of the same class. Since the bank's "secured claim" was based on invalid security instruments, it then became an unsecured claim and was grouped with those of the other unsecured creditors, each of whom, by the court's calculations, would be entitled to receive approximately 55 percent of his claim.[72] Thus, the bank—having received the $9,095 plus fifty-five percent of the $6,904—would realize a greater percentage of its debt than the other unsecured creditors. The court stated:

> The amount available for distribution on unsecured claims can be determined with reasonable certainty and the amount of dividends which could be paid on unsecured claims can be readily calculated. The benefit conferred on unsecured creditors can then be compared with the benefit conferred upon the beneficiary of the preferential transfer. Thus, it may be determined who would receive the greater benefit percentage-wise —the unsecured claimants or the beneficiary of the preferential transfer.[73]

Although *Collier*, as noted previously, adopts the *Swarts* percentage-classification test, he criticizes the phraseology of the sixth element of section 60(a)(1). His remarks, however, are not directed to the lack of definition, but rather to the fact that, if the "greater percentage" clause is applied literally, the debtor could pay priority creditors of one category (under section 64) equal percentages of their claims and yet not have given the prohibited preference even though, after making such transfers, the debtor then has insufficient assets left to meet other higher *priority* claims. Such a result clearly would defeat the intent of the statute to secure equity of distribution of the bankrupt's assets among his creditors. Since section 64's list of priorities conceivably could include all of the bankrupt's creditors, *Collier* suggests that the intended meaning of the clause would be better expressed if the controversial phraseology were changed to read:

> the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than *he would be entitled to under the distributive provisions of the Act.*[74] (emphasis added).

Thus, in effect, *Collier* is contending that the suggested change in phraseology would truly clarify and better carry out the equality of distribution contemplated by the Act in providing that even priority claimants under

[72] *Id.* at 845. The court calculated the bankrupt's assets on the date of bankruptcy as $22,250 against liabilities of $35,522. Subtracting the secured and priority claims ($5,840) from the assets left $16,410 with which to pay off the unsecured claims totaling $29,684, which included the bank's claim of $6,904. Thus, the unsecured claims would be reimbursed at approximately fifty-five cents on the dollar.

[73] *Id.*

[74] COLLIER, *supra* note 6, ¶ 60.34, at 902.

the statute should be recognized in their statutory "pecking order," with payments of like percentage being made to all creditors within each category.

## CONCLUSION

Although the *Swarts* test seems appropriate, it appears to be languishing along with the entire sixth element of section 60(a)(1) either because of a lack of understanding on the part of the creditor's attorney as to what the statute means, or because of the failure on the part of the referees and the courts to properly articulate the test and adequately delineate the manner of its application in such way as to fill the void created by the lack of meaningful substantive and procedural guidelines. If the wording of section 60(a)(1) were to be changed as suggested by *Collier*, so as to clarify the present phraseology, or, alternatively, if the courts would make a concerted effort to spell out the steps taken in determining what creditors are in the same class, as was done in *Kenneally*,[75] the forgotten "class" requirement might be rejuvenated to assume once again its intended stature as an essential element of section 60(a)(1).

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[75] Kenneally v. First Nat'l Bank, 400 F.2d 838 (8th Cir. 1968). Although the court there did not expressly state it was adopting the *Swarts* test, it obviously did so and went to considerable lengths to explain how it arrived at its decision.