An Inequitable Preference in Favor of Surety Companies

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AN INEQUITABLE PREFERENCE IN FAVOR OF SURETY COMPANIES.*—

The case of Central Trust Company v. Bank of Mullens,¹ is the third West Virginia case in which the court by direct decision or dictum has recognized the right of a surety company which underwrites a state depository bond, to be preferred to the general creditors of an insolvent bank.² Indeed this case goes a step further than the previous cases in establishing the right of the surety company by giving the surety company a claim for interest.

*Mr. Wilson Anderson of the Student Board of Editors collected the authorities cited in this note.

¹ 150 S. E. 221 (W. Va. 1929).
² Fidelity & Guaranty Co. v. Central Trust Co., 95 W. Va. 458, 121 S. E. 430 (1923); County Court v. Matthews, 99 W. Va. 483, 129 S. E. 399, 52 A. L. R. 751 (1925). In the last mentioned case the court held that a state may have a prerogative right to a preference but that a county, even though an arm of the state, has no sovereignty and therefore is not entitled to preference on the theory of high prerogative. The following two cases involve essentially the same question. Woodyard v. Sayre, 90 W. Va. 295, 110 S. E. 689, 24 A. L. R. 1497 (1922); Myers v. Miller, 46 W. Va. 595, 31 S. E. 976 (1899). Here the surety on an official bond of a defaulting sheriff claimed the right to be subrogated to the prerogative priority of the state. Both cases held that the state had such prerogative right and that the surety was entitled to be subrogated to that prior right. The Woodyard Case is the leading case on the question of state prerogative in West Virginia and is mainly relied on in the case under discussion.
at six per cent up to the time of payment by the bank, three per cent being preferred. Interest on deposits cease at the time of insolvency, so far as pro-rata distribution is concerned, and such deposits are not allowed the legal rate of interest for money wrongfully withheld. The surety company, on the other hand, is treated better in this respect than the depositor. It appears to have a claim against the assets (as distinguished from a claim against the bank) for six per cent after date of insolvency whereas the depositor gets interest only until insolvency. It is hard to see a reason for this advantage to the Surety. The surety company may also have a preferred claim for three per cent on the theory that the state would have had a prerogative right to that much interest. While objection might be made to allowing the surety company this additional preferred claim for interest, still it is not an illogical addition to the former decisions allowing it a preferred claim.

The question immediately arises, why should a surety company which is supposed to be taking a risk for profit, be permitted to escape that risk through the medium of the device of subrogation to the prerogative right of the state? It is submitted that the West Virginia Supreme Court has relieved the surety company on a depository bond from practically all risk. There are practically no cases in West Virginia where the assets of an insolvent bank were not sufficient to pay at least the preferred claims. The result seems to be one of extraordinary injustice to the general depositors. The state does not need this preference because it is protected by its bond. The bonding company does not need it because it is paid for taking a risk and makes a profit on its business as a whole. Why, then, should it be given this gratuitous present of a large portion of the bank’s assets to the detriment of that deluded class of individuals who think of debts owed to them

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3 It should be noted that there is a difference between allowing interest against the assets and similar allowance against the bank. As against the assets interest is calculated only to the date of suspension and the vesting of title to the assets in the receiver. No interest is allowed thereafter. As against the bank or its stockholders interest will be allowed on all claims from the date of insolvency or suspension. Therefore a suit for interest, or the claim of a creditor, out of surplus assets should be against the stockholders or the bank and not against the receiver. 7 C. J. Banks & Banking, 532, 847, 848; White v. Knox, 111 U. S. 784, 4 S. Ct. 686 (1883); Morse, BANKE'S AND BANKING, Vol. II, p. 1909, par. 250.

4 Bonding companies are not preferred in the case of national banks, nor are they preferred by many state courts. See notes 12 and 13, infra.
by banks as "cash in the bank", and who have no idea of the risks they are taking.5

We can think of only two reasons why a court would want to reach such a result. (1) That they were compelled to do so by inexorable logic; (2) that by giving the bonding company this preference they might accomplish some social or economic advantage, such as a decrease in the premium on bonds. Let us briefly examine these two suppositions.

First, what is the logic of the situation? It seems to have been pretty generally held that a state has a preferred claim against the assets of an insolvent bank because of its royal prerogative. This is based on the historical accident that the King of England had more power than he had any business to have. It has been repeated so often in this country, however, that it may be said to have become "a settled principle of law".6 To say that the state has a prerogative, however, does not necessarily mean that the bonding company has a preferred claim. That result is only reached when we have said that the bonding company is "subrogated" to the rights of the state. Do we have to so hold? Subrogation according to the atmosphere of the familiar generalizations, is supposed to be a doctrine which rests upon the principles of natural equity and good conscience.7 "It will not be ordered when the party claiming it has in fact been reimbursed and has thus sustained no loss".8 If the state had collateral security we would

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5 There is an important difference between depositors in an insolvent bank and general creditors in a business failure. Banks are protected by state banking laws and depositors are encouraged to put their money in banks rather than hoard it by inducing them to believe that a bank deposit is not like a loan. A general creditor of an insolvent bank or a person who lends money on the credit of the debtor should not be classed with a depositor who does not consider that he has loaned money on the credit of anyone.


7 37 Crc. 383; 25 R. C. L. 1311.

8 37 Crc. 370, 371.
have no difficulty in saying that it was fair for the bonding company to get the advantage of that collateral security, because it is not part of the general unpledged assets of the bank which closes. To hand the collateral to the depositors instead of the surety company would be giving them an unexpected windfall. Does it follow, however, that this historical anachronism called a prerogative should be treated as collateral security? Why should the sovereign, in the absence of statutory direction,loan his crown, even temporarily, to a surety company? Of course if we say he has done so that settles the matter, but there is no logical necessity of our saying so. Is it really similar to the ordinary case of equitable subrogation? The West Virginia Supreme Court had very respectable authority behind it when it allowed this subrogation, but that does not necessarily make the result sound.

The highest courts of at least four states have rejected the theory of prerogative right. Other states, while paying lip service to the doctrine of royal prerogative, have denied the surety company claim on the ground that the state has waived its prerogative by requiring security. These cases are just as logical as the West Virginia decision.

There is no such preference given to surety companies when a national bank fails. The reason for the difference is supposed to be the United States Statute which distributes the claims ratably among the creditors. However such a result does not necessarily follow from such a statute because various other kinds of preferred claims, based on trust relationships, are allowed against receivers of insolvent national banks. As a result in West

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9 Supra, n. 6.
Virginia a bonding company takes much less risk in underwriting state deposits for state banks than for national banks.

Let us examine the second ground upon which the preference to the bonding company might be justified, i.e., that it is socially or economically desirable to give the bonding company a preferred claim. Two possible advantages occur to us. (1) That it would make it easier for a state bank to get a depository bond than a national bank. (2) That it would make the rates for depository bonds less for state banks than for national banks.

As to the first there is no evidence that a sound national bank has any more difficulty in getting itself bonded than a state bank. If the decision enables an unsound state bank to get bonds it certainly does not achieve anything worthwhile.

As to the second ground we quote a letter from the Towner Rating Bureau to the secretary of the West Virginia Banking Association, in answer to a request for lower rates on state depository bonds, on account of this preference.

The Towner Rating Bureau of New York recommends the rates for most of the leading surety companies in the United States. The explanation of the Towner Rating Bureau showing why they refused to take this factor into account discloses that the bonding companies feel that the result of giving them a preferred claim is so absurd that they are unwilling to base a rate even on a decision of the Supreme Court. They frankly admit the injustice of the preference given to them. We quote the letter:

TOWNER RATING BUREAU

160 Broadway

New York

May 20, 1927.

West Virginia—State Depository Bonds.

J. S. Hill, Esq.,
Secy., West Virginia Banker’s Association,
Charleston, West Virginia.

Dear Sir:

I have your favor of May 17th instant. Experience has led us to seriously distrust any statute or decision of State Courts which apparently would favor surety companies by making State Deposits preferred claims in case of the failure of the banks. We were

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urged to take this supposed factor into account as contributing to the safety of surety companies on Public Deposits in the States of Mississippi and Iowa. In both States we refused to do so. Depository Bond Underwriters, nevertheless, wrote some Depository Bonds in these States in which they relied on the expectation that the deposits covered by the bond would be preferred deposits in case the bank failed. When the banks failed and the situation was disclosed that very large Public Deposits were protected by corporate surety bonds and application was made to have these deposits preferred as to claims against the assets of the bank there was a great public outcry echoed by all the local newspapers in both States. The result was that the Supreme Court reversed itself and declined to allow any preference and the surety companies had to pay just as though Public Deposits were not preferred. We don't necessarily assert that the result would be perhaps the same in West Virginia, but we think that a supposed or expected preference for any class of deposits is not sufficient ground for making reduced premium on Depository Bonds. Underwriters can take it into account if they want to, and in two cases as I have said, they found themselves leaning on a broken reed.

Sooner or later every State gets away from "preferred" deposits. They are a rank injustice to everyone concerned. They rob the innocent individual depositors in the bank who cannot afford to lose and divert the money which otherwise would be paid to them in order to pay it to the State which can afford to lose better.

14 In Mississippi the question was regarded as settled that that state did not have a prerogative right by the case of Shields v. Thomas, 71 Miss. 260, 14 So. 84 (1893). In 1908 a statute providing for the establishing of state depositories (Laws of Miss. 1908, ch. 96, § 11) was passed by virtue of which it was thought that state funds were preferred. As a result the case of Potter v. Fidelity & D. Co., supra, n. 10, came before the Mississippi Supreme Court. In this case the court reaffirmed its former stand and has maintained this position since in a later decision. The Iowa court has not been so consistent. In the much cited case of In re Marathon Savings Bank, 198 Ia. 696, 196 N. W. 729 (1924) rehearing 198 Ia. 692, 200 N. W. 199, the court held that the Iowa statute was declaratory of the common law (1913 Supp. 3825a) which allowed the state prerogative and that it was not in conflict with the state banking act (Code 1897, Par. 1877). By virtue of an amendment to the State Banking Act (Code 1924, Par. 9130 to 9154) the court took a different stand when the question was again presented in Leach v. Exchange Bank, 200 Ia. 185, 203 N. W. 31 (1925). In this case a preference was denied because of the change in statute. J. Arthur, concurred in the result but was of the opinion that the 1924 statute did not affect the situation and that the Marathon Case had been decided wrongly. Since the Leach Case the Iowa court has maintained its position of not allowing a preferential claim. Leach v. Commercial Bank, 205 Ia. 975, 213 N. W. 517 (1927); Poweshiek Co. v. Merchants Bank, 220 N. W. 63, (Ia. 1928). Both of these were county cases but reaffirmed the former position.
Moreover, if the State will take good corporate surety bonds to protect its deposits it need not have any loss and the individual depositors can then share pro rata with the State in all the assets of the closed bank. We are utterly opposed to any preference of State Deposits. We think them a rank injustice when they are granted and we consider them a mere trap for surety companies to entice them to give suretyship for banks which otherwise might not get it. Then when the bank closes sureties find that they had no preference after all, as recently in Iowa. We are opposed to any reduction of premium on account of supposed preference—by the State or anyone else.

Yours very truly,

R. H. Towner."

The figures of the Banking Commissioner for 1929 show the havoc which these decisions are working among depositors in West Virginia banks. In most instances the preferred claims given to surety companies amounted to about ten per cent of the entire balances. Assuming that the bank paid fifty cents on the dollar, these preferred claims mean that a dividend of five per cent is taken away from depositors and given to surety companies. In the case of Lumberport Bank, which failed on the 27th of August, 1929, the state's claim amounted to more than one-third of the total assets. When we consider the fact that the state in the recent Mullens Bank Case seems by implication to have added to this list of preferred claims all the drafts outstanding we

<table>
<thead>
<tr>
<th>Date Closed</th>
<th>Name of Bank</th>
<th>Total Deposits</th>
<th>State Balances</th>
<th>Other Pref. Trust Claims Allowed</th>
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<tbody>
<tr>
<td>1-21-29</td>
<td>Monongahela Bank $ 477,114.17</td>
<td>41,350.00</td>
<td>3,914.17</td>
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</tr>
<tr>
<td>2-4-29</td>
<td>Peoples Bank of W. Va. 635,618.09</td>
<td>24,433.78</td>
<td>29,063.71</td>
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<tr>
<td>6-6-29</td>
<td>Clarksburg Trust Co. 1,529,246.79</td>
<td>174,379.60</td>
<td>33,665.15</td>
<td>39,604.00</td>
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<tr>
<td>6-22-29</td>
<td>Bank of Jacksonburg 47,407.85</td>
<td>48.98</td>
<td></td>
<td></td>
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<tr>
<td>7-22-29</td>
<td>Tunnelton Bank 304,080.98</td>
<td>62,356.83</td>
<td>2,552.17</td>
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<tr>
<td>8-27-29</td>
<td>Lumberport Bank 147,117.09</td>
<td>49,500.00</td>
<td>394.37</td>
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</tr>
<tr>
<td>9-4-29</td>
<td>Pullman State Bank 128,523.02</td>
<td>56.89</td>
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<tr>
<td>9-6-29</td>
<td>Auburn Exchange Bank 129,378.95</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9-21-29</td>
<td>Bank of Cairo 427,652.34</td>
<td>32,095.63</td>
<td>919.59</td>
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</tr>
<tr>
<td>10-22-29</td>
<td>M. &amp; M. Savings Bank Grafton 459,885.43</td>
<td>6,102.50</td>
<td></td>
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</tr>
<tr>
<td>11-21-29</td>
<td>Peoples Bank, Phillippi 304,600.88</td>
<td>35,988.21</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12-14-29</td>
<td>Farmers Bank Clarksburg 723,843.22</td>
<td>61,125.00</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

5,402,526.93 487,631.55 72,415.03 30,604.06

can see how little of the assets are left available for the general depositors in such a case.

This rule giving a preference to bonding companies seems to have no reason for its existence. The beneficiaries of this rule are themselves loudest in its denunciation. How then did such a rule come into being? The answer is easy in West Virginia. Bonding companies were given a preference because the great weight of authority at the time the question arose gave them a preference. There was not enough public interest at the time to create a critical examination of the rule, and offset the weight of authority. Why, however, did the majority of decisions outside of West Virginia uphold this preference? If we examine the dates of these cases it is not difficult to hazard a plausible guess. The first case in this country was decided in 1834\(^{17}\) and followed the English view.\(^{18}\) There are very few cases involving this point between 1834 and 1920. This, no doubt, is due to the fact that it was not until more recent years that states sought to protect their deposits by bonds and not until then did bonding companies become engaged in this business on a large scale. Obviously the chances favor a decision for the bonding company unless some public interest is aroused, just as they favor every aggressive litigant who has as his opponent a litigant who is not affected by the case. It makes no difference to the receiver to whom he pays the money of the insolvent bank. Depositors are almost always unrepresented and the receiver is an uninterested litigant. To this fact we may attribute not only the inequitable results in giving preferences to bonding companies but countless other preferred claims which have been sanctioned and which are obviously unjust to the general depositor. After 1920 bank failures became so numerous and state deposits in insolvent banks are so large that in some states the public took an interest. The states which have refused to allow the preference are Arkansas, Arizona, Colorado, Wyoming, Mississippi and Iowa.\(^{19}\) Each one of these decisions was rendered at a time when public attention was focused on bank failures because of the agricultural depression existing in those states. In Iowa the depositors were represented by newspapers and general public discussion, sufficient in volume to make the court consider the equity of the situation. A re-examination of the preference found it so hollow that the court reversed itself. It might very plausibly be said that every

\(^{17}\) State v. Bank of Maryland, \textit{supra}, n. 6.
\(^{18}\) \textit{Re Churchill}, \textit{supra}, n. 6.
\(^{19}\) \textit{Supra}, n. 11.
court whose attention has been called to this problem through information gleaned outside of the dry arguments of counsel has decided against this preference.

The final question which will be discussed is whether the West Virginia Supreme Court might properly reverse itself on this question or whether they should leave the remedy to the legislature. Anyone who has had experience with legislatures will recognize that the probability of the legislature locking the barn door is greatest after the horse has been stolen. Unless there is a widespread series of bank failures in this state the chances are that the legislative branch of the government will not bother with the subject. As proof of this we cite the fact that legislatures in other states have not bothered with it and further the fact that a bill taking away this preference was vetoed by Governor Gore without any particular comment on anybody's part. Therefore, if the West Virginia Supreme Court does not correct itself on decision it is not likely it will not be corrected until public sentiment has been attracted to the question by a large number of failures and much criticism directed toward the courts for this inequitable preference.

As against both the advisability and the probability of the West Virginia Supreme Court reversing itself sometime in the future stands the ancient principle of stare decisis. At one time this would have been sufficient answer. Today it is no longer so. Our court has reversed itself several times. Instances of the changing attitude towards stare decisis in the West Virginia court have been collected in a very able article by Professor Hardman.²⁰

²⁰ 52 W. Va. L. Quar. 163.

The West Virginia Supreme Court has shown a tendency during the past two decades to fit the law to existing social and economic progress and has not felt itself bound to the rule of stare decisis which at one time governed its decisions. This is evidenced by statements in several cases. W. Va. Architects & Builders v. Stewart, 68 W. Va. 506, 515, 70 S. E. 113 (1911) where the court quotes Wigmore, Evidence, Par. 1530 (1st ed. 1904) : "In short courts must cease to be pedantic and endeavor to be practical." To the same effect "We think the practical administration of justice between parties is more the duty of the court than the preservation of some esoteric (legal) theory". Jones v. Cook, 90 W. Va. 710, 717, 111 S. E. 328 (1922). In the case of Ralston v. Town of Weston, 48 W. Va. 544, 33 S. E. 328 (1899), the court reversed a "settled precedent" which had been established by several decisions. City of Wheeling v. Campbell, 12 W. Va. 36 (1877); Tease v. City of St. Albans, 38 W. Va. 1, 17 S. E. 400 (1893). There is further evidence that our present court refuses to be bound by former decisions. In the case of Woodyard v. Sayre, supra, n. 2, the headnote distinctly applies the state prerogative to counties. This is directly overruled in the latter case of County Court v. Matthews, supra, n. 2.

A recent instance of reversal by the West Virginia Supreme Court was Ashland Finance Co. v. Dudley, 98 W. Va. 255, 127 S. E. 33 (1925) where
The rule of stare decisis is not a binding limitation on the courts, but only a self-imposed restraint. When it results in an inequitable decision the reasons are usually among the following: (a) Inertia on the part of the court; (b) failure to see how an equitable result can be obtained without disrupting the logical system on which other rules hang; (c) fear of social or economic consequences to interests which have relied on the former decision. The case of preferences of bonding companies is a case peculiarly outside the reason for the application of the rule of stare decisis. In the first place there has been no reliance on this rule by the bonding company in making their rates. In fact their attitude has been just the opposite. They refuse to believe that the Supreme Court would sustain the rule if public attention were called to it by a number of bank failures. In the second place the rule applies to such a narrow class of cases that it has no reverberating effects on the general logical system of either the law of subrogation, banks and banking, or trusts. No body of law has been built up on the principle of allowing surety companies preferred claims which would be weakened by reversal. In other words, it has no disastrous logical consequences. The only possible confusion which might arise from a reversal of this case would be a query as to the liabilities of receivers who have paid out money relying on the old rule. Of course our theory of law that each judicial decision represents the law as it always has been and the variance between this theory and the facts always creates a query as to the rights of people who have relied on a former decision before it was reversed. It is for that reason that the Iowa court, while reversing itself, was very careful to hang its reversal on an intervening statute, even though it had nothing to do with the case. That device silenced queries as to the rights of parties who had relied on the former decision. Nevertheless it can scarcely be argued for a moment that receivers who had relied on the former decision would be held liable for money previously paid out. The objection therefore seems to be rather imaginary.

We submit therefore that the rule allowing bonding companies

Hatcher, J., says that precedent had "become a judicial pariah in our reports."

Brannon, J., said, "No legal principle is ever settled until it is settled right." Where vital and important public and private rights are concerned, and the decisions regarding them have a direct and permanent influence in all future time, it becomes the duty, as well as the right of the court to consider them carefully, and to allow no previous error to continue if it can be corrected. Town of Weston v. Ralston, 48 Wi. Va. 181, 36 S. E. 446 (1900).

21 76 Pa. L. Rev. 481 (March, 1928).
a preference in the case of insolvent state banks has no justification whatever and that it occupies a peculiar position of being dis-owned even by its beneficiaries, the bonding companies. It is further one of those rare classes of case where the West Virginia Supreme Court may reverse its former holding without interfering either with its system of logical principles or with any vested social or economic interest which had been built up under the former rule.

—T. W. Arnold,

Gift of a Life Estate with Absolute Power of Disposal by Deed.—A testator ought to be permitted to dispose of his property by will in accordance with his desires, and if his intent appears from his language, such intent should be effectuated by the law unless there are good reasons of policy to the contrary. But there have been rules of property law which have operated to defeat intent. The classic example is the Rule in Shelley's Case, which in this state is partially abolished by statute, and should the proposed revision of the Code be enacted by the Legislature will be completely destroyed. Such a rule of construction of words, which is entirely contrary to the ordinary meaning of such words as understood by the layman, is a dangerous trap for one who makes a will or conveys property by deed. The courts of Virginia, in a case officially published in 1871, followed some thirty years later by those of West Virginia, have established another dangerous trap for one who makes a will or deed which is on a par with the notorious Rule in Shelley's Case. This is the now firmly established rule of property law that where there is a gift for life, followed by a general power to dispose of the fee by deed, the estate created is not a life estate with power of disposal, but is an absolute fee simple estate. Like the Rule in Shelley's Case this is a fixed rule of construction of language, and the courts hold it means what the one who used it clearly did not mean. A recent case furnishes an example of the operation of this rule. A testator by the fourth clause of his will devised all the residue of his property to his wife "for and during the term of her natural life ... to be used and enjoyed by her for her

1 Code of W. Va., ch. 71, § 11.
3 Ogden v. Maxwell, supra.