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Banks and Banking–Insolvency–Preference Against Trust Company Executor for Funds on Deposit at Testator's Death

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Complications of considerable difficulty often arise when a trust company, having trust funds deposited with its own banking department, becomes insolvent. The situation is further complicated if the funds were on general deposit in the banking department at the time the company took over its fiduciary obligations. The Supreme Court of South Carolina recently had to deal with this problem.¹

By his will, J. L. Michie named the People's Bank of Darlington his executor. The testator had on deposit in the bank $8,120.71. This account was changed on the books to the name of the bank as executor. The bank collected assets of the estate, amounting to $763.22, and paid off obligations to the extent of $2,573.78, leaving $6,310.15 of the estate funds in the bank at the

¹*Ex parte* Michie, 165 S. E. 359 (S. C., 1932).
time it failed. The liquid assets in the bank and in the hands of the receiver had always exceeded the amount owed the estate. The new administrator sought to charge the bank as trustee of the claim. A preference was denied on the ground that no trust res had been established.

Preferences have been established in favor of public funds in somewhat analogous situations. In a recent West Virginia case, a county court was allowed a preference in the assets of an insolvent bank for county funds held by the bank in excess of the amount it could legally hold under the statute. The court emphasized both the fact that the case involved public funds and that the bank had violated a positive statute by retaining the excess. These facts probably justify a different result from that reached in the principal case.

The result of the Michie case appears sound. The preference was sought to be predicated upon the trust theory which assumes some sort of a proprietary interest in the fund. Ordinarily, the trust res must be traced into the fund. Pretty clearly no res existed here. The bank merely owed a debt to the estate of the testator. It is fairly well settled that one cannot become trustee of his own debt. If the bank had paid the debt and then received the money as executor, there would have been, at least, a tangible res at the beginning. Such a distinction, though logical, might impress some as wanting in substance. The explanation is the fact that the case is so close to the line in fact that little practical basis for the distinction is discernible. The burden is on the creditors, however, to show an equity superior to the position of general creditors. No attempt was made to impress a trust for

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9 Monongalia County Court v. Bank of the Monongahela Valley, 164 S. E. 695 (W. Va., 1922). For a discussion of this case see page 180.

9 W. Va. CODE ANN. (Barnes, 1923) c. 39, § 50. It is interesting to note that the clause limiting the amount that could be deposited in one depository to $100,000.00 appears to have been entirely omitted by the revisers. See W. VA. REV. CODE (1931) c. 7, art. 6, § 1.


6 Hamer v. Sidway, 124 N. Y. 538, 27 N. E. 256 (1891); Day v. Roth, 18 N. Y. 448 (1858).

7 City of Lincoln v. Morrison, 64 Neb. 822, 90 N. W. 905 (1902); Peurifoy v. Boswell, 162 S. C. 107, 160 S. E. 156 (1931); White v. Commercial and Farmers' Bank, 60 S. C. 127, 38 S. E. 453 (1901). It is conceded that in a meritorious case, the court would be justified in brushing aside the strict
the $763.22 collected by the bank after it became executor. Seemingly that sum was conceded to have been a part of the money used in discharging obligations of the estate.

The court, however, concluded that even if these deposits had been considered the same as money collected and deposited by the bank after it became executor the result would have been the same. It was admitted that an individual trustee could not have so commingled the funds; but the court said a corporate trustee stood on a different footing, in that it could properly deposit trust funds in its own banking department. There is considerable authority in accord with that view. But when it is remembered that such a general deposit necessarily divests the trust funds of their trust character, some rather cogent objections can be found.

It has long been recognized that a trustee may properly deposit trust funds temporarily in a bank so long as he uses reasonable diligence to select a solvent bank and deposits the funds in a separate account. In such case, he is absolved from liability if the bank fails, the beneficiary having only a general claim

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against the closed bank. It would not only be a convenience but also a distinct financial advantage to a trust company to have authority to deposit trust funds in its own banking department. But since this convenience is all on the side of the trust company, even when it is solvent, and more especially when on the verge of insolvency, since then it is under an undoubted temptation to use trust funds to bolster up its own banking department, the rights of the beneficiary deserve careful consideration. He no longer has a disinterested trustee to look after his property. It is no answer to say that the beneficiary could go into equity and have a new trustee appointed or could demand that the funds be transferred to another bank. He usually does not discover the danger until the damage is done.

On principle the corporate trustee should be treated the same as the individual trustee in the matter of preferences. If it has commingled the trust funds with its own funds in its banking department, and they can be traced into the hands of the receiver by any of the recognized methods of tracing which would be employed against an individual trustee under similar circumstances, that cash balance should be impressed with a trust in favor of the beneficiary. It is difficult to justify a theory that permits an officer of a trust company to receive trust funds and then immediately divest the company of its fiduciary responsibility in caring for those funds by depositing the funds with the company itself in a general bank account.

The situation appears to be covered by statute in West Virginia. The statute is broad enough to give a preference in favor of trust funds improperly commingled with other funds of the trust company without any requirement of tracing or following the res.

—George W. McQuain.