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CASE NOTES

BANKRUPTCY—VOIDABLE PREFERENCES—PROPERTY GIVEN TO SECURE INDORSEMENT ON NOTE FOR ANTECEDENT DEBT IS VOIDABLE PREFERENCE AS TO CREDITOR IF INDORSER SATISFIES DEBT.

Aulick v. Largent (4th Cir. 1961).

Ansel B. Solenberger, the debtor and eventual bankrupt, was indebted to Mrs. Aulick in the amount of $10,700.00 and to Eldridge M. Lemley in the amount of $3,000.00. Mrs. Aulick, the creditor, was pressing for payment, and the debtor induced Lemley (hereinafter the transferee) to accept his promissory note for $10,700.00, payable to the transferee and to immediately indorse the same over to the creditor. In return, the transferee received a note for $13,700.00 (representing the amount of the indorsed note and the debt already owed to him) and, as collateral, a number of shares of the capital stock of a certain corporation. The creditor had no knowledge of the stock transfer, nor had she and the transferee any contact with each other previous to the above arrangement, but the transferee was aware of the purpose of the transaction. A month later, the debtor was adjudged an involuntary bankrupt. When the note which the transferee had indorsed reached maturity and remained unpaid, the creditor proceeded in a state court against the transferee as indorser and received judgment, which was satisfied in full. Thereafter, the referee in bankruptcy of the debtor's estate determined that the transfer of stock to the transferee as security for his indorsement resulted in a voidable preference to the creditor under § 60 of the Bankruptcy Act.[1] An action was brought in the district court to review these findings and the district court affirmed. On appeal, the Court of Appeals for the Fourth Circuit *held* that the transfer of stock to the transferee to secure a contemporaneous in-

1. Bankruptcy Act, § 60, 64 Stat. 24 (1950), 11 U.S.C. § 96 (1958): "Preferred creditors.

(a) (1) A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class....

(b) Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value. . . ."

dorsement of a note to the creditor, which was to cover an antecedent debt to the latter, was a voidable preference as to the creditor. The court ordered that the transferee should return the stock to the trustee in bankruptcy and that the creditor should turn over the payment made by the transferee on his indorsement to the trustee who, in turn, should restore it to the transferee. *Aulick v. Largent,* 295 F. 2d 41 (4th Cir. 1961).

Section 60 of the Bankruptcy Act deals with preferences and their voidability. Its prime purpose is to protect the general creditors who must share proportionately in the proceeds of the estate. A preference given to one creditor, of course, depletes the assets from which the other creditors may draw. Under this section, preferential transfers given directly to the creditor are voidable if the preferred creditor should reasonably have known at the time of the transfer that the debtor was insolvent. More circuitous transactions present greater difficulties. Nonetheless, it was early recognized that the restrictions imposed by the Bankruptcy Act could not be thwarted by bestowing the preference in a less direct manner.[2] So long as the creditor was the real recipient of the transfer, and the other statutory elements were met,[3] the courts have swept aside the ruse and declared the transaction for what it was.

In 1917, the United States Supreme Court, in *Dean v. Davis,*[4] announced what has become the leading decision in the field of indirect preferential transfers. In that case, Dean, at the request of a certain debtor, paid the amount of a note owed by the latter and received in exchange a new note which was secured by a mortgage on all of the debtor's property. Within four months, the debtor went into bankruptcy and the trustee brought suit against Dean, as transferee, claiming that the mortgage constituted a preference and was voidable as such.[5] The

2. *E.g.,* In re Beerman, 112 Fed. 663 (N.D. Ga. 1901); Grandison v. National Bank of Commerce, 220 Fed. 981 (W.D.N.Y. 1915), *aff'd,* 231 Fed. 800 (2d Cir. 1916), *cert denied,* 242 U.S. 644, 378 S. Ct. 213 (1916); Farmers' State Bank v. Freeman, 249 Fed. 579 (8th Cir. 1918); MacHenry v. Dwelling Building and Loan Ass'n, 259 Fed. 880 (E.D. Pa. 1919), *aff'd,* 263 Fed. 702 (3d Cir. 1920), *appeal dismissed,* 256 U.S. 685, 41 S. Ct. 622 (1920).

3. See, COLLIER, BANKRUPTCY, Vol. 3, at 755-56 (14th ed. 1961): "Briefly stated, the elements of a preference under § 60a consist of the following: a debtor (1) making or suffering a transfer of his property, (2) to or for the benefit of a creditor, (3) for or on account of an antecedent debt [resulting in the depletion of the estate], (4) while insolvent, and (5) within four months of bankruptcy or of the original petition under Chapters X, XI, XII or XIII of the Act, (6) the effect of which transfer will be to enable the creditor to obtain a greater percentage of his debt than some other creditor of the same class. . . . However, under subdivision *b* a preference is voidable by the trustee in bankruptcy only upon proof of the additional element that (7) the creditor receiving or to be benefited by the preference had reasonable cause to believe that the debtor was insolvent."

4. 242 U.S. 438, 37 S. Ct. 130 (1917).

5. The action was brought under § 60 of the Bankruptcy Act as amended in 1910. The amendments to the Bankruptcy Act after 1898 are relatively unimportant as far as the present problem is concerned, since they deal chiefly with the requisite knowledge of the transferee regarding the preference. The provisions which were added regarding the indirection of the transfer are also of little import, since the courts had already determined that mere circuity could not defeat

Court noted that since Dean had given present consideration for the transfer, the payment was not on account of an antecedent debt and, consequently, the transaction was not a preference as far as he was concerned. By way of dicta, the Court stated that the bank (the original creditor), not Dean, was preferred.[6] The Court, however, held that, notwithstanding the fact that the transfer was not a preference to the transferee, it did constitute a fraudulent conveyance under § 67e of the then Bankruptcy Act.[7] In this connection, the Court declared: "A transfer, the intent (or obviously necessary effect) of which is to deprive creditors of the benefits sought to be secured by the Bankruptcy Act, 'hinders, delays or defrauds creditors' within the meaning of § 67e."[8] It added that ". . . where the advance is made to enable the debtor to make a preferential payment with bankruptcy in contemplation, the transaction presents an element upon which fraud may be predicated."[9]

The present court deals extensively with the *Dean* case in relation to the latter's decision that there was no preference to the transferee under § 60, a holding which it regards as conclusive in the instant case, but seems to ignore as irrelevant the fact that the Court in *Dean* did find *fraud* as to Dean and compelled him to turn over the transfer to the depleted estate on this account. It is difficult to see why a similar result could not have been reached as to the indorser in the present case under the *Dean* rationale. Although the court seems to be upon solid ground regarding its finding that there was a voidable preference as to Mrs. Aulick (the creditor) but not as to Lemley (the transferee),[10] except as to the

the impact of the Act. See, *supra* note 2. *Cf.* COLLIER, BANKRUPTCY, at 764-77 (14th ed. 1961) for an excellent review of all the modifications of § 60 since 1898.

6. 242 U.S. at 443, 37 S. Ct. at 131 (1917).

7. Bankruptcy Act § 67e, ch. 541, 30 Stat. 564 (1898): "That all conveyances, transfers, assignments, or incumbrances of his property, or any part thereof, made or given by a person adjudged a bankrupt under the provisions of this Act subsequent to the passage of this Act and within four months prior to the filing of this petition, with the intent and purpose on his part to hinder, delay, or defraud his creditors, or any of them, shall be null and void as against the creditors of such debtor, except as to purchasers in good faith and for a present fair consideration. . . ."

8. Dean v. Davis, *supra* note 6, at 444, 37 S. Ct. at 131.

9. *Id.* at 444, 37 S. Ct. at 132.

10. A decision heavily relied upon by the creditor in the present case is National Bank of Newport v. National Herkimer County Bank, 225 U.S. 178, 32 S. Ct. 633 (1912), which was decided five years prior to the *Dean* decision. That case, however, seems quite distinguishable upon its facts. There the original creditor indorsed the note he held from the debtor to a third party and pocketed the proceeds. When the note neared maturity, the creditor paid the third party and had this amount entered on his account with the debtor. The debtor became bankrupt and the trustee brought suit against the third party on the theory that the charging of the bankrupt's account to the amount that the creditor paid to the third party was a preferential transfer as to the third party. The Court found no such preference. The relationship of the parties in the *Newport* case was quite different from that in the instant situation. There, the original debt was owed to the indorser and not to the defendant third party. The original creditor-indorser did not indorse the note for the benefit of the bankrupt, but for his own benefit. The creditor voluntarily assumed liability as an indorser; the bankrupt promised nothing in return. The subsequent payment of the note was also for his own protection. The bankrupt's crediting of the indorser's account was distinct from the transaction

$3,000.00 which the debtor already owed the transferee, the propriety of the remedy imposed is considerably more questionable in that it imposes the burden of the restitution upon the innocent creditor rather than upon the transferee who acted with full knowledge of the purpose of the debtor's machinations. Considering the policy behind *Dean v. Davis,* namely that of holding the knowing third-party transferee guilty of fraud when he receives security from the insolvent for a loan which he knows is to be used to prefer an antecedent creditor to the detriment of other creditors, and relating this to the Bankruptcy Act's general policy of prohibiting certain depletions of the debtor's estate, it would seem that in a case like the present one the knowing third-party should bear this burden rather than the innocent creditor. From an equitable point of view, one who takes under conditions which are constructively fraudulent should be the one to make restitution,[11] and such a result does not impair the protection

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between the indorser and the indorsee, and there is no evidence that this credit was given as an inducement to the indorser to pay the note. Moreover, under the terms of the Bankruptcy Act at that time, 32 Stat. 799 (1903), it was necessary that the person receiving the preference have reasonable cause to believe that he was being preferred in order that the transfer be deemed voidable. There was no evidence to this effect in that case. Under the present Act, all that is necessary is that the person benefited have reasonable cause to believe that the debtor is insolvent (See *supra* note 1). The trial court in the instant case found that both parties were aware of this fact. Also, it seems quite clear that the crediting of the account in *Newport* was not for the benefit of the defendant third party but solely for the indorser's benefit. If the transfer had been part of an agreement whereby the indorser would pay the indorsee-defendant-third party on the note, the case would be closer to the present problem. But even with the facts as they were, there is no indication that the trustee could not have had the transaction voided as far as the indorser-creditor was concerned. It should be noted that there has been some tendency to extend the broad language of this case beyond its context. *E.g.*, Olmstead v. Massachusetts Trust Co., 11 F.2d 410 (D. Mass. 1926), which was cited by the creditor in the present case as supporting her position.

On the other hand, Grandison v. Nat. Bank of Commerce, 220 Fed. 981 (W.D.N.Y. 1915), *aff'd*, 231 Fed. 800 (2d Cir. 1916), *cert. denied*, 242 U.S. 644, 37 S. Ct. 213 (1916), involved a situation very similar to the present one. A certain corporation had given a bank several notes evidencing the company's indebtedness. Because of the company's subsequent financial difficulties, the president of the corporation, at the request of the bank, personally indorsed the notes. As security for this indorsement, the company turned over to the president part of its accounts receivable, from which the president drew when the notes became due. The court held that the diminution of the company's assets for the benefit of the prior creditor (the bank) was a voidable preference as far as the bank was concerned and ordered the transfer returned to the trustee. The court reasoned, at 983:

> To constitute a preference it was not necessary that the assignment of the accounts receivable should be made directly to the bank. It was enough that the transaction which resulted in the indorsement of the renewal notes and the subsequent collection of the accounts receivable were for the benefit of the bank. Alexander [the company president] concededly received the assignment of the account from the bankrupt to secure him as an indorser on the overdue promissory notes held by the defendant [the bank]. Such a transfer made by insolvent falls within the prohibition of the Bankruptcy Act.

Although the Grandison case was decided prior to *Dean*, the present court was strongly influenced by its decision and rationale. Aulick v. Largent, 295 F.2d 41, 50-51 (1961).

11. § 67(d)(3) of the present version of the Bankruptcy Act, 66 Stat. 428 (1952), 11 U.S.C. § 107 (d)(3) (1958), relates to "constructive fraud": "Every transfer made and every obligation incurred by a debtor who is or will be thereby rendered insolvent, within four months prior to the filing of a petition initiating a proceeding under this title by or against him is fraudulent, as to then existing and