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SUBDIVISION TRUSTS AND THE BANKRUPTCY ACT

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Farmer Jones is ready, at long last, to sell his one hundred sixty acre piece of ground if he can get a good enough price for it. Home-builder Smith is willing to pay Jones that good price, since the land is on the edge of a growing city and prime subdivision material. But Smith's small working capital will not permit him to make a large down payment, and for the deferred annual payments he will depend to a large extent on income from the sale of houses on the lots into which the one hundred sixty acres have been subdivided. Smith can pay, but from the beginning of the transaction he must have the fullest sort of use of the land, including the right to re-sell parts of it free and clear of Jones' lien. Usually a developer such as Smith will want most if not all of the following rights as of the close of escrow:

(a) The right to subdivide the property into lots by recording a plat;

(b) The right to dedicate streets, alleys, and other easements immediately after making the down payment, in order to meet the conditions imposed by the various governmental bodies concerned with subdivision;

(c) The right to obtain an outright release from the vendor's lien of various parcels of the property as soon as an agreed pro rata portion of the purchase price, called a "release price," is paid;

(d) The right to place upon these various parcels, before any release price has been paid, an institutional construction mortgage which will be superior to the lien of the vendor. The proceeds of this construction mortgage will be used to build a house.

Smith's requirements are difficult to provide for under either of the two traditional real property security instruments: a deed to Smith with a mortgage back to Jones, or an agreement of sale with title

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* See Contributors' Section, p. 263, for biographical data.

retained in Jones until final payment. In Arizona, the device most frequently used to meet the requirements of this transaction is the subdivision trust. It is perhaps only natural that the remarkable versatility of the trust relationship should have led to its use here as well as in the countless other situations to which it has been adapted.

Where the subdivision trust is utilized, the Seller conveys the property to a Trustee, and Buyer, Seller, and Trustee enter into a trust agreement. This agreement provides for the payment of the purchase price by Buyer through Trustee to Seller, and provides that Buyer, when not in default, shall have the right to direct the Trustee to record a subdivision plat, make dedications, execute deeds to parcels which have been released, and deed parcels to Buyer for the purpose of placing construction mortgages on the parcels. In effect, the trust agreement is substituted for the vendor's lien under an agreement of sale as the Seller's security. Practically speaking, the Seller gives up some of the security of a traditional mortgage or agreement of sale transaction in order to get a higher price; the Buyer is willing to pay a higher price if he can obtain more flexibility in his right to use and dispose of the property while he pays for it.

Notwithstanding the wide popularity of this type of trust, and its marked advantages over alternative methods of administering the seller-developer relationship, certain of its incidents raise questions under the federal bankruptcy law. Customarily, the only instrument in the entire transaction which is recorded is the warranty deed from the Seller to the Trustee, delivered at the commencement of the trust. The agreement of sale, the trust agreement, and any subsequent assignment by Buyer or Seller of their rights under the trust, are not recorded. Under these circumstances, the thoughtful practitioner will naturally examine with care whether any of these transfers evidenced by unrecorded instruments could be attacked by a trustee in bankruptcy on the grounds of incompleteness.

Various motives have doubtless induced the avoidance of recording: desire to insure a clean record title, with no doubt of the Trustee's powers to make the necessary dedications; desire not to fully divulge the terms of an individual transaction; desire to keep subsequent transfers anonymous. But these would be dearly bought if the securing of them caused a serious risk of successful attack by the trustee after one of the parties to the trust takes bankruptcy.[1]

[1] In Arizona, the protection of the recording act may be obtained without disclosing either the purchase price or other specific terms, so long as reference is made in the recorded memorandum to the location of the instrument containing these. Carley v. Lee, 58 Ariz. 268, 119 P.2d 236 (1941). It seems probable, however, under the reasoning of this case, that the escrow agent or Trustee would be obligated to give unlimited public access to its files containing the full trust instrument in order for a memorandum recording of that instrument to be sufficient.

Three examples will illustrate the way in which such an attack might arise:

(a) The Buyer takes bankruptcy, and the trustee of his estate challenges the secured status of the Seller under the trust agreement;
(b) The Seller takes bankruptcy following a transfer by him to X of his beneficial interest under the trust. This transfer was effectuated by an unrecorded instrument from him to X, filed with the Trustee of the subdivision trust, more than four months prior to the filing by Seller of his petition. Seller's trustee challenges the assignment to X;
(c) The Buyer takes bankruptcy following a transfer by him to Y of his beneficial interest under the trust. This transfer is effectuated in the same manner and at the same time as the one described in the preceding paragraph, and is challenged by the Buyer's trustee.

In each of these cases, it will be remembered, the only recorded instrument in the chain of title after Seller acquired the property is the deed from Seller to Trustee. To keep the discussion manageable, it should also be assumed that each of these transfers was for an "antecedent debt" within the definition of § 60(a)(1) of the Bankruptcy Act.[2]

The trustee, of course, bases his attack on the strong-arm clause of § 60(a), reading as follows:

(1) A preference is a transfer, as defined in this title, 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 such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, 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.

(2) For the purposes of subdivisions (a) and (b) of this section, a transfer of property other than real property shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee. A transfer of real property shall be deemed to have been made or suffered when it became so far perfected that no subsequent bona fide purchase from the debtor could create rights in such property superior to the rights of the transferee. If any transfer of real property is not so perfected

[2] In Corn Exchange Nat. Bank & Trust Co. v. Klauder, 318 U.S. 434 (1942), the Supreme Court held that although an incompleted assignment of accounts receivable was given to the creditor for contemporaneous consideration, the effect of § 60(a), by which the assignment would be deemed to have been made immediately before bankruptcy was to likewise make the consideration for it an "antecedent debt." Whether this holding would extend to outright transfers, as well as to transfers as security, is beyond the scope of this article.

against a bona fide purchase, or if any transfer of other property is not so perfected against such liens by legal or equitable proceedings prior to the filing of a petition initiating a proceeding under this title, it shall be deemed to have been made immediately before the filing of the petition.

The question of whether the original Seller under the trust is protected in his security against attack by the Buyer's trustee in bankruptcy was answered in the affirmative by the United States Court of Appeals in *Barringer v. Lilley*.[3]

There Barringer had been the seller under a subdivision trust of property being developed in Phoenix, and therefore the state law, to the extent that state law was applicable, was that of Arizona. The trust agreement was basically of the type described at the beginning of this article, with a few added fillips thrown in to cast dust in the eyes of pursuing creditors. The buyer's assignee ultimately took bankruptcy, and in the ensuing proceedings the Referee refused to give the seller's claim for the unpaid purchase price under the subdivision trust anything more than the status of an unsecured claim. From the order of the District Court confirming the Referee's order, the seller successfully appealed.

Though there had been numerous assignments of the buyer's interest under the *Barringer* trust, there had been none of that of the seller. The question before the appellate court, then, was the basic one of whether the seller's security interest created by the original trust instruinstrument was good against the buyer's trustee. The predecessor of the present § 60 of the Bankruptcy Act, in effect at the time of *Barringer*, read as follows:

(a) A person shall be deemed to have given a preference if, being insolvent, he has, within four months before the filing of the petition, or after the filing of the petition and before the adjudication, procured or suffered a judgment to be entered against himself in favor of any person, or made a transfer of any of his property, and the effect of the enforcement of such judgment or transfer will be to enable any one of his creditors to obtain a greater percentage of his debt than any other of such creditors of the same class. Where the preference consists in a transfer, such period of four months shall not expire until four months after the date of the recording or registering of the transfer, if by law such recording or registering is required.

(b) If a bankrupt shall have given a preference within four months before the filing of a petition, or after the filing of the petition or before the adjudication, and the person receiving it, or to be benefited thereby, or his agent acting therein, shall have had reasonable cause to believe that it was intended thereby to give a preference, it shall be voidable by the trustee, and he may recover the property or its value from such person.

[3] 96 F.2d 607 (9th Cir. 1938).

The then applicable recording statutes of Arizona were identical with the present provisions.[4]

The Court of Appeals held that the trustee in bankruptcy, representing general creditors, could not rely on the state recording statute to invalidate the seller's security, since the general creditors dealing with the buyer had dealt with one whose interest in the property was not of record. The Court held that the fact that the record title to the property stood in the name of a trustee was notice to the entire world that the buyers under the trust had no interest of record in the property.

As a second and alternate ground for its holding, the Court held that as between the parties to the transaction, the unrecorded trust agreement establishing the seller's security was good, and it could not be attacked by the trustee since it was necessary for him to rely on the same instrument to establish the interest of the bankrupt in the property.

In placing the *Barringer* case in present perspective, it is important to note that it was decided before the drastic amendments to the Bankruptcy Act in 1938 and subsequent years became effective. These amendments to § 60 have spelled out in much greater detail the tests to be applied in determining whether recording is required in order that a transfer may be deemed complete for purposes of computing the four-months period. A transfer of realty is now deemed complete where no bona fide purchaser from the bankrupt could acquire rights in the transferred property superior to those of the transferee; a transfer of personalty is tested generally by whether a judgment creditor could have obtained rights in the transferred property superior to those of the transferee.

So far as the subdivision trust is concerned, the changes just mentioned do not change the basic test applicable at the time of *Barringer*: Was recording necessary to complete the transfers under state law? But other language since added to § 60 has a more pervasive effect on the *Barringer rationale.* § 60(a)(3), added in 1950, provides:

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[4] ARIZ. REV. STAT. ANN. § 33-411A (1956): "No instrument affecting real property is valid against subsequent purchasers for valuable consideration without notice, unless recorded as provided by law in the office of the county recorder of the county in which the property is located."

ARIZ. REV. STAT. ANN. § 33-412 (1956): "All bargains, sales and other conveyances whatever of lands, tenements and hereditaments, whether made for passing an estate of freehold or inheritance or an estate for a term of years and deeds of settlement upon marriage, whether of land, money or other personal property, and deeds of trust and mortgages of whatever kind, shall be void as to creditors and subsequent purchasers for valuable consideration without notice, unless they are acknowledged and recorded in the office of the county recorder as required by law, or where record is not required, deposited and filed with the recorder."

> The provision of paragraph (2) of this subsection shall apply whether or not there are or were creditors who might have obtained such liens upon the property other than real property transferred and whether or not there are or were persons who might have become bona fide purchasers of such property. 11 U.S.C. § 96(a)(3) (1938).

The Court of Appeals in *Barringer* held that the trustee could not challenge the secured status of the seller because as successor to the bankrupt he claimed under the same instrument. But certainly it is clear under the present act, if it were not before, that the trustee for purposes of attacking a preference does not stand in the shoes of the bankrupt, but in the shoes of a hypothetical bona fide purchaser or judgment creditor. If there is to be an estoppel against the trustee in this situation, it must be because a judgment creditor or bona fide purchaser would be estopped, and not simply because the bankrupt would have been estopped.

Thus, while there can be no doubt that the unrecorded trust instrument was, as stated by the Court of Appeals, good as between the parties thereto and their successors in interest with actual notice, this does not answer the question of whether or not it was good as against a bona fide purchaser from, or a judgment creditor of, the buyer. The Court cites the case of *Dickerson v. Colgrove*[5] in support of the doctrine that the buyer under the trust agreement was estopped to challenge the seller's secured status, since the buyer himself claimed under the trust agreement. But this appears to be only another way of stating that the instrument was good as between the parties themselves.

The other ground relied upon by the Court, the fact that record title was in a trustee designated as such, is more persuasive. It is certain that no one dealing with the buyer who had examined the state of the record title to the property would have been under the impression that it was in the buyer. Such record title is, under the law of Arizona as elsewhere, notice to all those who are under a duty to inquire. *Mountain States Tel. & Tel. Co. v. Kelton.*[6] Elsewhere it has been stated that although a judgment lien attaches to the title of the judgment debtor under an unrecorded deed, interests of both debtor and creditor could be defeated by a bona fide purchaser of the record title.[7]

But to conclude, from the fact that record title was in a trustee, that the transaction was analogous to a mortgage deed of trust given

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[5] 100 U.S. 578 (1879).
[6] 79 Ariz. 126, 285 P.2d 168 (1955).
[7] Emerson-Brantingham Implement Co. v. Cook, 165 Minn. 198, 206 N.W. 170 (1925).

to secure the seller's unpaid balance, as does the Court in *Barringer*, is to press analogy too far. The deed under which the trustee took title in *Barringer*, like all deeds in subdivision trust transactions in Arizona, was a warranty deed without any indication that it was taken as security for anything, and without any of the provisions commonly found in the trust deed which is a form of mortgage.

The basic question which must be resolved under the bankruptcy law as it stands today is whether instruments retaining a security interest to the Seller, or instruments transferring the Seller's or Buyer's beneficial interest under the trust, are required to be recorded under applicable Arizona statute. The fact that *Barringer v. Lilley* was decided prior to significant changes in the Bankruptcy Act, and the further fact that most of its reasoning is directed to the rights of the bankrupt, rather than to a bona fide purchaser from or a judgment creditor of the bankrupt, make it less than conclusive as an authority on this point. In addition, the situation where the Seller or Buyer has transferred his beneficial interest under the trust is distinguishable from *Barringer*. Unlike the situation in that case, transfers of the beneficial interest under the trust after its creation are effected by instruments separate and distinct from the trust agreement and therefore the trustee in bankruptcy would not be required to attack the instrument under which he claims title.

The law in other jurisdictions is by no means uniform on the general question of whether a transfer of an equitable interest in land is subject to the provisions of the Recording Act in the particular jurisdiction. The cases are collected in § 38 and § 49 of 45 Am. Jur., "Records and Recording Laws". In Arizona, however, the Supreme Court without much discussion appears to have confined the provision of the Recording Act to legal interests in land by its decision in *Jarvis v. Chanslor & Lyon Co.*[8]

In that case X and Y entered into an agreement providing for the sale of real property from X to Y. X delivered his deed to the property to the escrow agent. Before the close of the escrow, and while the record title to the property was still in X, Y executed a deed conveying his equity in the property to Z. This deed was also delivered to the escrow agent. After this delivery, but before either deed was recorded, W, a creditor of Y, attached the property. After the attachment, both of the deeds were recorded.

On appeal to the Supreme Court of Arizona from a Superior Court judgment refusing to enjoin a sale by the attaching creditor, the Supreme Court reversed. The Court said:

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[8] 20 Ariz. 134, 177 Pac. 27 (1919).

> We have no statute that requires the escrow deed from [X] to [Y] to be placed of record before its second delivery. ¶ 2080, Civil Code of 1913 [ARIZ. REV. STAT. ANN. § 33-412 (1956)] does not cover the case. Nor would the recordation or the lack of it affect the right of the grantee therein to transfer his equitable interest or make his interest less or more amenable to attachment by his creditors. It was liable to be subjected to his debts by attachment or execution as long as it was his, but no longer.

It is arguable from a careful reading of the foregoing language that the Court was not actually addressing itself to the question of whether the deed from Y to Z ought to have been recorded in order to put Y's equitable interest beyond the reach of his attacking creditor. Nonetheless, courts are not usually wont to so narrowly confine their previous statements, and there can be no doubt as to the *holding* of the case. *Jarvis* stands for the proposition that in Arizona a transfer of the Buyer's equitable interest under an agreement of sale is not subject to the Recording Act.

The holding is consistent with at least one reasonable reading of the language of the Recording Act, which language suggests that its terms are confined to *traditional legal estates* in land:

> All bargains, sales and other conveyances whatever of *land, tenements, and hereditaments, whether made for passing an estate of freehold or inheritance or an estate for a term of years* . . . shall be void as to creditors and subsequent purchasers for valuable consideration without notice, unless they are acknowledged and recorded in the office of the county recorder as required by law . . . . ARIZ. REV. STAT. ANN. § 33-412 (1956) (emphasis supplied)

Whatever difficulties may be presented by an effort to classify the various beneficial interests under the trust as "realty" or "personalty" it is clear that neither beneficiary has legal title to the land. Each has an interest which is "equitable" in the sense that that term means an interest separated from the legal title to the property. If the Recording Act by its terms applies only to interests which *include* legal title, this could be the implicit basis for the *Jarvis* holding.

Jarvis is likewise consistent with the decision of the Territorial Supreme Court in *Luke v. Smith*,[9] holding that the unrecorded equitable lien of a partner for moneys advanced to improve partnership real property was protected against a purchaser at an execution sale.

Further analysis of the beneficial interests in terms of whether either or both are "real property" is by itself inconclusive, although the case for requiring recordation of a transfer of the Buyer's interest under the trust is stronger than that for such a requirement in connection with the transfer of the Seller's interest.

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[9] 13 Ariz. 155, 108 Pac. 494 (1910).

The Seller's interest under a subdivision trust is quite unlike any recognized interest in real property. He holds neither legal nor record title to the land; the Trustee has these. He does not, under the theory of equitable conversion, have the customary rights of a purchaser of real property; if anyone has these, it is the Buyer. The Seller possesses, so long as the Buyer is not in default, only the right to receive periodic payments under the trust agreement. It is very difficult to transmute this into an interest in real property within even the broadest interpretation of the Recording Act.

The Buyer's rights are not so easily disposed of. He is acquiring the property, and has the right of possession and occupancy for many purposes in connection with its development. Clearly he would be the equitable owner of the property were it not for the provisions in the trust agreement that the interests under the trust of both Buyer and Seller are personalty.

The *Restatement of Trusts,* which the Supreme Court of Arizona has held will be followed by it in the absence of statute or precedent to the contrary,[10] draws the following distinctions between the nature of beneficial interests:

> § 130. Except as stated in § 131 . . .
> (b) if the trust property is real property, the interest of the beneficiary is real property unless the interest of the beneficiary is so limited in duration that if it were a legal interest it would be personal property . . . .
>
> § 131. Equitable Conversion.
> (1) If real property is held in trust and by the terms of the trust a duty is imposed upon the trustee to sell it and hold the proceeds in trust or distribute the proceeds, the interest of the beneficiary is personal property.

The Seller's interest under a subdivision trust does not fit precisely into the definition given in § 131, but this is because the property has already been sold and the Trustee's duty is to collect and disburse the proceeds. The Seller's interest under a subdivision trust is, a fortiori, personal property by the standards of § 131. Just as clearly, the Buyer's interest under the trust will be real property under the provisions of § 130.

However, even if it were not for *Jarvis v. Chanslor & Lyon, supra,* the fact that an interest under a trust be held "real property" in a general sense does not necessarily mean that an instrument transferring

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[10] Ingalls v. Neidlinger, 70 Ariz. 40, 216 Pac. 387 (1950). Of course Jarvis v. Chanslor & Lyon, 20 Ariz. 134, 177 Pac. 27 (1919) would be a contrary precedent if the Restatement was to require the conclusion that the transfer of a vendee's interest in an agreement for sale of land was subject to the Recording Act.

it must be recorded. As previously pointed out, a literal reading of the Arizona recording statute supports the view that it applies only to *legal estates* in land, a term by no means as broad as "real property."

There is authority in other jurisdictions holding that beneficial interests under other types of land trusts are personalty. The interest of a beneficiary in a trust of real property has been held to be personalty for purposes of a Massachusetts succession tax in *Dana v. Treasurer*[11] followed in *Priestly v. Burrill.*[12] The Wisconsin court has held otherwise for purposes of the Wisconsin inheritance tax.[13] A like interest was held to be personalty for purposes of determining the right of one of the beneficiaries to a partition of the real property in *Aronson v. Olsen.*[14]

In *Aronson* the Supreme Court of Illinois relied on a declaration in the trust agreement that the beneficial interest should be regarded as personalty. However, in *Gordon v. Gordon,*[15] the same court held that for purposes of conflicts of law jurisdiction a beneficiary's interest in a trust of real property was itself real property in the absence of an express contrary provision in the trust instrument. These decisions raise the question of how much weight, in determining the question of whether property is realty or personalty, a court will give to the declaration of the parties that it is one or the other. As previously pointed out, the typical Arizona subdivision trust provides that the interests of the beneficiaries shall be deemed personalty.

Conceivably a court would be more willing to permit the beneficiaries to determine the nature of their own interests with regard to what remedies should be available *inter sese,* as in *Aronson, supra,* than it would be with regard to whether the court has jurisdiction of the controversy at all, as in *Gordon, supra.* The Massachusetts holdings cited above suggest that even without such a stipulation in the trust instrument the interest of a beneficiary is personalty for some purposes. Under these circumstances, unless the policy of the Recording Act would be impaired or frustrated by such a holding, there appears no good reason why the parties should not be allowed to stipulate in the type of subdivision trust under discussion that the interests of the beneficiaries should be personalty. The Arizona court has said as much where dealing with the related question of whether or not improvements are realty or personalty, but in so saying has reserved the critical question of whether such a stipulation between the parties would be good as against third persons.[16]

[11] 227 Mass. 562, 116 N.E. 941 (1917).
[12] 230 Mass. 452, 120 N.E. 100 (1918).
[13] *In re* Petit's Estate, 252 Wis. 94, 31 N.W.2d 140 (1948).
[14] 348 Ill. 26, 180 N.E. 565 (1932).
[15] 6 Ill. 2d 572, 129 N.E.2d 706 (1955).
[16] Voight v. Ott, 86 Ariz. 128, 341 P.2d 293 (1959); Marcos v. Texas Co., 75 Ariz. 45, 251 P.2d 647 (1952).

This discussion could be extended to cases dealing with the statute of frauds and similar rules of law which require a determination whether a particular interest is real property. Yet it is clear from what the courts have done that what may be "real property" for one purpose may not be for another. The situation may be fairly summarized by saying that on principle the Seller's interest under a typical Arizona subdivision trust is plainly personal property by any test, and an instrument reserving it or transferring it is not within the recording statutes. The Buyer's interest is probably "real property" in most senses of the word, but this does not conclusively answer the question of whether on principle an instrument transferring it is within the terms of the Recording Act. Counterbalancing the fact that the Buyer's interest is undoubtedly "real property" for some purposes are the declarations that the interest is personalty and the fact that a textual interpretation of the Arizona Recording Act may restrict its coverage to interests in land which include legal title.

With the matter standing thus apart from authority, there is every reason for thinking that the case of *Jarvis v. Chanslor & Lyon* is and will remain good law in Arizona. There are no compelling policy considerations or arguments on principle which suggest that the Supreme Court of Arizona would be willing to examine it, particularly since it deals with an area of the law where stare decisis is of peculiar importance.[17]

If the foregoing analysis is correct, there can be little doubt that the Court in *Barringer* reached a result which is still correct today. Likewise, the same result should obtain in the case of an attack by a trustee in bankruptcy against a transfer of either the Seller's or Buyer's beneficial interest under the trust to a third person. Nonetheless, this reappraisal of the *Barringer* reasoning serves a purpose even though it only confirms the result of that case. The landmark opinion of the Supreme Court of the United States in *Corn Exch. Nat'l Bank & Trust Co. v. Klauder*,[18] was important not merely for its holding, but for the philosophy which it expressed. The Bankruptcy Act had for years been subject to judicially engrafted exceptions in favor of debatably secured claimants who would have suffered hardship from a literal application of the Act. Part of this may have been the fault of the rather imprecise statutory tests which the Act embodied prior to its amendment in 1938 and later years. The *Barringer* opinion reflects that earlier judicial climate. The Supreme Court in *Klauder*, rightly or wrongly, chose a drastic, literal interpretation of the Act

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[17] White v. Bateman, 89 Ariz. 110, 358 P.2d 712 (1961).
[18] 318 U.S. 434 (1942).

in a situation where an equally reasonable interpretation would have reached the opposite result.[19]

Though the recent case of *Lewis v. Manufacturers Trust Co*,[20] decided January 9, 1961, may furnish an outward limit to the Court's literal reading of the Act, the combined change in the wording of the bankruptcy law and in the attitude of the court of last resort charged with its interpretation make decisions rendered under the old regime somewhat precarious authority. But since the Bankruptcy Act makes state law determinative in this situation, *Barringer* will continue to be reliable authority so long as the Arizona law exempts equitable interests in real property from the provisions of the state Recording Act.

[19] The argument for the opposite result will be found in the opinion of Judge Jones, when the Klauder case was in the Third Circuit, in *In re* Quaker City Sheet Metal Co., 129 F.2d 894 (3d Cir. 1942). This was adopted by Justice Roberts as his dissent when the case was decided by the Supreme Court.

[20] 364 U.S. 603 (1961).