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Untwisting the Strong-Arm: Protecting Fraud Victims from Bankruptcy Courts

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I. INTRODUCTION

Put yourself for a moment in the position of Grandma and Grandpa. You worked hard your entire life, paid for your children's college education, and by clipping coupons and watching your money you were able to save a small retirement fund. You invested this money in an apartment building which will provide enough monthly rental income to allow you to retire comfortably, play golf, and spend some time with your grandchildren.

As you are about to retire, you discover that the broker who handled the purchase of the building fraudulently recorded the deed to the building in the broker's name. You are shocked to learn that you've been the victim of such an act. To your further dismay, you learn that the broker has declared bankruptcy and the building is about to be sold to pay off the broker's creditors. You rush to the bankruptcy court and tell the judge your story, expecting that the judge will set things right.

The judge listens to your story and believes every word. Nevertheless the judge then orders the building to be sold, with the proceeds being used to pay the broker's creditors. The judge tells you not to worry, that you have a claim against the broker's bankruptcy estate, but you will probably only receive pennies on the dollar of the money you lost. The balance of the money, the judge explains, will be going to several large banks who had voluntarily loaned the broker millions of dollars.

As if in a dream, you begin to wonder whether you are still in the United States. In the United States judges are supposed to right wrongs, not be accomplices to fraud. This scenario may sound too unbelievable to be true. But courts across the country have done exactly this. This Comment looks at the law these judges have so cruelly twisted.
II. BACKGROUND

A. The Bankruptcy Code and the Strong-Arm Clause

Simply stated, the purpose of bankruptcy laws "is to provide a collective forum for sorting out the rights of the various claimants against the assets of a debtor where there are not enough assets to go around."\(^1\) To this end, the principal goals of bankruptcy policy are: "(1) equality of distribution among creditors, (2) a fresh start for debtors, and (3) economical administration."\(^2\) Because the purpose of the bankruptcy laws is to sort out claims against the debtor's assets, two questions arise: (1) What assets are available to distribute to the debtor's creditors, and (2) How is the distribution managed?

The answer to the second question is simple. All the assets which can be used to satisfy creditors' claims against the debtor are brought into the bankruptcy estate.\(^3\) From this estate all of the claims are satisfied.\(^4\) The first question, however, is not so easy to answer.

Certainly any of the debtor's interests in property are assets which can be used to satisfy claims and are included in the bankruptcy estate.\(^5\) The bankruptcy laws, however, go beyond this limited definition. They include assets in the estate that, although not in fact assets of the debtor, are considered assets of the debtor to further the goals of the bankruptcy laws. These assets include assets that the debtor has transferred to defraud creditors,\(^6\) assets that the debtor has transferred to some creditors preferentially at the expense of others,\(^7\) and assets that the debtor's creditors would have been able to claim outside of bankruptcy.\(^8\)

This last class of assets—those that creditors could reach outside of bankruptcy—are brought into the estate through the trustee's strong-arm powers.\(^9\) Prior to 1978, the strong-arm provision conferred upon the trustee the status of a judicial lien creditor.\(^10\) The

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6. See id. § 548.
7. See id. § 547.
8. See id. § 544.
9. See id.
Bankruptcy Code enacted in 197811 expanded the trustee’s status to include that of a bona fide purchaser of real property.12 It is the trustee’s status as a bona fide purchaser of real property that this Comment addresses.

Some courts have interpreted the bona fide purchaser status to allow the trustee to bring into the bankruptcy estate property to which the debtor acquired title through fraud.13 To the extent that the purpose of bankruptcy laws is to sort out claims against the debtor’s property, this interpretation is indefensible. Property acquired through fraud is not the debtor’s property, and a court does not further the purpose of the bankruptcy laws by including such property in the estate. Similarly, including the assets in the estate does not further the goal of providing a “fair and equitable” distribution of the debtor’s assets to those with claims against the debtor. Equating the fraud victim’s claim to a voluntary creditor’s claim to property which, by all rights belongs to the victim, is neither fair nor equitable.

B. The Problem

The tension between § 541 and § 544 originated with the pre-1984 version of the Code. Prior to 1984, § 541(d) provided that property in which the debtor held only legal and not equitable title became property of the estate under § 541(a) only to the extent of the debtor’s legal title.14 However, § 544 permitted the trustee to bring certain equitable interests that were not held by the debtor into the estate.15 The issues addressed by the courts were whether there was a conflict between § 541(d) and § 544, and, if so, which section prevailed.

Some courts held that § 541(d) prevailed over § 544, reasoning that to hold otherwise would render § 541(d) meaningless.16 According to these courts, Congress could not have meant to allow the trustee to benefit from property that the debtor did not own.17 Other

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13. See, e.g., Belisle v. Plunkett, 877 F.2d 512 (7th Cir. 1989).
14. See Bankruptcy Reform Act, § 541(d).
16. See id. at 705.
17. See Vineyard v. McKenzie (In re Quality Holstein Leasing), 752 F.2d 1009, 1013 (5th Cir. 1985).
courts held that § 541 and § 544 operated independently.\textsuperscript{18} According to these courts, § 541(d) qualifies the trustee’s rights under § 541(a) to succeed to certain property interests of the debtor as of the time of the filing of the bankruptcy petition.\textsuperscript{19} Section 544, in contrast, permits the trustee to bring into the estate property of the debtor which had been improperly transferred notwithstanding the limitations of § 541(d).\textsuperscript{20} Thus, property not brought into the estate under § 541, could be brought into the estate under § 544.\textsuperscript{21}

In Belisle v. Plunkett\textsuperscript{22} the bankruptcy debtor had organized several partnerships to raise funds to purchase a leasehold interest.\textsuperscript{23} Despite acquiring the interest with partnership funds, the debtor recorded the purchase in his own name.\textsuperscript{24} The bankruptcy trustee sought to include the interest in the bankruptcy estate, while the defrauded partners attempted to quiet title in the partnerships.\textsuperscript{25} In analyzing whether the interest was part of the estate, the court noted that courts which had found a conflict between § 541 and § 544 failed to discuss that § 541(d) qualified only § 541(a) and not § 544(a)(3).\textsuperscript{26} The court concluded that because § 541(d) was so limited, there was no conflict between § 541 and § 544(a).\textsuperscript{27} Reasoning that if a bona fide purchaser’s rights came ahead of the true owner, then the trustee would come ahead of the true owner under § 544(a)(3).\textsuperscript{28} Thus, the court held that the trustee could bring into the estate through § 544(a)(3) property acquired by the debtor through fraud.\textsuperscript{29}

The tension between § 541 and § 544 continued after § 541(d) was amended in 1984. In In re Seaway Express,\textsuperscript{30} the bankruptcy debtor had given a security interest in its accounts receivable and inventory, and the proceeds of either, to a lender to secure a line of credit.\textsuperscript{31} The debtor received a parcel of real property as payment

\textsuperscript{18} See In re General Coffee Corp., 828 F.2d at 705.
\textsuperscript{19} See id.
\textsuperscript{20} See id.
\textsuperscript{21} See id.
\textsuperscript{22} 877 F.2d 512 (7th Cir. 1989).
\textsuperscript{23} See id. at 513.
\textsuperscript{24} See id.
\textsuperscript{25} See id.
\textsuperscript{26} See id. at 515.
\textsuperscript{27} See id. at 514.
\textsuperscript{28} See id. at 515.
\textsuperscript{29} See id.
\textsuperscript{30} National Bank of Alaska v. Erickson (In re Seaway Express), 912 F.2d 1125 (9th Cir. 1990).
\textsuperscript{31} See id. at 1126.
from one of its account debtors. The debtor refused to execute a trust deed on the property to the lender. After the debtor declared bankruptcy, the lender asserted that it had an equitable interest in the property, allowing it to remove the property from the estate. The court noted that § 541(d) excluded from the estate equitable interests held by others. However, the court noted further, that § 541(d), as amended in 1984, reached only property included in the estate under § 541(a)(1) and (2). Section 541(d) no longer affected “property brought into the estate by the trustee’s avoidance powers under §§ 541(a)(3)-(7).”

C. A Framework for Analyzing the Bankruptcy Code

The first step in analyzing the Bankruptcy Code is to look at the plain language of the statute. Where the “statutory scheme is coherent and consistent, there generally is no need for a court to inquire beyond the plain language of the statute.” However, the Supreme Court has cautioned: “In expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy.” “The strict language of the Bankruptcy Code does not control, even if the statutory language has a ‘plain’ meaning, if the application of that language ‘will produce a result demonstrably at odds with the intention of its drafters.’”

When Congress amends the bankruptcy laws, it does not write “on a clean slate.” In determining the drafters’ intent, there is a presumption that Congress intended to keep continuity between pre-Code practice and the Bankruptcy Code. Where the language of the statute is ambiguous, there must be some evidence in the legislative

32. See id.
33. See id.
34. See id. at 1127.
35. See id. at 1127-28.
36. See id. at 1128.
37. Id.
history to indicate that Congress had the intent to effect a major change in pre-Code law.\textsuperscript{44}

The steps to follow in analyzing a provision of the Bankruptcy Code can be summarized as: (1) Look at the text of the provision to see if it is ambiguous or is inconsistent with the policies of the Bankruptcy Code; (2) If there is an ambiguity, determine the pre-Code law; and (3) Look to the legislative history of the Code provision for an expressed intent to change the pre-Code law.

This Comment does not follow the Supreme Court rule to look at the text first. Instead, this Comment takes a chronological approach. Part III traces the development of the relevant portions of the pre-Code law. Part IV analyzes the legislative history to determine whether Congress intended to change the pre-Code law. Part V looks at the text of the Bankruptcy Code to determine if the text unambiguously effects a change in the pre-Code law. Because the cases which have interpreted the Code have focused on the text of the Code, Part V looks at the text in the context of these cases. Part V concludes that the text of the Code's strong-arm clause contains some ambiguities, and more importantly, conflicts with the policies of the Bankruptcy Code. Part VI concludes by proposing an amendment to the Bankruptcy Code to address these deficiencies.

III. THE PRE-CODE LAW

A. Pre-1910: The Trustee Stands in the Shoes of the Bankrupt

Congress enacted the first American bankruptcy law in 1800, only to repeal it three years later.\textsuperscript{45} Throughout the nineteenth century, Congress enacted and repealed several bankruptcy statutes.\textsuperscript{46} These early acts defined the property of the estate\textsuperscript{47} very simply as the property or estate of the debtor. For example, the 1800 Act

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\textsuperscript{45} See Act of Apr. 4, 1800, ch. 19, 2 Stat. 19 (repealed 1803).


\textsuperscript{47} The phrase "property of the estate" did not until the Bankruptcy code was enacted. See Commission Report, supra note 2, Pt. II, § 4-601 note 2, at 149. For clarity, this Comment uses the phrase to refer to the property brought under the jurisdiction of the bankruptcy court and available to settle the creditors' claims against the debtor.
\end{footnotesize}
imposed a duty upon the bankrupt to convey and assign his "estate" to the assignee "for the use of all . . . the creditors of such bankrupt."\(^{48}\)

The Bankruptcy Act, of 1898 \(^{49}\) continued this tradition by vesting the trustee "by operation of law with the title of the bankrupt" to six classes of property.\(^{50}\) Among these was all "property which . . . [the debtor] could by any means have transferred or which might have been levied upon and sold under judicial process against him."\(^{51}\) Despite the apparently broad scope of property that the law brought into the estate, the trustee did not in fact succeed to the title of all property that the bankrupt could have transferred by any means. The trustee was vested with title only to the property that the bankrupt could have transferred legally.\(^{52}\)

The trustee had no greater right or title to the property than the bankrupt.\(^{53}\) Under the Bankruptcy Act, the trustee took the debtor's property subject to all valid claims, liens, and equities that existed in the hands of the debtor.\(^{54}\) Property of other persons in the possession of the debtor did not form part of the estate.\(^{55}\) When there was a dispute as to the title of property in the debtor's possession, the trustee could take

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\(^{50}\) See id. § 70a, 30 Stat. at 565-66 (vesting the trustee by operation of law with the title of the bankrupt . . . to all (1) documents relating to his property; (2) interests in patents, patent rights, copyrights, and trade-marks; (3) powers which he might have exercised for his own benefit, but not those which he might have exercised for some other person; (4) property transferred by him in fraud of his creditors; (5) property which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him . . . ; and (6) rights of action arising upon contracts or from the unlawful taking or detention of, or injury to, his property”).

\(^{51}\) Id. § 70a(5), 30 Stat. at 566.

\(^{52}\) See WILLIAM H. OPPENHEIMER, BRANDENBURG ON BANKRUPTCY § 769 (4th ed. 1917).

\(^{53}\) See York Mfg. Co. v. Cassell, 201 U.S. 344, 352 (1906); Hewit v. Berlin Mach. Works, 194 U.S. 296, 302 (1904); Yeatman v. Savings Inst., 95 U.S. 764, 766 (1877) ("[The trustee] takes only the bankrupt's interest in property. He has no right or title to the interest which other parties have therein, nor any control over the same, further than is expressly given to him by the Bankruptcy Act . . . ."


possession, but not title, until the court determined ownership.\textsuperscript{56}

Additionally, the trustee was vested with title to “property transferred by [the bankrupt] in fraud of his creditors.”\textsuperscript{57} Preferential transfers from the bankrupt were considered constructively fraudulent.\textsuperscript{58} Thus, the trustee was given title to property that was transferred in actual fraud of the bankrupt’s creditors, as well as property that was preferentially transferred to certain creditors.\textsuperscript{59}

The only right or title the trustee had to the debtor’s property was acquired under section 70.\textsuperscript{60} If property of the debtor was not within one of the six enumerated categories, then it would not pass to the trustee.\textsuperscript{61} As the trustee was not given title over any other property, no other property could be used to satisfy the claims against the debtor.\textsuperscript{62}

In \textit{Hewit v. Berlin Machine Works}\textsuperscript{63} the debtor purchased two wood-working machines from the creditor and signed two promissory notes that reserved title and right of possession of the property in the seller until the buyer fully paid for the machines.\textsuperscript{64} New York law provided that this conditional sales contract\textsuperscript{65} was “void as against subsequent purchasers, pledgees or mortgagees in good faith” unless it was recorded.\textsuperscript{66} The creditor did not comply with the filing requirements until after the trustee was appointed.\textsuperscript{67} The Court noted that the trustee was not vested with any better right or title to the debtor property than that of the bankrupt.\textsuperscript{68} Because the conditional sales contract was void only as against subsequent purchasers, pledgees, or mortgagees, and not as against the debtor, the contract was valid as against the trustee and, the trustee could not bring the

\textsuperscript{56} See LOVELAND, supra note 28, § 152, at 444.
\textsuperscript{57} Bankruptcy Act, § 70a(4), 30 Stat. at 566.
\textsuperscript{58} See LOVELAND, supra note 54, § 157, at 466.
\textsuperscript{59} See id. §§ 157-160, at 466-78.
\textsuperscript{60} See id. § 175, at 506 (citing Steele v. Buel, 104 F. 968 (8th Cir. 1900); In re McDonnell, 101 F. 239 (N.D. Iowa 1900)).
\textsuperscript{61} See LOVELAND, supra note 54, § 175, at 506.
\textsuperscript{62} See id. § 153, at 460 (“[A]ll goods, property and rights of action properly available for the payment of the bankrupt’s obligations or debts pass to the trustee . . . .”).
\textsuperscript{63} 194 U.S. 296 (1904).
\textsuperscript{64} See Hewit, 194 U.S. at 300.
\textsuperscript{65} Under a conditional sales contract, the seller retains title to the property sold until the purchaser pays the full purchase price, at which time title passes to the buyer. See BLACK’S LAW DICTIONARY 295 (6th ed. 1990).
\textsuperscript{66} Hewit, 194 U.S. at 301 (internal quotations omitted).
\textsuperscript{67} See id. at 301-02.
\textsuperscript{68} See id. at 302.
machinery into the estate. Thus, once the bankruptcy petition was filed against the debtor, the creditors were unable to reach assets which they would have been able to reach if the petition had not been filed.

Interestingly, the attorney for the trustee argued that “[t]he policy of the Bankrupt Act is to clothe the trustee with title as against secret titles, liens and equities . . . and to give the trustee the protection which a purchaser in good faith or a creditor enjoys.” The Court rejected this argument, stating that the trustee “could not claim as a subsequent purchaser in good faith.”

In *York Manufacturing Co. v. Cassell* the Court again faced a conditional sales contract. Mount Vernon Ice, Coal, & Mining Company (“Mount Vernon”) purchased ice-making machinery from York Manufacturing Company (“York”). The contract required installment payments for the machinery, and it stipulated that title to the machinery would not pass to Mount Vernon until the purchase price was paid in full.

The applicable state law provided that, unless a conditional sales contract was filed with the town clerk, the contract would be void as to subsequent purchasers, mortgagees, and creditors. However, failure to file, would not render the contract void as between the parties. Because York never filed the conditional sales contract with the town clerk, the contract, while valid between the parties, was void as to Mount Vernon’s creditors.

After purchasing the machinery, but before it was delivered, Mount Vernon entered into an agreement with two third-parties, Waight and Ames, whereby Waight and Ames became sureties on notes given by Mount Vernon. At the same time, Mount Vernon executed a chattel mortgage to Waight and Ames to indemnify them for becoming sureties. Waight and Ames recorded this mortgage after York delivered and installed the machinery at Mount Vernon, but before Mount Vernon’s creditors filed a

69. *See id.*
70. *Id.* at 298.
71. *Id.* at 303.
72. 201 U.S. 344 (1906).
73. *See id.* at 344.
74. *See id.*
75. *See id.* at 345 & n.1.
76. *See id.* at 351.
77. *See id.* at 345.
78. *See id.* at 345-46.
79. *See id.* at 346.
bankruptcy petition against it.80

When the petition was filed, Mount Vernon had paid only twenty-five percent of the purchase price to York.81 After the adjudication of bankruptcy, York petitioned the court for permission to remove the machinery pursuant to the terms of the contract.82 Waight and Ames argued that they had had no knowledge of the York contract and that their mortgage should be given priority over York's claim.83

The Supreme Court noted that York's failure to file did not render the contract void as between the parties to the contract, York and Mount Vernon, but only as to creditors who had a specific lien on the machinery.84 Because Waight and Ames did not have a lien on the machinery,85 the Court addressed whether the adjudication in bankruptcy was equivalent to a judgment, attachment, or other specific lien upon the machinery.86 The Court stated: "The trustee . . . stands simply in the shoes of the bankrupt and as between them he has no greater right than the bankrupt."87 The Court held that York had the right to take the property.88

The foregoing cases reveal the weakness of the early bankruptcy acts in dealing with secret liens and conveyances. If the debtor had not been adjudged a bankrupt, the secret conveyances would have been ineffective against the bankrupt's creditors. The creditors could have reached the secretly-conveyed property to satisfy their claims.

Once the petition for bankruptcy was filed however, the creditors could no longer pursue the bankrupt's assets—it was the responsibility of the trustee to gather up these assets for distribution to creditors. Because the trustee was vested solely with the title of the bankrupt, and the secret liens and conveyances were effective as to the bankrupt, the conveyances and liens were effective as to the trustee and therefore against the creditors.

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80. See id.
81. See id. at 345.
82. See id. at 346.
83. See id.
84. See id. at 351.
85. See id.
86. See id. at 350-51.
87. Id. at 352.
88. See id. at 353.
B. The 1910 Amendments: The Trustee as Judicial Lien Creditor

In response to *York Manufacturing Co.*, Congress added the strong-arm powers to the Bankruptcy Act in 1910. Congress' impetus was that the result of the *York Manufacturing Co.* holding was that "creditors were prevented from setting aside a conveyance or transfer that might be voidable as to them [under state law], because the bankruptcy court had taken possession." The amendments invalidated, as to the bankruptcy trustee, an "unrecorded instrument [of conveyance] ... which would have been void in the state courts had the property been taken by the assignee or receiver of a state court, or levied upon by attachment or execution from a state court." In short, the amendment was "to prevent the evil of secret liens." As amended, section 47a(2) of the Bankruptcy Act stated:

[T]rustees, as to all property in the custody or coming into the custody of the bankruptcy court, shall be deemed vested with all the rights, remedies, and powers of a creditor holding a lien by legal or equitable proceedings thereon; and also, as to all property not in the custody of the bankruptcy court, shall be deemed vested with all the rights, remedies, and powers of a judgment creditor holding an execution duly returned unsatisfied.

One problem with the initial strong-arm clause was that it was added to section 47a of the Bankruptcy Act, which set forth the "Duties of Trustees." There was, however, no corresponding change to section 70 giving the trustee title to this property. This created a potential conflict. The strong-arm powers were enacted to overcome the limitations of section 70 by bringing into the estate property which was subject to a secret lien or conveyance. If section 70 remained a limitation on the ability to bring property into the estate, then the strong-arm powers would not benefit the estate at all.

Courts recognized the potential conflict between section 47 and section 70 almost immediately but seemed to dismiss it as a minor

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89. See 45 CONG. REC. 2271 (1910) ("On account of the decision in York Manufacturing Company v. Cassell (201 U.S. 344), section 8 of the bill is proposed."); H.R. REP. NO. 61-511, at 6-7 (1910).
90. 45 CONG. REC. 2275 (1910).
91. Id. at 2271.
92. Id. at 2275.
95. See, e.g., *In re Hammond*, 188 F. 1020, 1021 (N.D. Ohio 1911).
drafting error. To overcome the potential conflict, the courts construed the two sections together.\textsuperscript{96} "It cannot be assumed that Congress would have added this amendment to section 47, if the unamended language of section 70 were to operate to neutralize the amendment."\textsuperscript{97}

In 1924 the Supreme Court addressed whether the strong-arm powers allowed the trustee to include in the estate property acquired by the debtor through fraud. \textit{Cunningham v. Brown}\textsuperscript{98} involved six suits brought by the bankruptcy trustee of Charles Ponzi to recover preferential payments.\textsuperscript{99} Ponzi borrowed money, purporting to invest the money in international postal coupons.\textsuperscript{100} Ponzi promised to repay the notes at 150\% of the purchase price in ninety days and at 100\% if the notes were redeemed in less than forty-five days.\textsuperscript{101} Ponzi, in fact, made no investments of any kind and, as each note held to maturity cost Ponzi more than he received, the scheme unraveled.\textsuperscript{102}

The defendants in \textit{Cunningham} were investors who, when the scheme began to unravel, took advantage of Ponzi's offer to pay off the notes at face value.\textsuperscript{103} As a defense to the trustee's suits, the defendants argued that they had rescinded their contracts for fraud and were thus entitled to a return of their money.\textsuperscript{104} The Court rejected this argument stating that the defendants merely took advantage of Ponzi's agreement to pay his unmatured notes at face value.\textsuperscript{105} The Court concluded that the payments to the defendants were clearly preferences which the trustee could avoid.\textsuperscript{106}

The Court also outlined the remedies which would have been available to the defendants had they, in fact, rescinded the contracts for fraud. The defendants "could have followed the money wherever

\textsuperscript{96}See id. at 1021-22.

(It seems that this language might have found a more appropriate place in section 70 of the act; but, however that may be, it is plain that the two sections must now be construed together, and that the trustee can no longer be said to have the limited title of the bankrupt.);

\textsuperscript{97}In re Morris, 204 F. 770, 771 (2d Cir. 1913).

\textsuperscript{98}265 U.S. 1 (1924).

\textsuperscript{99}See id. at 7.

\textsuperscript{100}See id.

\textsuperscript{101}See id. at 7-8.

\textsuperscript{102}See id. at 8.

\textsuperscript{103}See id. at 10.

\textsuperscript{104}See id. at 9.

\textsuperscript{105}See id. at 10.

\textsuperscript{106}See id.
they could trace it and have asserted possession of it on the ground that there was a resulting trust in their favor.” This, the Court stated, would not violate the preference statute “because [the defendants] then would have been endeavoring to get their own money, and not money in the estate of the bankrupt.” Because it was impossible to trace the defendants’ funds, a constructive trust or equitable lien could not have been fastened to the funds. Although the statements are arguably dicta, they clearly expressed the Supreme Court’s opinion that the strong-arm clause did not reach property which the debtor had acquired by fraud.

C. The 1938 Amendments

Congress amended the Bankruptcy Act in 1938, moving the strong-arm clause from section 47a to section 70c because it fit “more logically” in section 70c. Section 70c contained the trustee’s defenses and powers. Congress made minor changes to the text of the strong-arm clause but did not change the substance. However, Congress did make significant changes in the trustee’s authority to void preferential transfers. Essentially, a preferential transfer is a transfer of property by the debtor to a creditor which allows the creditor to receive more than the recipient would have from the bankruptcy estate. Prior to 1938, the trustee could avoid a preferential transfer if the transfer was made less than four months before the bankruptcy petition was filed. The four month period would not expire until four months “after the date of the recording or registering of the transfer, if by law such recording or registering [was] required.”

In Carey v. Donahue the debtor transferred real property to a creditor more than four months before the debtor filed a petition in bankruptcy. However, the deed by which the real property was transferred was not recorded until less than four months before the

107. Id. at 11.
108. Id.
109. See id.
112. See Chandler Act, § 70c, 52 Stat. at 881.
113. See H.R. REP. NO. 75-1409 at 34-35.
116. Id.
117. 240 U.S. 430 (1916).
118. See id. at 432-33.
petition was filed.119 Under the applicable state law, unrecorded deeds were invalid as to subsequent bona fide purchasers but valid as to subsequent creditors.120 The Supreme Court first concluded that the unrecorded deed would have been valid as against the debtor's creditors and was therefore not avoidable under the trustee's strong-arm powers.121 The Court stated that the unrecorded deed would be valid "as against any class of persons represented by the trustee or with whose 'rights, remedies, and powers' he was to be deemed to be vested" under the trustee's strong-arm powers.122

The Court then looked to see whether the transfer was voidable as a preferential transfer. If the transfer was "required to be recorded," as provided in the preference clause, then the transfer would have been a preference. The Court noted that "subsequent purchasers are entirely outside of the purview of the bankruptcy act."123 Additionally, the Court stated that the restriction to transfers which are required to be recorded should not be taken as "an artificial one by which the rights of creditors are made to depend upon the presence or absence of local restrictions adopted . . . in the interest of others."124 The Court concluded that a transfer is required to be recorded if it is required to be transferred for the protection of creditors.125

In several other cases, the Supreme Court similarly interpreted the preference clause very restrictively.126 In Bailey v. Baker Ice Machine Company127 the debtor purchased machinery under a conditional sales contract more than four months before the bankruptcy petition was filed.128 The contract was recorded less than four months prior to the petition being filed.129 Under applicable state law, a conditional sales contract was void as against a creditor who fastens a lien on the property before the contract is recorded.130 Because no

119. See id. at 433.
120. See id.
121. See id. at 434.
122. Id.
123. Id. at 438.
124. Id.
125. See id.
127. 239 U.S. 268 (1915).
128. See id. at 269.
129. See id. at 270.
130. See id. at 275.
creditor had fastened a lien on the property prior to the bankruptcy petition, the Court held that the transfer could not be voided as a preference. The Court also held that since the trustee obtained the status of a lien creditor on the date the bankruptcy petition was filed, which was after the contract was recorded, the transfer could not be avoided under the trustee's strong-arm powers.

Congress amended the preference clause in 1938 to address the restrictions of these cases. The amendment provided that a transfer was deemed to have been made "when it became so far perfected that no bona-fide purchaser from the debtor and no creditor could thereafter have acquired any rights in the property so transferred superior to the rights of the transferee."

When the 1938 amendments were being considered, concern was expressed that the trustee's role under the Bankruptcy Act was to protect creditors and not purchasers, and that giving the trustee such status would have a fatal effect on many methods of secured financing. Proponents of the amendment felt that such concern was unwarranted based on prior Supreme Court decisions. As was to turn out, the critics' concern was warranted.

In Corn Exchange National Bank & Trust Company v. Klauder, a bank had made loans to the debtor and, at the same time, taken an assignment of the debtor's accounts receivable as collateral. Under applicable law, the failure to give notice of the assignment to the account debtors would allow a subsequent good-faith assignee who gives such notice to acquire a right superior to the bank. Neither the bank nor the debtor gave notice of the assignment to the debtors whose accounts were taken as security. Reading section 60 literally, the Court stated: "[Section 60's] apparent command is to test the effectiveness of a transfer, as against the trustee,

131. See id. at 276.
132. See id.
134. Chandler Act, § 60a, 52 Stat. at 869.
135. See Amending the Bankruptcy Act (Sections 60 and 70): Hearings on H.R. 2412 and H.R. 5834 Before the Subcomm. on Bankruptcy and Reorganization of the House Comm. on the Judiciary, 80th Cong. 7 (1948) (statement of Milton P. Kupfer, Chairman, ABA Committee on Amendment of Section 60a, Bankruptcy Act) [hereinafter Hearings on Amending the Bankruptcy Act I].
136. See id. at 8.
137. 318 U.S. 434 (1943).
138. See id. at 435.
139. See id. at 436.
140. See id. at 434.
by the standards which applicable state law would enforce against a
good-faith purchaser. Because notice was not given, the transfer
was not perfected under state law and the transfer was not effective
under section 60 as to the trustee. The transfers were deemed to
have occurred immediately prior to the filing of the bankruptcy peti-
tion. Thus, the Court held that the assignments were preferential
transfers which the trustee could avoid.

D. The 1950 Amendments

The 1938 amendments went beyond remedying the problems
created by the Supreme Court. The amendments, by giving the
trustee in the status of a bona fide purchaser, invalidated many oth-
erwise valid liens, acquired in good faith and for value. One of the
drafters of the 1938 amendments to the preference clause was Profes-
sor MacLachlan of Harvard Law School. In hearings on the 1950
amendments, Professor MacLachlan expressed his opinion that the
1938 amendments had overreached their original purpose. The
drafters of the 1938 amendments were relying on the courts application
of a strict construction to the Bankruptcy Act. In interpreting
the 1938 amendments, the courts instead took a liberal view of the
word “purchaser.” Professor MacLachlan stated: “I cannot see the
theoretical justification for allowing the trustee to take advantage of
the rights of the bona fide purchaser, because he is just not a bona
fide purchaser.”

In drafting the 1950 amendments, Congress sought to accomplish

141. Id. at 436-37 (footnote omitted).
142. See id. at 437.
143. See id.
144. See id.
146. See id.
147. See Discharge of Taxes in Bankruptcy: Hearing on S. 976 (H.R. 3438) Be-
fore the Senate Comm. on Finance, 89th Cong. 52 (1965) (Statement of James A.
MacLachlan); Revision of the Bankruptcy Act: Hearing on H.R. 6439 and H.R.
8046 Before the House Comm. on the Judiciary, 75th Cong. 120-31 (1937). In the
1937 Hearings, Professor MacLachlan’s last name is given as McLaughlin. Pro-
fessor MacLachlan formally changed his name in 1948. See Amending the Bank-
ruptcy Act (Sections 60 and 70): Hearings Before Subcomm. No. 2 of the House
Comm. on the Judiciary, 81st Cong. 55 (1949) (statement of James A. MacLach-
lan) [hereinafter Hearings on Amending the Bankruptcy Act II].
148. Hearings on Amending the Bankruptcy Act II, supra note 147, at 49.
149. See id.
150. See id.
151. Hearings on Amending the Bankruptcy Act II, supra note 147, at 54.
the objectives of the 1938 amendments but "eliminate the evil of allowing a trustee in bankruptcy to take the position of a potential and artificial bona fide purchaser, and restore him to the position of a lien creditor, in harmony with his functions under the Bankruptcy Act."\textsuperscript{152} Section 60a was amended to differentiate between a transfer of real property and a transfer of other types of property. A transfer of property other than real property was deemed to occur when no subsequent lien holder could obtain superior rights.\textsuperscript{153} Because commercial financing transactions did not usually involve real property, the reference to "bona fide purchaser" was not changed for transfers of real estate.\textsuperscript{154} Transfers of real property were still deemed to occur when a bona fide purchaser could not obtain rights superior to the transferee.\textsuperscript{155}

IV. THE LEGISLATIVE HISTORY OF THE BANKRUPTCY CODE

A. The Commission Bill

The trustee's strong-arm powers remained essentially unchanged until the Bankruptcy Reform Act of 1978\textsuperscript{156} ("Bankruptcy Code" or "Code"). The Bankruptcy Code was the first comprehensive overhaul of the bankruptcy laws in eighty years.\textsuperscript{157} As might be expected in an undertaking of this magnitude, the process took time. The transition was gradual, with the proposed bills going through many revisions and incarnations.

Congress began the process of reforming the Bankruptcy Act in 1968.\textsuperscript{158} First, Congress established a commission to study the then-existing bankruptcy laws ("Bankruptcy Commission" or "Commission").\textsuperscript{159} The Commission submitted its report, containing a draft of a proposed bill ("Commission Bill"), to Congress on July 31, 1973.\textsuperscript{160} The Commission Bill was introduced in the 93rd Congress

\textsuperscript{152} H.R. Rep. No. 81-1293, at 6.
\textsuperscript{153} See Act of Mar. 18, 1950, ch. 70, § 60a, 64 Stat. 24, 25.
\textsuperscript{154} See Hearings on Amending the Bankruptcy Act II, supra note 147, at 53.
\textsuperscript{155} See id.
\textsuperscript{158} See S.J. Res. 100, 90th Cong., 2d Sess. (1968).
\textsuperscript{160} See Commission Report, supra note 2.
as House Bill 10792 and Senate Bill 2565.\textsuperscript{161} The National Conference of Bankruptcy Judges disagreed with many of the provisions of the Commission Bill and proposed an alternative bill (the "Judges Bill"). The Judges Bill was introduced in the 93rd Congress as House Bill 16643.\textsuperscript{162} While the Commission Bill and the Judges Bill differed in many aspects, they both contained essentially the same provisions regarding the property of the estate and the trustee's strong-arm powers.\textsuperscript{163}

1. Property of the estate

The Commission Bill's definition of property of the estate was derived from section 70a of the Bankruptcy Act.\textsuperscript{164} However, because the Commission sought to remedy some of the problems in the Bankruptcy Act, the Commission Bill departed from the Bankruptcy Act in several regards.

The Bankruptcy Act relied heavily on state law to define the property interests which became part of the estate.\textsuperscript{165} This resulted in the application of inconsistent standards to different interests to determine whether the property became part of the estate.\textsuperscript{166} Generally, the trustee was vested with title to property that the debtor could transfer or was leviable under state law.\textsuperscript{167} However, certain rights of action would only pass to the trustee if they were subject to judicial process.\textsuperscript{168} Other property interests would pass to the trustee regardless of transferability or vulnerability to creditor's process.\textsuperscript{169}

Relying on state law often led to illogical distinctions in the treatment of property. For example, if a debtor's interest in a future estate was transferable, it passed to the trustee and could be sold

\textsuperscript{161} See 119 CONG. REC. 33,430 (1973) (introduction of House Bill 10792); id. 33,795 (introduction of Senate Bill 2565).
\textsuperscript{162} See 120 CONG. REC. 30,969 (1974) (introduction of House Bill 10792).
\textsuperscript{163} See Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary, 94th Cong., app. at 163-87 (1976) (comparing the text of House Bill 31 and House Bill 32). Because the Commission Bill and the Judges Bill were very similar with regard to the property of the estate and the strong arm provisions, this Comment discusses only the Commission Bill.
\textsuperscript{164} Commission Report, supra note 2, pt. II, § 4-601 note 1 at 148.
\textsuperscript{165} See id. pt. I, at 15.
\textsuperscript{166} See id. at 15-16.
\textsuperscript{168} See Bankruptcy Act, § 70a(5); see also Commission Report, supra note 2, pt. I, at 16.
even if its value was minimal and the hardship on the debtor was unconscionable. At the same time, a valuable interest in an estate by the entirety that was not severable under state law did not pass to the trustee. Relying on state law also resulted in inconsistent treatment of property in different states. Because each state had its own property laws, certain categories of property would become part of the estate in one state but not in another.

To remedy these problems, the Commission recommended that "[t]he property of the estate be defined in the act comprehensively and that the tests of transferability and leviability under state law be abandoned." The Commission defined property of the estate to have a broad sweep. The Commission Bill stated: "The following is property of the estate: (1) all property of the debtor as of the date of the petition . . . (3) property recovered pursuant to section 4-603 to 4-608 inclusive and section 4-610 . . .." Section 4-603 dealt with property of the debtor in the hands of a custodian. Sections 4-604 through 4-608 contained the trustee's avoidance powers.

2. The strong-arm clause

As to the strong-arm power, the Bankruptcy Commission stated: "One of the essential features of any bankruptcy law is the inclusion of provisions designed to invalidate secret transfers made by the bankrupt prior to the date of filing the petition . . .." The Commission recommended that the strong-arm clause be continued with "simplifying language" and language which clarified that the trustee's rights and powers were not affected by the trustee's or any of the creditors' knowledge about the transfers to be avoided.

The strong-arm clause of the Commission Bill, section 4-604, essentially carried over the strong-arm clause from section 70c of the Bankruptcy Act. The trustee was vested with "the rights and
powers of a judicial lien creditor of the debtor and of a creditor with an execution returned unsatisfied against the debtor.\textsuperscript{181}

The Commission did, however, make some changes to the strong-arm clause. In the Bankruptcy Act, the trustee was given the rights and powers of a creditor who obtained a judgment on the date of bankruptcy.\textsuperscript{182} This status was discarded in the Commission Bill because the Commission deemed it unnecessary.\textsuperscript{183} The Bankruptcy Act also provided that “a transfer . . . valid in part against the creditors whose rights and powers are conferred upon the trustee . . . shall be valid to a like extent against the trustee.”\textsuperscript{184} This clause was intended to preserve the part of a security interest that was perfected as to some but not all of the collateral.\textsuperscript{185} Because the trustee only had the power as a hypothetical judicial lien creditor to avoid the unperfected part, the “saving clause” of the Bankruptcy Act was deemed unnecessary.\textsuperscript{186} The Commission Bill made clear that the trustee’s status was purely hypothetical and was not affected by the knowledge of the trustee or any of the creditors.\textsuperscript{187}

\textbf{B. House Bill 6}

The Commission Bill and the Judges Bill, in various incarnations, were the subject of extensive hearings in both the House and Senate.\textsuperscript{188} These hearings resulted in the drafting of single bill, House Bill 6,\textsuperscript{189} which was introduced in the 95th Congress.\textsuperscript{190} House Bill 6 contained substantial organizational changes from the prior bills and introduced the Bankruptcy Code’s structure and numbering scheme.

\begin{footnotesize}
\begin{enumerate}
\item[181.] \textit{Id.} § 4-604(a), at 160-61.
\item[185.] \textit{See} Commission Report, \textit{supra} note 2, pt. II, § 4-604 note 2, at 160.
\item[186.] \textit{See id.} (citing Frank R. Kennedy, \textit{The Bankruptcy Amendments of 1966}, 1 \textit{GA. L. Rev.} 149, 169-70 (1967)).
\item[187.] \textit{See id.} § 4-604 note 3, at 161.
\item[188.] \textit{See 1 Resnick \& Wypyski, \textit{supra} note 157, Preface.} Despite the scope of these hearings, very little light was shed on the operation of the strong-arm and property of the estate provisions.
\item[189.] H.R. 6, 95th Cong. (1977).
\item[190.] \textit{See} 123 \textit{Cong. Rec.} 125 (1977).
\end{enumerate}
\end{footnotesize}
1. The property of the estate

House Bill 6 included some minor changes to the "property of the estate" provision which made the language more specific. Prior bills had simply stated that "[t]he following is property of the estate" and then enumerated the property which became part of the estate.\(^{191}\) Section 541 of House Bill 6 stated that the commencement of a bankruptcy case creates an estate and "[s]uch estate is comprised of the following property."\(^{192}\) Additionally, instead of the general statement that the estate includes "[a]ll property of the debtor,"\(^{193}\) House Bill 6 used the more specific statement that the estate includes "all legal or equitable interests of the debtor in property."\(^{194}\)

Earlier bills had included in the estate "[p]roperty recovered pursuant to [the trustee's avoidance powers]" by directly referring to the sections of the bill containing those avoidance powers.\(^{195}\) House Bill 6 instead included in the estate "[a]ny interest in property that the trustee recovers under section ... 550."\(^{196}\) Section 550 then gave the trustee the power to recover property if the transfer of that property was avoided pursuant to the trustee's avoidance powers.\(^{197}\)

2. The strong-arm clause

During hearings on Senate Bills 235 and 236, Professor Vern Countryman noted that the proposed strong-arm clause permitted the trustee, as the representative of the creditors, to only avoid transfers which were avoidable by an unsecured creditor.\(^{198}\) Professor Countryman noted that the Uniform Commercial Code and most state real estate perfection laws do not protect unsecured creditors.\(^{199}\) The trustee would, therefore, be unable to avoid transfers pursuant to the strong-arm clause. Although there is no legislative history to so indicate, Professor Countryman's concerns appear to have worked their way in to the strong-arm clause of House Bill 6.

\(^{191}\) See, e.g., H.R. 31, 94th Cong. § 4-601(a) (1976).
\(^{192}\) H.R. 6, § 541(a).
\(^{193}\) H.R. 31, § 4-601(a).
\(^{194}\) H.R. 6, § 541(a)(1).
\(^{197}\) See id. § 550.
\(^{198}\) See The Bankruptcy Reform Act: Hearings on S. 235 and S. 236 Before the Subcomm. on Improvements in Judicial Mach. of the Senate Comm. on the Judiciary, 94th Cong. 1040 (statement of Vern Countryman) (1975) [hereinafter Hearings on The Bankruptcy Reform Act].
\(^{199}\) See id. (Statement of Vern Countryman)(citing IV AMERICAN LAW & PROPERTY § 17.9 (Casner ed. 1952)).
The strong-arm clause of House Bill 6 granted the trustee “rights and powers,” as well as the ability to “avoid any transfer of property of the debtor or any obligation incurred by the debtor.” House Bill 6 also added to the trustee’s status as a hypothetical creditor, the status of a bona fide purchaser of real property.

There is little legislative history to explain these changes to the strong-arm clause. The only explanation for the addition of the trustee’s status as a bona fide purchaser is that it is new. The explanation for the addition of the trustee’s avoidance powers is similarly cryptic: “The avoiding powers under section 544(a)(1), (2), and (3) are new.”

C. House Bill 8200

After further amendments and additional technical, drafting, and style corrections, House Bill 6 was re-introduced in the 95th Congress as House Bill 8200. After further amendments, House Bill 8200 would eventually be enacted into law as the Bankruptcy Code.

Senate Bill 2266, a bill analogous to House Bill 8200, was introduced in the Senate. The Senate added section 541(e) to Senate Bill 2266 which provided:

Notwithstanding the provisions of subsection (a) of this section [541] and section 544, a mortgage secured by real property, or an interest in such a mortgage sold by the debtor but of which the debtor has retained legal title for the purpose of servicing, or supervising the servicing of, the mortgage or an interest therein shall be deemed property held by the debtor for the benefit of the owner or holder of such mortgage or interest therein and shall not become property of the estate.

The Senate Committee report stated that this new section “confirms the current status under the Bankruptcy Act of bona fide secondary

200. H.R. 6, § 544(a).
201. See id. § 544(a)(3).
209. S. 2266, 95th Cong. § 541(e) (1978).
mortgage market transactions as the purchase and sale of assets.\textsuperscript{210} The report also stated that this section "makes clear that the seller's retention of the mortgage documents and the \emph{purchaser's decision not to record} do not impair the asset sale character of secondary mortgage market transactions."\textsuperscript{211}

The strong-arm powers would normally allow the trustee to recover any unrecorded transfer of an interest in real property.\textsuperscript{212} The proposed amendment would thus have acted as an absolute exemption to sections 541 and 544 for secondary mortgage market transactions. The Senate subsequently substituted the text of Senate Bill 2266 into House Bill 8200.\textsuperscript{213}

The House moved the Senate's section 541(e) to section 541(d) and amended it to read:

Property in which the debtor holds . . . only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a) of this section [541] only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.\textsuperscript{214}

While the Senate version was a narrowly tailored exception for the secondary mortgage market, the House version excepted from the property of the estate all property where "the debtor holds . . . only legal title and not an equitable interest."\textsuperscript{215} Section 541(d) appeared to act as a restriction on the strong-arm powers also.

When introducing this amendment to House Bill 8200, Representative Edwards explained that this provision "reiterates the general principle that where the debtor holds bare legal title without any equitable interest, that the estate acquires bare legal title without any equitable interest in the property."\textsuperscript{216} This would appear to indicate


\textsuperscript{211} \textit{Id.} at 84, \textit{reprinted in} 1978 U.S.C.C.A.N. at 5870 (emphasis added).

\textsuperscript{212} See Richard B. Levin, \textit{An Introduction to the Trustee's Avoiding Powers}, 53 AM. BANKR. L.J. 173, 175-76 (1979); \textit{supra} Part III.B.2.


\textsuperscript{214} 124 CONG. REC. 32,363 (1978).

\textsuperscript{215} Id.

\textsuperscript{216} 124 CONG. REC. 32,399 (1978) (Statement of Don Edwards upon introducing the House amendment to the Senate amendment to House Bill 8200).
that the House intended section 541(d) to emphasize that section 541(a) was limited by its own terms as to which property interests it brought into the estate.

The strong-arm clause was originally enacted because the trustee’s power over the estate property was limited to the same power the debtor had. The House amendment, thus, appeared to negate the trustee’s strong-arm powers. However, Representative Edwards further explained:

Thus, as section 541(a)(1) clearly states, the estate is comprised of all legal or equitable interests of the debtor in property as of the commencement of the case. To the extent such an interest is limited in the hands of the debtor, it is equally limited in the hands of the estate...

Representative Edwards’ reference to section 541(a)(1) indicates that the new section was intended to only limit the property included in the estate under this section. Such an application is consistent with the Bankruptcy Act, in which the trustee’s title to property was limited to that of the debtor, but through the strong-arm clause the trustee was able to bring into the estate interests that the debtor’s creditors could reach.

F. The 1984 Amendments

Congress apparently became aware of the textual conflict between § 541(d) and § 544 shortly after passing the Bankruptcy Code. In 1979, just one year after Congress passed the Bankruptcy Code, a bill was introduced in the Senate to correct technical errors and clarify the Code. That bill addressed the “inevitab[e] errors and omissions” and was “basically one of technical and conforming type amendments that... reflect the congressional intent that may not always have been clear regarding the Code.” In 1980, the House version of this bill proposed to amend § 541(d) by “inserting ‘(1)’ immediately after [the] ‘(a)’.” When finally enacted into law in 1984, the amendment was modified slightly so that § 541(d) referred to “§ 541(a)(1) or (2)” and

217. See supra Part III.B.2.
218. 124 CONG. REC. 32,399 (1978) (Statement of Don Edwards upon introducing the House amendment to the Senate amendment to House Bill 8200) (emphasis added).
221. 126 CONG. REC. 26,489 (1980).
not just § 541(a)(1), as originally introduced.\textsuperscript{222}

The amendment to § 541(d) was intended to "make[] clear the cross-reference with respect to which property of the debtor becomes property of the estate."\textsuperscript{223} As amended, "the exclusion of equitable interests from the estate, as required by § 541(d) applies only to the estate considered \textit{ab initio}."\textsuperscript{224}

V. THE TEXT OF THE BANKRUPTCY CODE

A. Section 541: The Property of the Estate

Section 541(a) of the Bankruptcy Code defines the property of the estate as "comprised of all the following property, wherever located and by whomever held."\textsuperscript{225} Section 541(a) then enumerates seven categories of property which comprise the estate. The two categories of import to this Comment are "all legal or equitable interests of the debtor in property as of the commencement of the case,"\textsuperscript{226} and "[a]ny interest in property that the trustee recovers under section \ldots 550 \ldots of this title."\textsuperscript{227}

In \textit{Belisle v. Plunkett}\textsuperscript{229} the court concluded that property could enter the estate through sections of the Bankruptcy Code other than § 541.\textsuperscript{229} The Bankruptcy Act conveyed title of the debtor's property to the trustee by operation of law.\textsuperscript{226} Instead of conveying title to the trustee, the Bankruptcy Code simply provided that certain property became property of the estate. The legislative history of the Bankruptcy Code reveals that this change was only grammatical and was not a change in what property was property of the estate. Therefore, for the \textit{Belisle} decision to be correct the text of the Bankruptcy Code must show an unambiguous change in the prior law.

The key to this determination is the term "comprise". \textit{Comprise} is synonymous with \textit{include}.\textsuperscript{231} There are, however, minor differences

\textsuperscript{223} H.R. REP. NO. 96-1195, at 16 (1980).
\textsuperscript{225} 11 U.S.C. § 541(a) (1994).
\textsuperscript{226} \textit{Id.} § 541(a)(1).
\textsuperscript{227} \textit{Id.} § 541(a)(3).
\textsuperscript{228} 877 F.2d 512 (7th Cir. 1989).
\textsuperscript{229} \textit{See id.} at 515.
\textsuperscript{230} \textit{See Bankruptcy Act of 1898, ch. 541, § 70a, 30 Stat. 544, 565.}
between the two: "Comprise usually implies that all of the components are stated.... Include... more often implies an incomplete listing." 232 When one wants to make clear that the listing is exhaustive, however, the use of comprise [instead of include]... will avoid ambiguity." 233 This distinction between include and comprise is consistent with their usage in the Bankruptcy Code.

In the Bankruptcy Code include is not limiting. 234 While the use of include may indicate that all of the components are listed, it is not necessarily so. In American Surety Co. v. Marot 235 the Court stated: "It is plain that 'shall include'... cannot reasonably be read to be the equivalent of 'shall mean' or 'shall include only.'" 236 American Surety involved the distinction between "include" and "mean" in the Bankruptcy Act. 237 The Court's conclusion, however, applies equally to the distinction between include and comprise: "When the section as a whole is regarded, it is evident that these verbs are not used synonymously or loosely, but with discrimination and a purpose to give to each a meaning not attributable to the other." 238

That Congress did not mean include when it used the term comprise is further evidenced by the number of times Congress used include and comprise in the Bankruptcy Code. Include appears in seventy-four sections of the Bankruptcy Code. 239 However, there is only a single use of comprise. 240 Thus, looking at the Bankruptcy Code as a whole, it is evident that Congress did not use these verbs synonymously.

The court's conclusion in Belisle may be because of § 541(d). In Belisle the court applied the pre-1984 version of § 541(d) which stated that property in which the debtor holds only legal but not equitable title becomes part of the estate under § 541(a) only to the extent of

232. Id.
233. Id.
237. Id. at 516-17.
238. Id. at 517.
239. Search of LEXIS, Genfed Library, USCODE File (Sept. 23, 1997) (search for records containing "TITLE 11" in the HEADING field and "INCLUD!" in the TEXT field).
240. Search of LEXIS, Genfed Library, USCODE File (Sept. 23, 1997) (search for records containing "TITLE 11" in the HEADING field and "COMPRIS!" in the TEXT field).
UNTWISTING THE STRONG-ARM

the legal title. If § 541(a) is the sole means by which property enters the estate, property interests which the trustee recovers pursuant to the strong-arm powers become property of the estate under § 541(a)(3). The pre-1984 version of § 541(d) would have negated the strong-arm clause. Therefore, the court faced a dilemma: either § 541(d) did not mean what it said or § 541(a) was not the sole means by which property could enter the estate. The Belisle court, like a majority of courts, concluded the latter.

The 1984 amendments appear to have cured the conflict between § 541(d) and § 544. However, courts, relying on the pre-1984 cases, still permit property to enter the estate outside of § 541(a). Courts must recognize the constraints under which the pre-1984 courts were operating in interpreting § 541. Those constraints no longer apply, and the pre-1984 cases should not be relied on as valid precedent.

The text of § 541(a) clearly indicates that it is an exhaustive list of property interests which become the bankruptcy estate. To the extent that there is an ambiguity in the text of the Code, the pre-Code law and the legislative history of the Bankruptcy Code lead to the same conclusion—§ 541(a) is the exclusive means by which property can enter the bankruptcy estate.

B. Section 544: The Strong-Arm Clause

The strong-arm clause of the Bankruptcy Code, § 544, provides:

The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—(1) a creditor that obtains...a judicial lien on all property on which a creditor on a simple contract could have obtained...a judicial

241. See Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 541(d) (codified as amended at 11 U.S.C. § 541(d) (1994)). The pre-1984 version of § 541(d) provided:

Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, becomes property of the estate under subsection (a) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

Id. (emphasis added).

242. See infra Part V.B.

243. See In re General Coffee Corp., 828 F.2d 699, 705 (11th Cir. 1987).

244. See, e.g., National Bank v. Erickson (In re Seaway Express Corp.), 912 F.2d 1125 (9th Cir. 1990).
lien...; ...or (3) a bona fide purchaser of real property...
from the debtor, against whom applicable law permits such
transfer to be perfected. ...245

To focus on those portions of § 544 that are relevant to the trus-
tee's status as a bona fide purchaser of real property, § 544 can be
rewritten as:
The trustee shall have the rights and powers of, or may
avoid any transfer of property of the debtor or any obliga-
tion incurred by the debtor that is voidable by a bona fide
purchaser of real property from the debtor, against whom
applicable law permits such transfer to be perfected, that
obtains the status of bona fide purchaser and has perfected
such transfer at the time of the commencement of the case.

In short, § 544(a) grants the trustee certain authority that is de-
ferred from certain hypothetical categories of persons.246 The analysis
that follows is divided into two issues. First, what is the trustee's
authority? Second, from what category of persons is it derived?

1. The trustee's authority

In the Bankruptcy Act, the strong-arm clause stated that the
trustee has the "rights and powers" of certain creditors.247 These
rights and powers included the power to avoid transfers. The Bank-
ruptcy Code gives the trustee, in addition to certain rights and pow-
ers, the ability to "avoid transfers."248 The legislative history of the
Bankruptcy Code does not reveal any clear intention of Congress to
change the trustee's strong-arm powers.249 Since the Bankruptcy
Code specifically conferred upon the trustee the ability to void trans-
fers, the trustee's rights and powers under the Code do not appear to
include the avoidance powers; otherwise the clause that gives the
trustee the ability to avoid transfers would be superfluous.
The use of "or" in defining the scope of the trustee's authority
indicates that the trustee may either exercise the rights and powers of
a bona fide purchaser or avoid a transfer that is voidable by a bona

245. 11 U.S.C. § 544(a) (1994). Although not relevant to this Comment, the
strong-arm clause also gives the trustee the rights and powers of a creditor with a
writ of execution on the debtor's property, see id. § 544(a)(2), and the power to
avoid transfers of interests in the debtor's property that an unsecured creditor
could avoid under non-bankruptcy law. See id. § 544(b).
246. Id. § 544(a).
249. See supra Part IV.
fide purchaser or both. The "power to avoid any transfer of prop-
erty of the debtor that is voidable by a bona fide purchaser is in ad-
dition to the trustee's... position of having the 'rights and powers' of a
bona fide purchaser." Generally, the courts seem to agree with this
rule when considering the trustee's status as a lien creditor.

However, the courts reach different results when they consider
the trustee's bona fide purchaser status. In In re Mill Concepts
Corp. the court noted that the trustee's rights and powers were
separate from the trustee's ability to avoid transfers insofar as the
trustee's status as a creditor. However, the court concluded that
the trustee's rights and powers had no application to the trustee's
bona fide purchaser status. This conclusion is inconsistent with the
text of § 544. Section 544 grants the trustee the rights and powers of
three categories of persons, and the ability to avoid transfers which
are voidable by these categories of persons.

In Belisle v. Plunkett, the court also recognized that the
grant of rights and powers to the trustee and the grant of the ability
to avoid transfers were separate grants. As to the trustee's
bona fide purchaser status, the court stated: "Section 544(a)(3)
allows the trustee to have a bona fide purchaser's rights or avoid a
transfer, so a 'transfer' by the debtor cannot be a necessary
condition of the exercise of the strong-arm power."

The apparent argument of the Belisle court is that if a bona fide
purchaser would have taken the property free of a claimed interest,
then the trustee's rights and powers as a bona fide purchaser include

5963, 6272 ("If a party 'may do (a) or (b),' then the party may do either or
both.").
251. In re Granada, Inc., 92 B.R. at 505; see also In re Mill Concepts Corp., 123
B.R. 938, 941 (Bankr. D. Mass. 1991) ("It also seems apparent from the wording
and placement of commas that the grant of 'rights and powers' and the grant of
the ability to avoid a transfer are separate grants.").
252. See, e.g., Belisle v. Plunkett, 877 F.2d 512, 515 (7th Cir. 1989) ("Section
544(a)(3) allows the trustee to have a bona fide purchaser's rights or avoid a
transfer... "); In re Mill Concepts Corp., 123 B.R. at 941 ("It... seems appar-
ent from the wording and placement of commas that the grant of 'rights and
powers' and the grant of the ability to avoid a transfer are separate grants.").
254. See id. at 941.
255. See id. at 941-42 ("Use of 'or' solidifies the existence of the single avoid-
ance function of subparagraph (3).").
256. 877 F.2d 512 (7th Cir. 1989).
257. See id. at 515.
258. Id.
the power to take the property free of that claim. Under such an interpretation, the trustee would have no need to avoid transfers of property.259 The text of the strong-arm clause which specifically gives the trustee the power to avoid transfers would therefore be superfluous.

2. The scope of the trustee’s authority

The scope of the trustee’s authority is defined with respect to three categories of persons. The first two categories, carried over from the Bankruptcy Act, give the trustee the status of certain hypothetical creditors.260 The third category, contained in § 544(a)(3), is that of a bona fide purchaser of real property from the debtor.261 By giving the trustee a status that the trustee did not have under the Bankruptcy Act, Congress has clearly made a change from the Bankruptcy Act. The question becomes: By how much did Congress intend to change the law?

Under § 544(a)(3) the trustee’s authority is that of “a bona fide purchaser of real property . . . from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case.”262 In Belisle the court concluded that a transfer of property was not a necessary condition to the trustee’s exercise of the strong-arm power.263 The court stated: “The statute mentions ‘transfer’ only in the sense of the hypothetical transfer that measures the trustee’s rights.”264 The court’s statement only refers to the hypothetical transfer to the trustee. But the trustee’s status as hypothetical bona fide purchaser is qualified as a bona fide purchaser “against whom applicable law permits such transfer to be perfected.”265 Thus, § 544(a)(3) presumes two transfers: a transfer to the trustee as a bona fide purchaser, and a transfer against which the trustee’s status is measured.

The necessity of transfer by which to judge the trustee’s status is

259. For example, assume the debtor sold a parcel of real property to a purchaser, but the transfer was not recorded. If the debtor then sells that same parcel to a bona fide purchaser, the second purchaser would take the property free of the first purchaser’s claim.
261. See id. § 544(a)(3).
263. See supra Part V.B.1.
264. See Belisle, 877 F.2d at 515.
shown in In re Michael. The debtors in In re Michael had not yet recorded a declaration of homestead under state law at the time they filed their bankruptcy petition and did not list their home as exempt property in their bankruptcy filing. After their debt was discharged, the debtors recorded a declaration of homestead and attempted to amend their bankruptcy filing to list their home as exempt property. If the debtors had transferred their home to a bona fide purchaser, that purchaser would take the home free of all homestead rights. The trustee argued that his status as a bona fide purchaser allowed him to defeat the homestead exemption. The court held that since it was impossible for the debtor to perfect the homestead exemption against a subsequent purchaser, § 544(a)(3) prevented the trustee from defeating the homestead exemption.

In reaching its conclusion, the court stated that “section 544(a)(3) permits the trustee to assume the status of a bona fide purchaser with respect to a particular transfer only if ‘applicable law permits such transfer to be perfected’ against a bona fide purchaser.” The court stated: “It is clear that in enacting [§ 544(a)(3)], Congress intended to prevent the trustee from using his powers as bona fide purchaser to defeat interests which by their very nature could never be perfected against such a purchaser . . . .”

Under Belisle, the trustee’s rights and powers as a bona fide purchaser allows the trustee to defeat claims which a bona fide purchaser could defeat. Since a bona fide purchaser would take the property free of the homestead exemption, the trustee would do the same. In re Michael shows that it is not sufficient to simply say that the trustee is a bona fide purchaser and that a transfer of the debtor’s property is not required. The text of § 544(a)(3) requires a transfer of the debtor’s property against which to determine the trustee’s bona fide purchaser status.

The trustee’s avoidance powers in § 544(a) specifically refer to a transfer. The reference to a transfer in § 544(a)(3) does not therefore pose a problem. But the trustee’s rights and powers as a bona fide purchaser are the rights and powers of a bona fide purchaser, against

266. Michael v. Martinson (In re Michael), 49 F.3d 499 (9th Cir. 1995).
267. See id. at 500.
268. See id.
269. See id. at 501.
270. See id.
271. See id. at 502.
272. Id. at 501.
273. Id. at 502 (emphasis added).
whom such a transfer can be perfected. Without a reference to a transfer in defining the trustee’s rights and powers in § 544(a), there is no transfer against which to determine the trustee’s rights and powers as a bona fide purchaser. The text of § 544(a), thus, presents a question: Is a transfer required for the trustee to exercise the rights and powers of a bona fide purchaser?

VI. PROPOSED AMENDMENT TO THE BANKRUPTCY CODE

This Comment demonstrates that trustee’s strong-arm powers preclude including in the estate property acquired by the debtor through fraud. Courts should recognize the mistakes made by courts in applying the strong-arm powers and not repeat them, or rely on them as precedent. Instead courts should follow the dictates of the Supreme Court. This requires looking at the pre-Code and then determining whether the legislative history or the text of the Bankruptcy Code indicates a change in the law.

But it is not sufficient to merely hope that courts will apply a correct analysis in future cases. Congress must amend the Bankruptcy Code to make clear that the trustee’s bona fide purchaser status can only be used to recover, for the benefit of the estate, property interests transferred by the debtor. To accomplish this, the following amendments are suggested.

A. The Property of the Estate

When the Bankruptcy Act was first enacted, a single section defined the property that became the estate and the trustee’s powers with respect to that property. When the strong-arm clause was enacted this changed. The trustee’s strong-arm powers were contained in a section that defined the trustee’s duties, as opposed to the trustee’s rights with respect to property. This discrepancy was subsequently corrected and, once again, a single section of the Bankruptcy Act defined the property of the estate and the trustee’s rights and powers with respect to property which was, or was to become, part of the estate.

In the Bankruptcy Code, the property that becomes the bankruptcy estate is defined in a section separate from the section that defines the trustee’s rights and powers with respect to property.

274. See supra Part III.A.
275. See supra Part III.B.
276. See supra Part III.C.
277. See supra Part V.
However, the two sections remain inextricably linked. The Code specifically defines the estate to include property recovered pursuant to the trustee’s avoidance powers, including the strong-arm powers.  

That § 541 is the sole means by which property becomes part of the bankruptcy estate is also evidenced by the text of the Code. Section 541 provides that the estate “is comprised of” the enumerated interests. The use of “comprise” indicates that the list is exhaustive—any property interest not contained in the list does not become part of the estate.

Despite the unambiguous text of § 541, courts have continually held that property can enter the estate through provisions other than § 541. To provide guidance to these courts, § 541(a) should be amended to clearly reflect that § 541(a) is the “only” section of the Code by which property becomes part of the estate.

Additionally, § 541 must be amended to address the status of property acquired by the debtor through fraud. Prior to the enactment of the Code, courts held that property acquired by the debtor through fraud did not become part of the estate. The trustee’s title as derived from the debtor was subject to the claims of the rightful owner. The trustee’s rights and powers of the strong-arm clause were limited to those of a hypothetical judicial lien creditor and were held not to allow the trustee to bring into the estate property acquired by the debtor through fraud.

The Bankruptcy Code, by giving the trustee the status of a bona fide purchaser, created a problem. A bona fide purchaser would be able to acquire the property fraudulently acquired by the debtor free of the claims of the rightful owner. Thus, the trustee’s new status as a bona fide purchaser potentially conferred the same rights on the trustee. To clearly indicate that Congress did not intend for the Code to change the pre-Code law, § 541(b) should be amended to specifically except from the estate property acquired by the debtor through fraud.

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279. See id. § 541(a).
280. See supra Part V.A.
281. See id.
283. See id.
284. See id.
285. See supra Part II.B.
To achieve these results, the following amendments are suggested.²⁸⁶

§ 541. Property of the estate.
(a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. "Such estate is comprised of all comprises only the following property, wherever located and by whomever held:

(b) Property of the estate does not include—

(5) any interest of the debtor in real or personal property acquired by the debtor through fraud.

B. The Strong-Arm Clause

When Congress amended the strong-arm clause to confer on the trustee the status of a bona fide purchaser, the strong-arm clause extended far beyond its original purpose, which was to permit the trustee to avoid secret liens and conveyances of the debtor's property.²⁸⁷ This is analogous to what occurred when the preference clause of the Bankruptcy Act was amended so as to define when a transfer occurred in terms of when a bona fide purchaser could no longer defeat the interest transferred.²⁸⁸ Congress recognized the implications of the amendments to the preference clause and corrected it.²⁸⁹ This same correction is now required upon the text of the strong-arm clause.

The trustee's strong-arm powers under the Bankruptcy Act were limited to those rights of a judicial lien creditor.²⁹⁰ The Code expanded these powers to encompass the rights and powers of a bona fide purchaser.²⁹¹ Since a bona fide purchaser from the debtor would take the property interest acquired by the debtor through fraud free of the claims of the rightful owner, the trustee arguably has the same right. However, the legislative history of the Code indicates that the

²⁸⁶. The recommended amendments set out the text of the current statute. Text in the current statute which is to be removed is stricken out and text to be added is italicized.
²⁸⁷. See supra notes 89-92 and accompanying text.
²⁸⁸. See supra Part III.C.
²⁸⁹. See supra Part III.D.
²⁹⁰. See supra Part III.
trustee’s bona fide purchaser status was added because creditors were being denied remedies inside of bankruptcy that they had available outside of bankruptcy. Giving the trustee the rights and powers of a bona fide purchaser, goes further than necessary to protect the legitimate interests of creditors.

The text of § 544 should be limited to reflect that the trustee’s rights and powers as a bona fide purchaser are limited to those that a creditor could exercise outside of bankruptcy. To achieve this end, the trustee’s abilities as a bona fide purchaser should be limited to avoiding transfers that a bona fide purchaser can avoid. By limiting the trustee’s powers as a bona fide purchaser of real property to avoiding transfers, the trustee will be able to recovery property interests conveyed by unperfected transfers. If, however, the debtor has acquired an interest in real property by fraud, the trustee would not be able to bring the remaining interests in that property into the estate since the possessors of those interests did not acquire them by a transfer from the debtor.

To accomplish these goals, § 544 should be amended to read:

§ 544. Trustee as lien creditor and as successor to certain creditors and purchasers.
(a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any other creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—
(1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;
(2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists;
(3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits

292. See supra Part IV.B.2.
such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.

(b) The trustee may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.

(b)(c) The trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

VII. CONCLUSION

The Bankruptcy Reform Act of 1978 was a comprehensive revision of the United States' bankruptcy laws. It was not, however, created in a vacuum. Its roots go back for centuries. Certainly, things have changed since the early Roman days when "the creditors might cut the debtor's body into pieces, and each of them take his proportionable share" and the bankruptcy laws must evolve as times change.

The courts must recognize changes in the law. But the past cannot simply be discarded because the words may have changed. The courts which have further victimized fraud victims have done so by attempting to interpret the text of the Bankruptcy Code without taking into consideration the history behind the Code.

The strong-arm powers were enacted "to preserve but not to enlarge the rights of creditors." The extension of the strong-arm powers in 1978 to confer on the trustee the status as a bona fide purchaser of real property should be read in light of this principle.

The history of the strong-arm clause and the property of the es-

293. William Blackstone, Commentaries 472.
tate clause clearly show that property the debtor acquires by fraud cannot be used to settle the claims against the debtor. The strong-arm powers should not be extended to give creditors remedies inside of bankruptcy that are not available outside of bankruptcy, at the expense of innocent third-parties who would be protected outside of bankruptcy.

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