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The Status of Creditors in Bankruptcy Administration in Kentucky

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THE STATUS OF CREDITORS IN BANKRUPTCY ADMINISTRATION IN KENTUCKY

Is it too bold to announce that in a bankruptcy administration in the Federal Courts in Kentucky, that the line drawn by the Kentucky Courts, between creditors antecedent and subsequent, to the execution and delivery of an unrecorded chattel mortgage, will be disregarded? That is, that an unrecorded chattel mortgage which is not good against subsequent creditors without notice, will also fail against antecedent creditors, whether or not such antecedent creditors have secured any equity in the mortgaged property by way of attachment, execution, levy, or the like. From our study of the situation, we are constrained to take this position.

In view of the decisions of the Court of Appeals of Kentucky, and the decisions of the United States Circuit Court of Appeals for the Sixth Circuit, our position, at first blush, may seem somewhat startling, but a careful reading of the State and Federal cases, we think, will sustain our views.

There can be no doubt that the rule in Kentucky is now, and has been for more than half a century last past, that an unrecorded mortgage is not good against subsequent creditors without notice, but is good against all antecedent creditors who have not secured some equity in the property at some time prior to the recording of the mortgage.

It is almost needless for us to sustain this pronouncement of the Kentucky rule by the citation of authorities, but some of the more recent Kentucky cases on this subject are:

Mason & Moody v. *Scruggs*, 207 Ky. 66.
Evans v. *Wheeler*, 208 Ky. 1.
Stone v. *Keith*, 218 Ky. 11.
Goodin & Barney Coal Co., v. *Southern Elkhorn Coal Co.*, 219 Ky. 827.
Farmers Bank v. *Kinslow*, 221 Ky. 627.
Sears v. *Cane*, 242 Ky. 702.

It will be remembered that Section 496 of the Kentucky Statutes, often referred to as the Kentucky Recording Act, was amended in 1916. Prior to the amendment, that Section provided that—

"No deed, or deed of trust, or mortgage, conveying a legal or equitable title to real or personal estate shall be valid against a purchaser for valuable consideration, without notice thereof, or against creditors, until such deed or mortgage shall be acknowledged or proved according to law and lodged for record."

This Section was amended in 1916 by the addition of the following:—

"The word creditors as used herein shall include all creditors irrespective of whether or not they have acquired a lien by legal or equitable proceedings or by voluntary conveyance."

As shown by the above cited Kentucky authorities, the Court of Appeals has continued to construe the Section, as amended, with reference to creditors, in the same manner as the Section had been construed prior thereto, that is, to divide "all" creditors into the two classes, namely, subsequent creditors without notice, and antecedent creditors who have failed to obtain some equity in the mortgaged property.

It is interesting to note that this Section (496) as amended in 1916, reached the United States Circuit Court of Appeals for the Sixth Circuit for construction, prior to the time it reached the Court of Appeals of Kentucky.

The case in which the Section as amended was construed by the United States Circuit Court of Appeals, is the case of *In re Duker Avenue Meat Market,* 2 F. (2d) 699, 5 A. B. R. (N. S.) 407, in which the Federal Appellate Court held that the amendment of 1916 to Section 496, was intended to and did wipe out the distinction between antecedent and subsequent creditors in Kentucky, and held that the rights of the trustee in bankruptcy of the mortgagor, were superior to the rights of the mortagee who held the unrecorded mortgage at the time of bankruptcy, basing its opinion upon its construction of the amended statute to the effect that "all" creditors meant "all" creditors. As above suggested, at the time that the United States Circuit Court of Appeals decided the Duker Avenue Meat Market case, the Kentucky Recording Act as amended had not reached the Kentucky Court of Appeals for construction.

Shortly after the determination of the Duker Avenue Meat Market case, Section 496, as amended, reached the Court of Appeals of Kentucky, in the case of *Mason and Moody* v. *Scruggs,* and the Court of Appeals, although the Statute had been amended, continued to adhere to its construction of the

recording statute, prior to the amendment, and held that "all creditors" in the statute meant subsequent creditors without notice of the unrecorded mortgage, and such antecedent creditors as had secured some equity in the property at some time prior to the recording of the mortgage. This construction, of course, was not in harmony with the holding of the United States Circuit Court of Appeals in the Duker case.

The question went back to the United States Circuit Court of Appeals again in the later case of *In re Frost,* 12 F. (2d), page 1, and even though the *Mason and Moody* v. *Scruggs* case had been decided by the Kentucky Court of Appeals, the Federal Court did not find it necessary to depart from its ruling in the Duker Avenue case, because the filing of the petition in bankruptcy in the Frost case before the mortgage was recorded, gave to the trustee in bankruptcy, representing antecedent creditors of the mortgagor, the necessary equity in the property, at some time prior to the recording of the mortgage, the Federal Court bringing into play the 1910 amendment to Section 47 of the Bankruptcy Act (11 U. S. C. A., Section 75), which amendment placed the trustee in bankruptcy on the footing of a creditor holding a lien by legal or equitable proceedings.

At any rate, the Frost case follows very fine lines of distinction in order not to overrule the prior Duker Avenue case in the same Court, and yet remain within the ruling of the Court of Appeals of Kentucky in *Mason and Moody* v. *Scruggs.*

Then followed the last case in the United States Circuit Court of Appeals construing this same Section of the Kentucky Statutes (496) as amended in 1916, in which last case, to-wit, *In re Gibson* (65 F. (2d) 921-21 A. B. R. (N. S.) 408), the Appellate Federal Court, in the light of the many cases on this subject that had reached the Kentucky Court of Appeals since the Duker Avenue case, modified and overruled the Duker Avenue and the Frost cases, in so far as they might be in conflict with the determination of the subject by the Kentucky Court of Appeals.

In taking the position that it did in the Gibson case, the Appellate Federal Court, it appears, followed the well known rule of construction to the effect that the Federal Courts will, as nearly as possible, adopt such construction of State statutes as

is given such statutes by the respective State Courts of last resort.

It would seem then that in an administration in bankruptcy in the Federal Courts in Kentucky, where a claim is filed by the holder of an unrecorded mortgage, seeking priority in distribution, that we are met with the task of classifying creditors either as antecedent or subsequent to the execution and delivery of the unrecorded mortgage, in order to determine their rights in the proceeds of the sale of the mortgaged property unless such classification is wiped out in a bankruptcy proceeding.

That such classification of creditors in a bankruptcy proceeding is disregarded, irrespective of the State law on the subject, appears to have been concluded by the Supreme Court of the United States in the case of *Moore, Trustee,* v. *Bay,* 284 U. S., page 4, 18 A. B. R. (N. S.) page 675.

The facts in the *Moore* v. *Bay* case are that the bankrupt had executed a chattel mortgage which was admitted to be bad as against creditors who were such at the date of the mortgage, and those who became such between the date of the mortgage and the date on which the mortgage was recorded, there having been a failure to observe certain requirements of a California statute. This case went to the Supreme Court on certiorari from the Circuit Court of Appeals for the Ninth Circuit. Both the District Court in California, and the Circuit Court of Appeals, following the State Court of last resort in California, had held that the mortgage was bad as against certain creditors of the bankrupt, but good as against another class of creditors, and therefore, the rights of the mortgagee were prior to the rights of those creditors against whom the mortgage was good under the State laws.

The Supreme Court in reversing the California Federal Courts said:—

"The trustee in bankruptcy gets the title to all property which has been transferred by the bankrupt in fraud of creditors or which prior to the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him. Act of July 1, 1898, 30 Stat. at L. 565, chap. 541, Sec. 70, U. S. C. title 11, Sec. 110. By Sec. 67, U. S. C. title 11, Sec. 107 (a), claims which for want of record or for other reasons would not have been valid liens as against the claims of creditors of the bankrupt shall not be liens against his estate. The rights of the Trustee by subrogation are to be enforced for the benefit of the estate. The Circuit

Courts of Appeals seem generally to agree, as the language of the Bankruptcy Act appears to us to imply very plainly, that what thus is recovered for the benefit of the estate is to be distributed in "dividends of an equal per centum on all allowed claims, except such as have priority or are secured."

If, as the Supreme Court says, that what thus is recovered for the benefit of the estate is to be distributed in dividends of an equal per centum on all allowed claims, except such as have priority, or are secured, then when an estate comes on to be administered in bankruptcy in the Federal Courts in Kentucky, and the trustee in bankruptcy takes such assets as a subsequent creditor without notice, is not the distinction between subsequent and antecedent creditors wiped out in the bankruptcy administration, and do not the creditors share ratably so far as the unrecorded mortgage is concerned?

It would appear that the Supreme Court has answered this question in the affirmative, when it says that the dividends of an equal per centum are to be distributed on all allowed claims except such as have priority or are secured. The priority referred to necessarily means the priority in distribution in every bankruptcy case, that is, costs, taxes, wage claims, and the like; and the secured claims referred to must be claims secured by mortgages or pledges that meet legal requirements, and claims secured by statutory liens.

Since the *Moore* v. *Bay* case was decided by the Supreme Court, the principal therein ennunciated, to the effect that the rights of the trustee are to be enforced for the benefit of all of the creditors, has been followed in the Circuit Court of Appeals for the Fifth Circuit in the case of *In re Lewis Company,* 62 F. (2d) 353, 22 A. B. R. (N. S.) 427, and by Federal District Courts in Oklahoma, the Southern District of New York, and in the Southern District of California.

The administration of bankruptcy estates in Kentucky, encumbered by chattel mortgage liens, has furnished an interesting study since the passage of the Bankruptcy Act in 1898, and especially has the rule in Kentucky distinguishing between antecedent and subsequent creditors given rise to many difficulties in such administrations. Shall we hope that the Supreme Court's decision in *Moore* v. *Bay,* has solved the problem and relieved a trustee in bankruptcy, in administering his trust

estate, from the Kentucky antecedent and subsequent creditor rule.

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