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A TRUSTEE IN BANKRUPTCY AS A JUDGMENT CREDITOR

I. INTRODUCTION

Congress has been attempting to eliminate secret liens under the bankruptcy act for years. The battle has once again been joined over the question of whether a trustee in bankruptcy is a judgment creditor within the meaning of section 3672 (a) of the Internal Revenue Code. Although Congressional intent appears to clearly indicate that he is, the question has been brought into sharp focus by several recent decisions.

In the case of *In Re Green*,¹ the United States District Court of Alabama reviewed the certificate of Stephen B. Coleman, Referee in Bankruptcy, and held that he erred in avoiding the United States lien for taxes established by the Internal Revenue Code of 1954 section 3670² because a trustee in bankruptcy is not a judgment creditor within the meaning of section 3672(a)³ of the Code.

¹ 124 F. Supp. 481 (N.D. Ala. 1954)

² INT. REV. CODE OF 1954, § 3670, hereinafter cited as code, which reads as follows:

§ 3670. Property subject to lien

"If any person liable to pay tax neglects or refuses to pay the same after demand, the amount (including any interest, penalty, additional amount, or addition to such tax, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person."

³ INT. REV. CODE OF 1954, § 3672 (a) which reads as follows:

§ 3672. Validity against mortgagees, pledgees, purchasers, and judgment creditors:

(a) Invalidity of lien without notice. Such lien shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed by the collector. . . .

(1) Under State or Territorial laws. In the office in which the filing of such notice is authorized by the law of the State or Territory in which the property subject to the lien is situated, whenever the State or Territory has by law authorized the filing of such notice in an office within the State or Territory; or

(2) With clerk of district court. In the office of the clerk of the United States, district court for the judicial district in

The court stated that the words judgment creditor as used in section 3672(a) were used in the usual, conventional sense of a judgment of a court of record, and that if the trustee in bankruptcy is endowed with the status of a judgment creditor, it would have to come from the provisions of section 70(c) of the Bankruptcy Act.⁴ The court indicated that since Congress did not state in clear and appropriate language in section 70(c) that the trustee was a judgment creditor and since Congress did not add trustee in bankruptcy to the categories of persons described in the Code section 3672(a), Congress did not intend to make a trustee a judgment creditor within the purview of that section.

II. INTERPRETATION OF CONGRESSIONAL INTENTION

A. BY EXAMINATION OF LEGISLATIVE REPORTS

One method of determining Congressional intent is to examine the Legislative Reports. The second sentence of section 70(c) of the Bankruptcy Act⁵ called the "strong-arm clause", first appeared in the act in 1910. It was inspired by the holding in *York Manufacturing Co. v. Cassell*⁶ that the trustee took only the same title as that of the bankrupt, and bankruptcy was declared not to operate as a judgment or attachment.

which the property subject to the lien is situated, whenever the State or Territory has not by law authorized the filing of such notice, in an office within the State or Territory; or

(3) With clerk of District Court of the United States for the District of Columbia. In the office of the Clerk of the District of Columbia, if the property subject to the lien is situated in the District of Columbia.

⁴ 11 U. S. C. § 110 (C) (1952) which reads as follows:

"The trustee may have the benefit of all defenses available to the bankrupt as against third persons, including statutes of limitation, statutes of frauds, usury, and other personal defenses; and a waiver of any such defense by the bankrupt after bankruptcy shall not bind the trustee. The trustee, as to all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt could have obtained a lien by legal or equitable proceedings at the date of bankruptcy, shall be deemed vested as of such date with all the rights, remedies, and powers of a creditor then holding a lien thereon by such proceedings, whether or not such a creditor actually exists."

⁵ *Supra* note 4.

⁶ 201 U. S. 344 (1906).

Congress added an amendment to the Bankruptcy Act⁷ which stated that the trustee was vested with all the rights, remedies, and powers of a creditor holding a lien by legal or equitable proceedings, as to property coming into custody of the court, and the rights of a judgment creditor to that property not coming into court.⁸

The draftsman wrote a note explaining the amendment stating that the *York* case gave an advantage to holders of unrecorded liens. He stated: "It is this evil and the injustice worked upon creditors who rely upon the debtor's apparent ownership against which the bankruptcy law has set its face."

In 1938 the "strong arm clause" of section 47 (a) (2) was recast as part of section 70 (c), but the substance was not changed.¹⁰ The "strong-arm clause" was revised again in 1950 so that the trustee was given the rights, remedies, and powers of a creditor holding a lien by legal or equitable proceedings, as to all property of the bankrupt whether any such creditor actually existed or not.¹¹

The house report¹² explaining the bill stated that the amendment was placed in the bill for the protection of trustees in bankruptcy giving them the position of a lien creditor with respect to all the property, and to some extent expand the general expression of the rights, of trustees in bankruptcy.

This puts the trustee in a stronger position where under the state law an execution creditor could not prevail against a prior lien or transfer, even though improperly recorded, or where under state law a transferee or lienor, in spite of imperfections in the transfer which would otherwise be fatal, can prevail over a subsequent judgment execution creditor if the transferee has taken prior possession. In his former capacity as judgment creditor the bankruptcy trustee would not have had superior rights to the lien improperly recorded or an imperfect transfer. However, in his present capacity as a creditor holding a lien by legal or

⁷ At this time the "strong-arm clause" of the bankruptcy act was cited at § 47 (a) (2).

⁸ 36 Stat. 838 (1910).

⁹ 45 CONG. REC. 2277 (1910).

¹⁰ H. R. REP. NO. 12889, 74th Cong., 2d Sess. 288 (1936); and H. R. REP. NO. 1409, 75th Cong., 1st Sess. 3435 (1937).

¹¹ Public Law 461, 81st Cong. (S.88).

¹² H. R. REP. NO. 1293, 81st Cong. 1st Sess. 4 (1949).

equitable proceeding the trustee's title is superior. The 1952 amendment¹³ merely simplified section 70 (c), clarified its meaning, and made it conform to the amended section 60 (a).¹⁴

It is apparent then from the legislative reports that the amendment was intended to expand the trustee's powers, not contract them, and if the 1910 amendment had given the trustee the power of a judgment creditor and Congress intended to expand the trustee's power, then the term "judgment creditor" was intended to be included within the bounds of the phrase "creditor holding a lien by legal or equitable proceedings."

B. BY COMPARISON TO OTHER SECTIONS OF THE ACT

Another method of determining what Congress intended by the words "creditor holding a lien by legal or equitable proceedings" is to see how those words are used in other sections of the act. It is desirable, and presumably in accord with the intention of Congress that different parts of the statute be given similar construction unless the context shows affirmatively that a different construction was intended.¹⁵

The court in *Sampsell v. Straub*¹⁶ used this type of reasoning in construing section 70 (c) of the Bankruptcy Act as applied to the California Homestead Law and held that a trustee in bankruptcy attained the same status as a California judgment creditor who had voluntarily recorded his abstract of judgment. The court found that the phrase "legal or equitable proceedings" was used in section 3 (a) (3) and section 67 (a) (1) to include "judgement creditors." Section 3 (a) (3) makes it an act of bankruptcy for an insolvent person to permit any creditor to obtain a lien through legal proceedings, and not discharge it within 30 days. And section 67 (a) makes any such lien voidable if obtained within four months before bankruptcy. Both sections are designed to prevent creditors of the bankrupt who had no preference in the normal course of business from later obtaining a lien by legal proceedings.

Congress wanted to maintain equality among the general creditors after insolvency, and under the California statute which

¹³ Public Law 456 (S.2234) 82d Cong. 2d Sess.

¹⁴ H. R. REP NO. 2320, 82d Cong., 2d Sess. 16 (1952).

¹⁵ For situations in which such differing constructions are affirmatively indicated see Rutledge J., concurring in *Nat. Mut. Ins. Co. v. Tidewater Transfer Co.*, 337 U. S. 582, 604 (1949).

¹⁶ 194 F.2d 288 (9th Cir. 1951).

provides that a "judgment or decree becomes a lien" upon the filing of the abstract of judgment, this policy would be violated just as much if the general creditor should be given a lien by obtaining a judgment and recording it, as if he should get similar preference by obtaining a judgment alone. So the only reasonable construction of the phrase "by legal or equitable proceedings" as used in these two sections is that which includes a California judgment lien among liens obtained by legal proceedings, even though to create the lien it has to be recorded.

Section 70 (c) is employed to protect general creditors of the bankrupt against secret liens. The trustee enjoys the rights of a creditor who has levied attachment on the bankrupt's property and the lien given in California to a judgment creditor who has recorded his judgment also prevails over secret liens. So the trustee's assertion of this status of a California judgment lienor would be consistent with section 70 (c) of the Bankruptcy Act. Section 70 (c) then permits the inclusive conception of liens by legal proceedings which the policy of sections 3 (a) (3) and 67 (a) require. The court goes on to say, if section 67 (a) included the judgment lien and section 70 (c) did not, a judgment creditor who actually recorded his abstract of judgment within four months of the debtor's bankruptcy, his lien, though voidable under section 67 (a) could be preserved and asserted by the trustee for the benefit of all creditors as a claim superior to the debtor's subsequently recorded homestead exemption. While on the other hand if no such lien actually existed, or if it had been obtained more than four months before bankruptcy, the trustee would have no such power to override a tardily recorded homestead exemption, under the rights of a hypothetical creditor given to him by section 70 (c).

Therefore, in this situation the trustee's powers under section 70 (c) measured by what a creditor might have done, would be less than his powers measured by what some creditor actually had one, if there had not been an intervention of bankruptcy. This does not seem to be the intention of Congress because section 70 (c) as was pointed out in the report explaining the section is to stop secret liens, and other impediments of the debtor's property, and give the trustee the status of a diligent general creditor. Thus there is a good argument for consistency in the construction of equivalent phrases of the Bankruptcy Act.¹⁷

By research into the general intention of Congress under section 70 (c) of the Bankruptcy Act and by research as to what

¹⁷ Accord, *McKay v. Trusco Fin. Co.*, 198 F.2d 431 (5th Cir. 1952).

the words "legal or equitable proceedings" meant in other sections of the act it is clear that Congress intended that the trustee have more power than he formerly had as a "judgment creditor" and that the term "legal or equitable proceedings" was intended to include within its fold the term "judgment creditor". This reasoning is axiomatic when the judicial process that is necessary to obtain a lien is considered.¹⁸

Assuming that the trustee is a judgment creditor the next question presented is whether Congress in section 3672 (a) of the Internal Revenue Code intended "judgment creditor" as there used to include a trustee in bankruptcy who obtains this title through the Bankruptcy Act.

III. TRACING SECTION 3672 (a) OF THE INTERNAL REVENUE CODE

The forerunner to sections 3670 and 3672 (a) provided that if a person neglected or refused to pay any tax after demand, the amount became a lien in favor of the United States at the time the collector got the assessment list.¹⁹ The court in *United States v. Snyder*²⁰ held that the statute gave a valid binding lien even against a bona fide purchaser for value without knowledge or notice of the existence of such a lien. So Congress amended the statute in 1912 and added:

. . . that such lien shall not be valid as against any mortgagee, purchaser, or judgment creditor until notice of such lien shall be filed by the collector. . . .²¹

The house report that accompanied the proposed amendment,²² stated that the lien is so comprehensive that it covers all the property of the delinquent, and a person who took title would have to ascertain whether any person, who had owned the real estate has ever been delinquent in the payment of taxes. It was

¹⁸ In re Calhoun Supply Co., 189 Fed. 537 (N.D. Ala. 1911).

¹⁹ 20 Stat. 327, 331 (1879) which reads as follows:

"If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount shall be a lien in favor of the United States from the time when the assessment-list was received by the collector, except when otherwise provided, until paid, with the interests, penalties, and costs that may accrue in addition thereto, upon all property and rights to property belonging to such person."

²⁰ 149 U.S. 210 (1893).

²¹ 37 Stat. 1016 (1912).

²² H. R. REP. NO. 1018, 62d Cong. 2d Sess. 2 (1912).

pointed out that this was an impossible task since the business carried on under the Internal Revenue Code may be a great distance from the property affected by the secret lien.

In 1939 the Act was amended to include pledgees, and in 1954 section 3672 (a) of the Internal Revenue Code was transferred to section 6323 (a) without substantial change, so the meaning of the term "judgment creditor" as used in section 6323 (a) has not been changed since 1912.

It has been held that the term "judgment creditor" is used in section 3672 (a) of the Internal Revenue Code in the usual, conventional sense of a judgment of a court of record.²³ However, in *In Matter of Sport Coal Co.*,²⁴ the court stated that in West Virginia a chose in action owned by a corporation is subject to a lien. To effect such a lien, it is necessary that the creditor obtain a judgment, cause a writ of execution to be issued thereon and delivered to the executing officer. Before a creditor could have obtained a lien by legal or equitable proceedings on a chose in action, he first must have recovered a judgment. The words "such proceedings", as used in section 70 (c) of the Bankruptcy Act means whatever proceedings are necessary to enable the creditor to effect a lien on the property involved. So the trustee is vested with all the rights of a judgment creditor who has caused execution to be issued and delivered to the proper officer. The case was reversed by the United States Court of Appeals because the United States, before the taxpayer's bankruptcy, had served notice of the tax lien on the taxpayer's debtor. But they left open the question of what rights the United States would have had if such rights were dependent upon the inchoate lien on all property created by sections 3670 and 3672 (a) of the Internal Revenue Code.²⁵

If the reasoning of the court in the *Sport* case is correct, then if the state law includes in its proceedings a requirement that to obtain a lien by "legal or equitable proceedings" he must first have obtained a judgment, the trustee who became a "judgment creditor" under section 70 (c) of the Bankruptcy Act would have become so by fulfilling the requirements of this section. He has

²³ *United States v. England*, 226 F.2d 205 (9th Cir. 1955). See also: *In re Taylorcraft Aviation Corp.*, 168 F.2d 808 (6th Cir. 1948). *In re Ann Arbor Brewing Co.*, 110 F. Supp. 111 (E. D. Mich. 1951), where the courts held that a trustee in Bankruptcy was not a judgment within § 3672 (a) of the Code without discussing the point.

²⁴ 125 F. Supp. 517 (S.D. W. Va. 1954).

²⁵ *United States v. Eiland*, 223 F.2d 118 (4th Cir. 1955).

in fact been given a judgment of a court of record as used in the conventional sense of the word. The state court that would have issued the judgment was merely stated to have done so by the bankruptcy statute and if Congress has by its act in effect given a result which ordinarily would have required court action, the process of the court proceedings has been complied with.

IV. STATUTORY CONSTRUCTION

The court in the principal case, *In re Green*, has construed the term "judgment creditor" very narrowly, as used in section 3672 (a) of the Internal Revenue Code. They have in effect held that the congressional intent in the bankruptcy statute to make the trustee a "judgment creditor", is not within the meaning of this section because, even though the congressional act includes a procedure that would entail a judgment by the court, the court itself has not acted.

The court suggested in its closing paragraphs that there are social and economical problems presented by its holding, but that these problems will have to be taken up before the legislature. This statement is a conclusion based upon the reasoning of the case, used to justify the holding. The court was not actually compelled to its decision here, as the intent of Congress is expressed in many ways other than the literal words used in a specific act, and since this is a civil statute the court is to apply liberal construction.²⁶

A court does not always bind itself to the specific words of a statute if the intent of Congress is indicated to be the contrary. In *Keifer & Keifer v. R. F. C.*²⁷ the court states that it is important to give "hospitable scope" to Congressional purpose even when meticulous words are lacking. In *United States v. Hutchinson*²⁸ the court, while reviewing a penal code, stated that legislation must not be read in a spirit of mutilating narrowness, and here examined three statutes together to find Congressional intent.

The courts, in some cases, have even supplied words Congress has omitted²⁹, or employed Congressional intent when the statute has read to the contrary.³⁰ And in the case of *Martin v. Robson*,³¹

²⁶ *Miller v. Robertson*, 266 U.S. 243 (1924).

²⁷ 306 U.S. 381, 391 (1939).

²⁸ 312 U.S. 219 (1941).

²⁹ *Supra* note 27.

³⁰ *Holy Trinity Church v. United States*, 143 U.S. 457 (1892).

³¹ 65 Ill. 129 (1872).

the court determined the intention of Congress from a group of statutes showing the Congressional trend in lawmaking when no statute had been enacted on the specific point under consideration.

V. SUMMARY AND ANALYSIS

As indicated from its reports Congress' primary intention under the Bankruptcy Act was to do away with the evil of secret liens. The situation here presented is certainly another example of a secret lien. The creditor has difficulty evaluating the debtor's financial position since he usually gets his information from commercial reports or other credit information, or from the debtor's own statements. Tax claims are usually not limited as other debts, so solvent debtors through fraud or neglect may obtain large tax obligations which do not appear on the books or financial statements. The tax claims often cannot be determined even by diligence on the part of the creditor, because the claim may not have been discovered at the time of the loan or may have been unliquidated. Thus the creditor is acting at his peril.

If the federal government is then not required to file its tax lien to be valid against "judgment creditors" as created by the bankruptcy act the tax may actually amount to a tax on the creditor, who did not incur the debt and could not even know of its existence. A court in holding that a trustee is not a judgment creditor within the meaning of section 3672 (a) defeats the very purpose for which Congress adopted the Bankruptcy Act.

The 1912 amendment to the Internal Revenue Code was added so that a person taking title was not subject to the impossible task of ascertaining whether a person who owned real estate had at any time been delinquent in paying his taxes. Congress felt that it was inequitable for the statute to provide that section 3670 constitutes notice. This amendment along with the amendment in 1939 which added pledgees to the list of exceptions, after the courts had construed the former statutes strictly, shows that Congress was trying to relieve the burden of a harsh rule of law laid down by section 3670.

VI. CONCLUSION

The Creditors of the bankrupt are in the same situation as the purchaser of real estate; they are harmed inequitably by secret liens, so they are certainly within the spirit if not the letter, of the law Congress intended to adopt.

Why should the court now again construe the statute strictly in the face of the spirit of congressional intent and require Congress to again amend the act?

Duane Mehrens, '61