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Banks and Banking--Preferred Claims Against Insolvent Bank on the Theory of Trusts--Bank Drafts as Assignments of Funds

James E. Hogue Jr.
West Virginia University College of Law

the profits, . . .'' The note to the L. R. A. report of this case says: "The opinion of the judges in the above case very fully presents the principles of the law as to the existence of a partnership. Without attempting any annotation of the question we call attention to the earlier cases'', etc.

It is therefore submitted that the parties A and B in the West Virginia case were not joint adventurers. They were not partners.

It is also contended that the same result could have been reached on the contract theory alone, i. e., the B Company at the most is entitled to no more than the worth of its contract at the time of the breach. Even if the A Company had breached the contract this would be so. Therefore, the B Company can receive the amount the A Company was to pay it by its contract with that company less the cost of completing that contract. This would be what the A Company spent in completing the contract, and if the B Company charged rent on the machinery, that would be part of the A Company's costs and would be deducted from the amount to be paid to the B Company and would be in effect not allowing the B Company rent on the machinery. The A Company and the B Company were simply contractor and sub-contractor, and the decision reached could have been obtained solely on the basis of the contract between them.

We are, therefore, a little puzzled as to why the court used the joint-adventure theory. Did the court intend to impose a fiduciary relationship upon such a relationship as contractor and subcontractor?

—HENRY K. HIGGINBOTHAM.

BANKS AND BANKING—PREFERRED CLAIMS AGAINST INSOLVENT BANK ON THE THEORY OF TRUSTS.—BANK DRAFTS AS ASSIGNMENTS OF FUNDS.—The Bank of Mullens, a state bank in West Virginia, and the Federal Reserve Bank of Richmond made an arrangement whereby the Federal Reserve Bank agreed to cash checks drawn on the Mullens Bank by its depositors. The Bank of Mullens agreed to remit immediately to the Federal Reserve Bank by draft on certain designated banks, one of which was the First National Exchange Bank of Roanoke, Virginia.

In accordance with this arrangement about $20,000 worth of checks were cashed by the Federal Reserve Bank and sent to Mullens. The Mullens Bank drew two drafts on the bank in Roanoke aggregating some $12,000, and returned the remaining checks with said drafts to Federal. The amount of the deposit in the Roanoke bank was sufficient to cover the drafts. When they were presented for payment, Mullens had been closed by the banking commissioner and payment was refused.

The Central Trust Company, having been appointed receiver for Mullens, filed a suit in equity to convene the creditors and settle its affairs. The Federal Reserve Bank Intervened seeking a preferred claim. Held, The Federal Reserve Bank was allowed a preferred claim on three grounds: (1) "That said fund and cash in the bank was a trust in the hands of the receiver for reimbursement of the Federal Reserve Bank." (2) "That the Federal Reserve Bank should be preferred over general creditors as an equitable assignee of the fund on which the drafts * * * were drawn", in spite of the Negotiable Instruments Law, which declares that a check of itself does not operate as an assignment of any part of the funds to the credit of the drawer with the bank. (3) While the court apparently bases the decision on the above principles, it would seem that the real footing upon which the case rests is the notion of the court that a contrary holding would have a disastrous economic effect upon banking transactions of this character. Near the end of the opinion the court quotes with approval from Morse on Banks and Banking to the following effect: "But if the effect upon commercial life of subjecting checks to this uncertainty be considered, it appears at once that justice to social prosperity requires that the check-holder shall be preferred".[1]

It is submitted that the decision is certainly doubtful, if not erroneous, on all three grounds. The points will be taken up in order, the trust theory being considered first.

1. It is admitted in the opinion, and the cases so hold, that in the absence of any reciprocal accounts between two banks, the relation between a forwarding and a collecting bank is one of principal and agent before collection.[2] It is also the majority rule that after collection has been actually made, the relation is that of debtor and creditor, the conclusion being based upon the custom of banks to credit the forwarding bank and remit in the bank's usual exchange, thereby destroying the trust res.[3] There are comparatively few cases holding that the trust relation exists where

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[1] Central Trust Co. *v.* Bank of Mullens, 150 S. E. 137 (W. Va. 1929).

[2] Andrew *v.* Hamilton Co. State Bank, 223, N. W. 176 (Ia. 1929); Chase & Co. *v.* Norfolk Bank, 151 Va. 65, 145 S. E. 594 (1928); Sinclair Refining Co. *v.* Tierney, 270 Pac. 792 (N. Mex. 1928); Kaplan *v.* W. A. Ferson Co., 194 N. C. 712, 140 S. E. 617 (1927); Cameron *v.* Carnegie Trust Co., 292 Pa. 114, 140 Atl. 768 (1928); Dudley *v.* Phoenix-Girard Bank, 16 Ala. 591, 114 So. 188 (1927); National Bank *v.* Finn, 253 Pac. 757 (Cal. 1927); Citizens Bank *v.* Spokane Trust Co., 143 Wash. 9, 254 Pac. 238.

[3] U. S. Nat. Bank *v.* Glanton, 146 Ga. 786, 92 S. E. 625 (1917); Citizens Bank *v.* Spokane Trust Co., *supra;* C. & S. Ry. Co. *v.* Docking, 124 Kan. 48, 257 Pac. 743 (1927); Sabine Canal Co. *v.* Crowley Trust & Savings Bank, 164 La. 33, 113 So. 754 (1927); Union Nat. Bank *v.* Citizens Bank, 153 Ind. 44, 54 N. E. 97 (1899).

the proceeds of the collection are to be remitted forthwith. But even though a trust exists, the cestui is not entitled to a preferred claim upon the insolvency of the collecting bank unless there has been an augmentation of the assets; or in other words, unless the proceeds of the collection which constitutes the trust fund can be traced into the general assets of the insolvent bank.[4] These cases also hold that there must be an *actual* increase in the assets, and not a mere juggling of accounts on the books of the bank.[5]

But the question still remains as to whether the trust theory can be supported in the principal case. A trust relation requires a trust res. What is the res in the principal case, or in *Federal Reserve Bank* v. *Peters,*[6] upon which the court in the instant case mainly relies? Actually, there is none.

It must be assumed that the Federal Reserve Bank actually cashed and paid out money on the checks sent by it to Mullens for collection. It was, therefore, not merely a forwarding agent for the holder of the check because the agreement with Mullens required it to *cash* its check. The moment Federal cashed the checks in accordance with such an agreement it advanced or loaned money to Mullens—purely the relation of debtor and creditor.

Upon principle and reason, how can this relation be transformed into one of cestui and trustee by agreeing in advance upon the procedure of immediate remittance upon collection? The sending of the checks to Mullens amounted only to a demand for remittance forthwith according to the agreement. There never was any trust res.

It is here admitted that in true collection and remittance cases a trust relation is established after collection. But in those cases the forwarding bank simply acts as an agent for the holder of the paper, which is the trust res. It is presented to the maker or drawer and collection made, which in truth becomes the trust fund. Then, if the fund is wrongfully mingled with the assets of the bank, the owner of the paper is entitled to a preferred claim provided he can trace the fund into the general assets of the insolvent bank. But those cases are wholly disimilar to the principal case, and those relied upon to support it.[7]

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4 Hecker-Jones-Jewel Milling Co. *v.* Trust Co., 242 Mass. 181, 136 N. E. 333 (1922); Billingsly *v.* Pollock, 69 Miss. 759, 13 So. 828 (1892); State Bank of Winfield *v.* Alave Security Bank, 232 Fed. 847 (1916); Rorebeck *v.* Benedict Flour Co., 26 F. (2d) 440 (1928).

5 Midland Nat. Bank *v.* Brightwell, 148 Mo. 358, 49 S. W. 994 (1899). For general discussion of cases dealing with above propositions, see 24 A. L. R. 1152; 42 A. L. R. 754; 3 R. C. L. 265; 1 MORSE, BANKS AND BANKING (6th ed.) 214.

6 139 Va. 45, 123 S. E. 379 (1924).

7 Authorities cited above.

The courts adhering to the view in the instant case, however, try to evade this objection by calling the checks the trust res. When sent to the drawee bank for collection, it becomes the agent to present them to itself for collection. Then, according to the agreement to remit forthwith, the collecting bank is treated as if it had agreed to set apart the funds collected. After setting up this fictitious duty to segregate the funds the courts say, "Equity regards that as done which ought to have been done," and *ipso facto* there is the trust fund.[8] The whole procedure is theoretical and fictional, and the courts never do explain what became of the debtor-creditor relation which was established in the first instance. Suppose the payee of a note sent it to the maker for collection. Would the court hold that such transmittal made the maker an agent to present to himself and thereby gave the payee a preferred claim in bankruptcy because the maker was supposed to segregate the funds which he paid to himself as agent. Yet that would seem to be the result of the logic of the principal case.

2. Apparently not quite satisfied with the conclusion as based upon the trust theory, the court proceeded to announce another principal concerning the delivery of a draft or check, saying it amounted to an assignment as between the drawer and payee. It will be observed at the outset that this principle alone would have decided the case in favor of the Federal Reserve Bank, and the court need not have uttered a syllable about a trust. Before the Negotiable Instruments Law there was a conflict of authority upon this question. The majority rule was that a check of itself did not operate as an assignment of the fund of the drawer with the bank, but was simply an authority to the bank to pay the check on presentment. Consequently, the death or insolvency of the drawer *ipso facto* revoked the agency and the holder (if also the payee) was not entitled to a preferred claim in the estate of the decedent or bankrupt.[8] The minority view, followed in West Virginia, was contra and preferred claims were allowed in insolvency cases[9] and by analogy with other jurisdictions probably would have allowed them in cases of death.[10]

Due to the irreconcilable conflict in the law merchant as enforced in the various states, the Uniform Negotiable Instruments Law was drafted. The purpose of the act, in connection with the point here involved, is aptly expressed by Mr. Brannan.[11] He says:

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[8] 17 HARV. L. REV. 104.
[9] Hulings *v.* Hulings, 38 W. Va. 351, S. E. (19).
[10] 14 HARV. L. REV. 538.
[11] BRANNAN'S NEGOTIABLE INSTRUMENTS LAW, p. 407.

"Before the Negotiable Instruments Law, the question whether a check was an assignment of any part of the drawer's funds had been considered by the courts, both with respect to the rights of the holder against the drawee and the rights of the holder against the drawer or the latter's creditors or estate, and there had been differences of opinion on both questions. Before the statute, the weight of authority was that a check was not an assignment in either respect. The purpose of the Uniform Negotiable Instruments Law was to abrogate this conflict, and when the statute declares that a check of itself does not operate as an assignment, to say that it does so operate in any case is to declare the exact opposite of the statute."

In the principal case, therefore, the court has repealed the first part of the statute,[12] and has gone back to the rule announced in the Hulings Case before the statute was enacted. The court, however, did not hesitate to abrogate it because it had the notion that "justice to social prosperity required that the check holder should be preferred" over depositors.

The net result, then, of the points actually decided is that a doctrine of trusts is established where there is no trust, and every holder of a bank draft or check is entitled to a preferred claim upon the insolvency or death of the drawer. Since this decision, the writer understands that the banking commissioner allows preferred claims to all holders of bank drafts.

3. Considering the fact that the court admits that an important factor in the decision of the principal case was that of economic effect, the soundness of its point of view in that respect remains to be discussed. It is not the purpose of this note to condemn the court for looking to that factor in deciding the case. On the contrary, it is admitted that the court properly considered it. The question is, did the court get off the fence on the right side? In so far as the principles of law enunciated in the opinion are concerned, the briefs submitted to the court by counsel presented two plausible courses. The court selected the one which supported the desired result.

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[12] Ch. 98A, § 189, CODE.

The factor of economic effect raises two questions.

(a) What effect will the decision have upon the augmentation of preferred claims? Certainly, it cannot be doubted that the holding creates a new class of preferred claims. The only question is how large the amount will be. In the instant case the total drafts outstanding in the hands of Federal alone was more than $12,000, but was reduced to some $10,000 by stipulation. Of course, the amount will vary according to the volume of business done by the particular bank. However, the assertion may be safely made that the figures will range somewhere between $10,000 and $20,000. But whatever the amount, the depositors bear the loss. In natural equity and justice, should they be compelled to stand it? It is believed that they should not. In the first place, a bank is better able financially to bear it, and further, it has recourse against the indorsers. In the second place, the forwarding bank has facilities for ascertaining the true financial condition of its correspondent, and the depositors have not. By the exercise of a reasonable amount of diligence, a forwarding bank should lose nothing, whereas the depositors are totally in the dark. The decision places a premium on a depositor's good faith and trust in a bank.

(b) What effect would a contrary holding have upon the circulation of bank drafts? It is submitted there would be none. The doctrine established in the principal case is of very recent origin. Banks transacted business in the same manner for many years, and the only preferred claims allowed were those given by courts adhering to the rule that the draft operated as an assignment. It would seem that such a sudden and drastic departure from the settled rule should be supported by some explanation showing a real need for it. The only explanation appearing in the opinion is the one previously quoted, *viz.*, the justice to social prosperity requires it. And in another place, the court says, "Although probably contrary to the weight of authority, we are in accord with the modern trend. . . ." But it should be noted that nowhere in the opinion is there any economic data to support either of these conclusions.

We have the decision. What can be done about it? Apparently nothing but the passage of a statute disallowing this particular type of preferred claims altogether. Both the law of trusts and the negotiable instruments law have been unavailing.

—JAMES E. HOGUE, JR.