ANNOUNCEMENT

The Review is pleased to announce the election of the following members of the Second Year class to the Editorial Board: Kendall M. Barnes, J. Horace Churchman, Eugene C. Fish, Robert L. Lingelbach, Howard S. McMorris, Leon I. Mesirov, A. Arthur Miller, Emanuel E. Minskoff, Gilbert W. Oswald, Edward J. Rourke, Robert H. Skilton, Sydney S. Stern, Henry R. Thalenfeld, Theodore K. Warner, and Jerome B. Weinstein; and of Solomon Freedman and Charles W. Woolver to the Business Board.

NOTES

TORT LIABILITY FOR NEGLIGENT MISREPRESENTATION—Tort liability for misrepresentation, in this country, is not entirely an academic problem. Yet, like causation, its main interest grows out of the method with which each case is handled. Cases involving liability for misrepresentation have been considered, generally, under the category of deceit. The connotation of this term is historically accurate but practically unfortunate. To the average man deceit smacks of fraud. And fraud in turn involves intentional culpability. By the law of deceit at first only intentional misrepresentations were recognized; and in fact such rule still prevails in England.1 But in this country, by one method or another, degrees of culpability less than intentional wrongs have been recognized as creating liability.2 So that in effect we have a situation today where a natural growth is hindered by an ill-fitting garment.

A few states recognize, as such, liability for negligent misrepresentation.3 In such jurisdictions, the obvious problem is whether the rules derived from cases involving liability for negligent conduct other than misrepresentation are applicable here. Professor Bohlen raised the query in 1929,4 and seemed to lean rather strongly toward an affirmative answer in 1931.5 Professor Green has taken the opposite position with considerable warmth.6 As an abstract proposition these authorities have argued the question ably. This note makes no attempt to analyze further, but offers a case study which at this point might be of value. One thing, however, stands in the way.

Liability for negligent misrepresentations infers, as a general rule, no liability for innocent misstatements of fact. Otherwise it would be superfluous to talk about such a thing as a negligent misrepresentation. But it has been suggested that absolute liability should govern in this field. Professor Williston was so minded in 1911.7 Among other reasons8 he suggests that since estoppel is based

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1 Peek v. Derry, 14 App. Cas. 337 (1880).
2 Bohlen, Misrepresentation as Deceit, Negligence or Warranty (1929) 42 Harv. L. Rev. 733, 735.
4 Supra note 2.
5 Bohlen, Should Negligent Misrepresentation Be Treated as Negligence or Fraud? (1932) 18 Va. L. Rev. 703.
6 Green, Deceit (1930) 16 Va. L. Rev. 749; Note (1931) 26 Ill. L. Rev. 49.
8 Williston cites also the following branches of the law to support his contention: warranty of quality and title, warranty by an agent of his authority, rescission for misrepresentation, and defamation. For criticism of these see Carpenter, Responsibility for Intentional, Negligent and Innocent Misrepresentation (1930) 24 Ill. L. Rev. 749; Weisiger, Bases of Liability for Misrepresentation (1930) 24 Ill. L. Rev. 866.
upon a misrepresentation of fact, the law of tort liability ought to be consistent with the application of the principle of estoppel which disregards culpability.\(^9\) The soundness of this proposition depends upon the accuracy of the premise that estoppel does not rest upon culpability. Five situations are cited:\(^10\) (1) A warehouseman, in reply to an inquiry, states to a prospective purchaser that the seller has a certain quantity in store; (2) A bailee issues a receipt for goods never received; (3) A bailee fails to take up a document when goods are delivered; (4) A corporation issues a certificate of stock to one who is not a shareholder and a bona fide purchaser acquires it; (5) A trustee gives misinformation as to trust property to one who proposes to lend money to the cestui. In each of these cases the person who has made the misrepresentation is estopped.

The second, third and fourth cases arise out of contract. Bigelow makes a sharp distinction:

"... this class of estoppels being founded upon contract, it can seldom be an answer to the alleged estoppel, unlike the case of estoppel by conduct, that the party supposed to be estopped acted in ignorance of the facts and under mistake."\(^11\)

Unfortunately no reasons are given. It may be noted here without anticipating that most of the cases under deceit which talk about liability for misrepresentations made innocently are those where the fact misrepresented was the basis of a contract between the parties.\(^12\) The reasons for this will concern us later, but it is important to realize at this point that absolute liability is imposed in similar deceit cases without anyone contending that for this reason alone such is or should be the general rule.\(^13\)

In the case of the warehouseman, Bigelow concedes that absolute innocence should be an excuse.\(^14\) The fifth case is a situation which often arises in deceit. The actual case is Burrowes v. Lock.\(^15\) Here a trustee upon inquiry informed a third person that there was no charge upon the trust fund. He had been informed otherwise, but his excuse was that he had forgotten. The court expressly placed liability on the ground of gross negligence.\(^16\)

Finally, after listing these five cases Professor Williston concludes:

"In all these cases, and their number might easily be increased, a cause of action exists because of damaging misrepresentation, certainly without regard to any fraudulent intent, and probably without regard to any other negligence than necessarily exists when a person whose position qualifies him to have accurate knowledge about a matter makes a misstatement in regard to it."

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\(^9\)As far back as 1900, Ewart was sufficiently interested in the problem to devote an entire chapter to it. Ewart, Estoppel (1900) 222.

\(^10\)Supra note 7, at 426.

\(^11\)Bigelow, Estoppel (6th ed. 1913) 496.

\(^12\)Both in deceit and estoppel most of the vendor-vendee cases show, on their facts, negligence. A few cases show absolute innocence; and in deceit there are several instances where liability was refused. Infra notes 25, 27 and 30.

\(^13\)Carpenter, supra note 8, at 763.

\(^14\)Supra note 11, at 677. The author criticizes those few jurisdictions which permit mere mistake as a justification. But he disfavors liability for innocent misstatement. "If from the nature or situation of the property the case were such that the party making the admission might not be bound to know the facts, it might be right to hold that there was no estoppel."

\(^15\)10 Ves. 470 (Eng. 1805).

\(^16\)Id. at 476: "... it was gross negligence to take upon him to aver positively and distinctly, that Cartwright (the cestui que trust) was entitled to the whole fund, without giving himself the trouble to recollect whether the fact was so or not; without thinking upon the subject."
NOTES

This statement is damaging to his cause. It is the law of torts that persons who enter into a particular business or calling are required to possess the knowledge that a reasonable man in that business would have, even though as members of their class of society they might not be expected to know such.\textsuperscript{17} If it is admitted that this is negligence, then obviously an estoppel based on the same, is not founded upon an innocent misrepresentation.

In the field of deceit itself innumerable cases will be found which appear to impose liability for innocent misrepresentation. It is pertinent to note that all of these cases involve a situation where the fact misrepresented was the inducement for the plaintiff’s entering into a contract with the defendant. And it is even more pertinent to realize that upon analysis all but a few of the cases show negligence.

A very common type of case is the contract for sale of land. The defendant may misrepresent the boundary,\textsuperscript{18} the acreage content,\textsuperscript{19} the quality of soil,\textsuperscript{20} the presence of certain inducements,\textsuperscript{21} or the state of title.\textsuperscript{22} In all of these the defendant is held, regardless of “good faith”. What actually happens is that the defendant pleads the absence of \textit{scienter} because he made the statement in “good faith”. Thus, when the court decides that “good faith” is no excuse, it means that the absence of any intentional or wilful misleading is not a bar to recovery. If the cases were discussed in terms of negligence, liability could be fastened, in some cases, on sheer carelessness,\textsuperscript{23} and in others upon a duty of the landowner not to represent a fact concerning title, acreage, or contents, unless he was reasonably certain.\textsuperscript{24} Obviously a case could arise where the defendant’s statement was based upon a reasonable belief.

In \textit{Pratt v. Thompson}\textsuperscript{25} the inducement to a contract for the sale of land was the representation that a certain flow of water came from a natural spring. This was not so, but the source of the water was so artfully concealed that defendant had been on the land six years before the erection of an upstream dam disclosed the true source of the water. It was held that this representation constituted a fraud in law. The plaintiff was not guilty of contributory negligence (laches) since his conduct was based on the same circumstances and facts as that of the defendant. This makes the case doubly strong on the side of liability for innocent misrepresentation.

On the other hand in \textit{Sacramento Co. v. Melin},\textsuperscript{26} a representation by the vendor that land was suitable for fruit-growing, made after reasonably careful investigation, was held to be non-actionable. It may be possible to reconcile this case with \textit{Pratt v. Thompson} on the ground that this involves a representation in the nature of an opinion, and therefore the court would be likely to reach a different result.\textsuperscript{27} But fundamentally both cases are alike.

Another common type of case is the contract for sale of a chattel, stock, or business. Here will be found exactly the same variance existing in the land cases. Most of the cases speaking of liability for innocent representation rest, factually,

\textsuperscript{17} Gobrecht v. Beckwith, 82 N. H. 415, 135 Atl. 20 (1926).
\textsuperscript{18} Ohrmundt v. Spiegelhoff, 175 Wis. 214, 184 N. W. 692 (1921).
\textsuperscript{19} Glasgow v. Brecht, 117 Wash. 245, 200 Pac. 1089 (1921).
\textsuperscript{20} Sacramento Co. v. Melin, 36 F. (2d) 907 (C. C. A. 9th, 1929).
\textsuperscript{21} Pratt v. Thompson, 133 Wash. 218, 233 Pac. 637 (1925).
\textsuperscript{22} Leach v. Helm, 114 Ore. 405, 235 Pac. 687 (1925).
\textsuperscript{23} Becker v. McKinnie, 106 Kan. 426, 186 Pac. 496 (1920).
\textsuperscript{24} Shane v. Jacobson, 136 Minn. 396, 162 N. W. 472 (1917).
\textsuperscript{25} \textit{Supra} note 21.
\textsuperscript{26} \textit{Supra} note 20.
\textsuperscript{27} The first point that the court decided was that the representation was not a mere matter of opinion.
upon negligence. Yet a few cases have raised the real issue. In *Barclay v. Deyerle* the defendant sold bank stock to the plaintiff and represented the bank’s affairs as disclosed on its books. Actually the cashier had tampered with the books, but the defendant had no reason to suspect this. The court found liability in deceit. In *Peake v. Thomas* on precisely similar facts the opposite result was reached. But it may be said with some assurance that most courts, considering their language, would find absolute liability. Is this a sound doctrine? How does it square with liability for negligent misrepresentation?

Professor Carpenter finds justification for absolute liability on the ground of extension of warranty. He believes that it is unjust for a seller to obtain enrichment at the expense of an innocent buyer by reason of his own misrepresentation. On the other hand Professor Weisiger would reach the same result through the analysis applied in all cases where the courts have found it socially wise to impose absolute liability. The “nature and relative values of the interests, the plaintiff’s opportunity for protecting his interest, the exigencies of business practice and social customs and the relations existing between the parties should determine in which class a case will fall.” The latter has the merit of flexibility. It is conceivable that situations may arise apart from contract where the wisest judgment would lead to an imposition of absolute liability. In the recent case of *Baxter v. Ford Motor Co.*, the plaintiff recovered for personal injuries against the manufacturer on a representation that the windshield was shatter-proof. The court did not name the ground of recovery, but obviously warranty fails because there was no privity of contract between the parties. On the other hand it is difficult to explain the consequences without the existence of some negligence on the part of the defendant, but it is even more difficult to prove such negligence. An interesting corollary is a New York case where the plaintiff who had purchased a battery from a dealer sued the manufacturer on a warranty, for personal injuries. The court held that lack of privity prevented any recovery on a warranty but that the plaintiff might have succeeded in deceit or in an action for negligent words. Neither court discusses the problem of absolute liability, yet one permitted recovery and the other intimated that it would. The explanation of the

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28 In *Pellete v. Mann Auto Co.*, 116 Kan. 16, 225 Pac. 1067 (1924) the defendant dealer sold a Dodge to the plaintiff representing that it was the latest model. The defendant had the car in his possession from September, 1920, to June 24, 1921, the date of the sale. The jury found (1) that a later model was turned out in June, 1921, and (2) that it had been issued before June 24, 1921. Other dealers seemed to be familiar with the fact. Here negligence may be placed on the ground that defendant being a dealer and having had a car for so long a period, should have known that it was likely for a new issue to be made soon. In *Tischer v. Bardin*, 155 Minn. 361, 194 N. W. 3 (1923), the defendant auto dealer represented that a certain party was the owner of a car and that it was in adequate condition; all that he based his statement on was the word of such party. In *Schmelz Bros. v. Quinn*, 134 Va. 78, 113 S. E. 845 (1922), a bank director induced a loan to a corporation by a representation that there were certain assets on hand. Such belief was based on examination of the corporation books. But the director knew that the corporation had falsified its books in respect to certain transactions with his bank. For other cases see *Turner Agency v. Pemberton*, 38 Idaho 235, 221 Pac. 133 (1923); *Romine v. Thayer*, 74 Ind. App. 536, 128 N. E. 456 (1920); *Goar v. Balinder*, 213 Mo. App. 336, 249 S. W. 977 (1923).

222 Ky. 405, 300 S. W. 885 (1927).
3 Supra note 8, at 761.
2 Supra note 8, at 875.
12 P. (2d) 409 (Wash. 1932).
22 Id. at 74, 161 N. E. at 424: “There can be no warranty where there is no privity of contract. A cause of action for breach of warranty, either express or implied, is not, and cannot be stated. . . . A cause of action for deceit conceivably might arise from such a transaction or for negligent words, . . . .”
situation may be that social ends, considering the interests and exigencies of the case, require the imposition of liability without fault.\(^3\)  

There may be many other cases where absolute liability is highly desirable. But it does not necessarily follow that it would be best to handle all cases in this manner. There still would remain, just as in any other field of tort law, numerous situations lending themselves to the most efficacious analysis under the principles of negligence. It is really stretching the philosophy of standardization to contend that the adaptability of absolute liability to so many cases in misrepresentation justifies uniform imposition. After all a decision in any given case is oftentimes welded out of the struggle between the desire to adhere to a rule of law and the demands of justice under the particular circumstances. Is it not somewhat unwise to sacrifice a desired result for the sake of uniformity when every other branch of tort law, on the whole, has been categorized into degrees of culpability? Speculation aside, the fact remains that there are a considerable number of cases which have been decided on the issue of negligence. These are now our concern.

The cases of *Cunningham v. Pease House Furnishing Co.,*\(^37\) *Weston v. Brown,*\(^38\) *Glanzer v. Shepard,*\(^39\) *International Products Co. v. Erie R. R.,*\(^40\) *Jailet v. Cashman,*\(^41\) and *Ultramires Corp. v. Touche,*\(^42\) have become landmarks in the law of torts. Each has come in for more than the usual share of review, comment and criticism. But there are others, though they have received less attention and in some cases have gone unnoticed, that are of considerable interest. The first thing that crops up is our old acquaintance of the formidable countenance—the contract problem. In *Maxwell Co. v. Brackett Co.,*\(^43\) the representation pertained to the type of work a certain machine would do. The defendant vendor had knowledge vastly superior to that of the vendee. The court held that the jury was justified in finding the defendant negligent. Nothing was said as to his liability if he were not negligent. This case, however, is one of that type where negligence can always be found, so that the problem of what New Hampshire will do with a contract case sans negligence is still open.

Next come a group of cases that deal with the question as to the existence of a duty and whether it is owed to the particular plaintiff or not. Under this we have three cases dealing with abstracter’s certificates. In *Mulroy v. Wright,*\(^44\) the buyer of property relied upon a negligent certificate given to the seller by the county clerk. Although the defendant clerk did not furnish the certificate to the plaintiff, he knew its purpose. The Minnesota court decided as a matter of law that a duty was owed to the plaintiff. In the extremely interesting case of *Cole v. Vincent,*\(^45\) a county clerk filed a judgment incorrectly. The owner of the property hired the defendant abstracter to search title. The latter returned an abstract showing no judgment after he had been expressly warned to look for such. The plaintiff purchased the property in reliance on the certificate. His suit was in contract. The court held that no action would lie in contract and that if the suit were based on negligence then the case must be submitted to the jury to determine: (1) the question of fact as to the care of the abstract company; (2) whether plaintiff was one to whom defendant owed a duty of care and this would depend upon whether the defendant knew the purposes of the certificate. This decision

\(^{39}\) (1932) 81 U. of Pa. L. Rev. 94.

\(^{37}\) Supra note 3.

\(^{38}\) Supra note 3.

\(^{39}\) Supra note 3.

\(^{40}\) Supra note 3.

\(^{41}\) Supra note 3.

\(^{42}\) 235 N. Y. 511, 139 N. E. 714 (1923).

\(^{43}\) 255 N. Y. 175, 174 N. E. 441 (1931).

\(^{44}\) 80 N. H. 236, 116 Atl. 34 (1921).

\(^{45}\) Supra note 3.
fits in nicely with *Mulroy v. Wright*. In the latter it had already been established that the defendant had been careless and that he knew of the purpose of the certificate. Therefore negligence existed as a matter of law. In effect the two cases are correlative. In *Shine v. Nash Abstract Co.*  the abstracter, as in the other cases, furnished the certificate to the vendor, and the court held that the existence of the duty is determined by whether defendant had knowledge that it was intended for the vendee. These abstracter cases seem to be midway between the *Glanzer* and *Ultrainires* cases. In the latter the defendant owed no duty to an indefinite number of persons who might rely on his statement even though he knew that his statements were to be used in such manner. In the abstracter situation the defendant owes a duty of care if he knows the purpose even though he does not know the particular person who relies. In the *Glanzer* case the communication was directly to the person who relied.

Additional problems in the existence of a duty to the plaintiff are presented in *National Iron & Steel Co. v. Hunt*, 46 *Doyle v. The Chatham and Phenix Bank*, 47 *Courteen Seed Co. v. Hong Kong and Shanghai Banking Corp.*, 50 and *Scanlon v. First National Bank*. 51 In the *Hunt* case, A hired the defendant appraiser to test the quality of rails he was purchasing. The defendant turned a certificate over to A. A then sold to the plaintiff who relied on such certificate. The court held that there was no duty owing to the plaintiff. Professor Weisiger believes that this case is *contra* to *Glanzer v. Shepard*. 52 But one apparent difference is the fact that the defendant in the *Hunt* case prepared the statement for his employer as a purchaser. He had no reason to know that the same certificate would be used by a subsequent vendee. He prepared it for the purpose of one transaction. The use of the certificate in the second transaction was unforeseeable.

In the *Doyle* case, the question was whether a duty of care was owed by a trustee authenticating a bond issue to the plaintiff purchaser. The very purpose of creating the trusteeship was to protect purchasers. Certainly a duty existed.

In the *Courteen* and *Scanlon* cases the question revolved around the expiration date on a letter of credit. In the former case the defendant bank had no relations with the plaintiff. It bought a draft drawn on the letter of credit and in response to an inquiry from plaintiff's bank, negligently stated that the draft was drawn before the expiration date. The plaintiff relied upon this to his loss. Here the court held that there being no dealings between the parties, and no relations between them, the defendant had no reason to believe that the plaintiff would act upon the information under the circumstances of the case. In the *Scanlon* case the defendant bank had agreed with the plaintiff to receive a letter of credit and have drafts drawn on it. The defendant received the letter of credit but never notified the plaintiff of the expiration date. The court held that there was no duty to impart such information since, if the plaintiff himself had negotiated for the letter of credit, the defendant could not be expected to realize that plaintiff was ignorant of its terms. If in the *Scanlon* case there had been an active misrepresentation, as in

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46 217 Ala. 498, 117 So. 47 (1928).
47 *Supra* note 42, at 188, 174 N. E. at 448: "Liability for negligence if adjudged in this case will extend to many callings other than an auditor's. Lawyers who certify their opinion as to the validity of municipal or corporate bonds, with knowledge that the opinion will be brought to the notice of the public, will become liable to the investors, if they have overlooked a statute or a decision, to the same extent as if the controversy were one between client and adviser. Title companies insuring titles to a tract of land, with knowledge that at an approaching auction the fact that they have insured will be stated to the bidders, will become liable to purchasers who may wish the benefit of a policy without payment of a premium."
48 312 Ill. 245, 143 N. E. 833 (1924).
49 253 N. Y. 369, 171 N. E. 574 (1930).
51 249 N. Y. 9, 162 N. E. 567 (1928).
52 *Supra* note 8, at 875.
the Courteen case, it is entirely likely that the court would have found a duty. Once the plaintiff inquires as to certain facts, the defendant would not be entitled to assume that the plaintiff knew. On the other hand if the information had been voluntarily communicated, there is no reason to establish a duty of care.

The Courteen case presents the problem of the duty to impart information. It is possible to infer from the court's language that such a duty might exist under proper circumstances. In deceit in certain cases silence may constitute a fraud. There is no reason why silence, under some circumstances, may not constitute negligent misrepresentation. In the case of Conway National Bank v. Pease, the plaintiff bank sent the defendant an abstract of a note to determine whether his name had been forged thereon. Defendant did not reply for over a month. The real question was whether the plaintiff could estop the defendant from denying the genuineness of the signature, but the court expressly discussed the problem in terms of deceit. The court sent the case back to the jury to determine whether defendant knew or should have known that plaintiff was relying upon his silence and whether plaintiff was free from fault. It also said that in case the defendant's silence was wilful, then contributory negligence would not be a bar.

What is probably the most interesting of the problems has arisen in the case of Cole v. Vincent. Besides the action against the abstract company there was also an action against the county clerk. This was not an action for misrepresentation but for negligent conduct. He carelessly filed a judgment. The question is whether an intervening negligent misrepresentation destroys the chain of causation. Properly speaking the causal connection is clear. The only issue is whether the defendant was negligent with respect to the particular risk involved. The court lumped it all under causation just as so many courts often do in cases of personal injuries. If this case had arisen in a jurisdiction which permitted recovery for negligent misrepresentations under the action of deceit, it is interesting to speculate whether the court would have treated it as an intentional or negligent intervening act. At least that much confusion was avoided in Cole v. Vincent where negligent misrepresentations are called such.

In conclusion, liability for innocent misrepresentation can be explained by the factors which determine absolute liability in other fields of tort. This may dispose of the perplexing contract cases. A vast field remains where the application of negligence principles is proper and appropriate. An examination of cases other than the leading decisions shows the courts considering the existence of a duty, whether it is owed to the plaintiff, causation, and the duty to act affirmatively. The language, terminology, and method of approach, good and bad, display a striking similarity to the "jargon" of the more familiar negligence cases.

S. C.

Status of Surety of State Bank Deposits in Pennsylvania—The recent epidemic of bank failures has made imminent a clarification of the rights of a surety company which guarantees the payment of state funds deposited in a bank which subsequently fails and the surety has been required to indemnify the state. The problem thus presented is: what right has the surety to share in the proceeds arising from the sale of the bank's assets? If the surety is to be permitted to share in this fund, does it succeed to all the rights possessed by the

55 Cooley, Torts (4th ed. 1932) § 351.
56 76 N. H. 319, 82 Atl. 1068 (1912).
57 Supra note 45.
58 (1931) 80 U. of Pa. L. Rev. 137.
state prior to payment by the surety? It has never been denied that the surety is entitled to share pro rata with other general creditors of the bank. The doubtful case is presented where the surety demands to be subrogated to a priority over the other creditors of the bank.

The determination of this question involves a consideration of two subsidiary problems: (1) Was the state entitled to a priority in payment over other depositors? (2) Does a surety upon paying the state become entitled to such priority?

The weight of authority in the various states favors the sovereign’s right of priority in payment of its claims over the claims of other creditors.\(^2\) Debts due the United States government are accorded priority by statute.\(^2\) This prerogative became early established in England and was crystallized by the statute of 33 Hen. VIII.\(^3\) It therefore became part of the common law of this country\(^4\) except in those states where it was considered repugnant to the principles of American law.\(^5\) A careful examination of the decided cases shows that only New Jersey\(^6\) and North Carolina\(^7\) have denied the priority on this ground. It would seem that granting such priority to the state with resulting protection to public funds is a very desirable policy since it is a sound principle of political science that the normal functions of government must not be impeded by abnormal business conditions. The availability of a ready supply of cash to meet the current expenses of running the government should not be adversely affected by the closing of a state depository. Incidentally, it should be noted that the loss borne by each depositor who is forced to submit to the prior claim of the state is quite disproportionate to the great loss which the denial of the preference causes the state.

A second reason assigned for the denial of the prerogative is that the state in making a deposit exercises not a sovereign but a business function and since the prerogative is present only when the sovereign acts, the state may not

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\(^3\) See Dale. The Adoption of the Common Law by the American Colonies (1882) 21 Am. L. Reg. 553.

\(^4\) In Middlesex County v. State Bank, supra note 1, at 272, which is the leading case supporting the minority view, the court says: “... this prerogative was so purely an attribute of a despot government, and so strongly in antagonism to the cardinal objects of a government established by the people for their common protection and security, that it could not either as a matter of law or reason, be held to belong to the latter, as one of its inherent functions, in the absence of an express legislative declaration to that effect.”

\(^5\) Ibid. The New Jersey Court denied priority to the state also because the federal government had no such priority except by statute and therefore such right could not be possessed by any state government which was, by hypothesis, inferior to the federal government. Since the several states reserve to themselves, by CONSTITUTION, ART. X, all rights not granted to the federal government, this reasoning is fallacious.

exercise any priority.\textsuperscript{8} The adherents to this doctrine base their conclusion on the fact that the depository bank is required to pay a fixed rate of interest on all state deposits. This reason seems untenable because the prime purpose for the creation of the priority, protection of the public treasury, still exists, since the interest is merely an incident of the deposit and not the purpose for which it was made. And again is not the safekeeping of the public moneys as important a governmental function as the accumulation of such funds by taxation? In \textit{State Bank of Commerce v. United States Fidelity \& G. Co.},\textsuperscript{9} it was suggested that the state in making such deposits also fulfills another public purpose in preventing "any disturbance in the channels of commerce by the withdrawal and retirement of so large a volume of the currency of the country during the tax paying season." Since the power to deposit money for safekeeping must be a necessary incident to the collection and disbursement of governmental funds, the exercise of the power should be recognized as sovereign.

Some cases, while recognizing the existence of a broad general right of priority, have held that this right as respects deposits in defunct banks has been removed by legislation requiring state officers to guarantee their deposits in banks by depository bonds.\textsuperscript{10} The taking of a bond is held to effect a waiver of this sovereign right. Since the bank depository provisions which create the requirement for a bond are contained in general banking statutes it would seem that these courts are abrogating a power of the sovereign by implication. While the state has a right to waive its priority and place itself on a footing with other creditors, such waiver must be express.\textsuperscript{11} This difficulty is not removed by any necessary implication of a waiver arising from the taking of the bond as is suggested by the Arizona court:

"Bearing in mind that the object of such preference is to secure the state in its revenues, if the legislature has adopted other means to attain the purpose, then the reason for applying the common-law rule of the sovereign prerogative, . . . does not exist in Arizona."\textsuperscript{12}

But the acceptance of a surety bond by the state does not absolutely remove the necessity for protection of the public fund since the surety company may become insolvent prior to the extinguishment of its obligation on the bond.\textsuperscript{13}

\textsuperscript{8} Fidelity \& Cas. Co. v. Union Savings Bank; National Surety Co. v. Morris, both \textit{supra} note 1. In the former case the court at 128, 162 N. E. at 422, said: "A distinction must be made between sovereignty and the rights of sovereignty. The rights of sovereignty are those which are deemed essential to the existence of government." And since the deposit of money at interest is a business function, the state will not be heard to assert its alter ego, its sovereignty, and thus the prerogative will not be recognized in the case of deposits in defunct banks.

\textsuperscript{9} 28 S. W. (2d) 184, 187 (Tex. 1930).

\textsuperscript{10} Central Bank of Wilcox v. Lowdermilk, 23 Ariz. 574, 205 Pac. 915 (1922); United States Fid. \& G. Co. v. McFerson, 78 Colo. 338, 241 Pac. 728 (1925); Smith v. Arnold, 165 Ky. 214, 176 S. W. 983 (1915); \textit{In re} Holland Banking Co., 313 Mo. 307, 281 S. W. 702 (1926); National Surety Co. v. Fixon, 60 Utah 289, 208 Pac. 578 (1922); National Surety Co. v. Morris, \textit{supra} note 1.

\textsuperscript{11} Booth & Flinn v. Miller, 237 Pa. 297, 85 Atl. 457 (1912); Woodyard v. Sayre, 90 W. Va. 295, 110 S. E. 689 (1922); \textit{Cooley, Constitutional Limitations} (8th ed. 1927) 316. In \textit{Commonwealth v. Commissioner of Banks}, 240 Mass. 244, 133 N. E. 625 (1922) the court held that insolvency statutes of that state giving a priority to all debts due to the state did not apply to banks because the latter had been the subject of special statutes which failed to mention the preference.

\textsuperscript{12} Central Bank of Wilcox v. Lowdermilk, \textit{supra} note 10, at 578, 205 Pac. at 916.

\textsuperscript{13} In \textit{Commissioners of San Miguel v. McFerson}, 90 Colo. 408, 9 P. (2d) 614 (1932) priority was refused although the state funds involved amounted to over $74,000 secured by
Under the old English law, the prerogative of the Crown continued only so long as the King's debtor retained the title to the assets upon which the priority claim was asserted. The prerogative was defeated by a *bona fide* sale, by an antecedent lien on the property or by a *bona fide* assignment for the benefit of creditors but was not affected by a transfer of possession to a third party or by placing the goods *in custodia legis*. Today under modern banking statutes, the possession of assets of a bank upon a declaration of insolvency is vested in the state superintendent of banking or a receiver appointed by such officer. Because the bank has been divested of title, those courts which are unwilling to grant the priority, and yet are unable reasonably to refuse the right, seize upon this opportunity to declare that the priority is now lost. Since the present title holder is a representative of the state and holds the title in his capacity as representative of the state it would seem that the analogy to the taking of goods *in custodia legis* is stronger than an analogy to a divesting of title by *bona fide* sale or assignment inasmuch as the divestment of the title is temporary and not permanent. The title thus obtained is not absolute and, in most cases, the state banking official may not dispose of assets except by leave of court. The superintendent of banking is required to turn back to the stockholders and directors of the bank any assets remaining after its obligations have been completely satisfied.

Another reason for permitting the prerogative to be effective in such case is that:

"... it would seem to be anomalous for us to hold that merely because the state takes possession of the property of an insolvent bank for no other purpose than to secure payment to the creditors of the insolvent bank, of whom the state is one, it thereby defeats its right to collect its own debts or to assert any priority the state might possess..." 10

Finally, it would seem to be a futile gesture to grant the prerogative subject to the condition that the right is lost if the bank becomes insolvent since a $40,000 bond, the surety upon which was insolvent (the court estimated that $1000 could be realized on the bond). Similarly in *In re Holland Banking Co.*, *supra* note 10, the evidence showed the surety undertakings to be insufficient to protect the public funds. Since the assets of the bank upon liquidation may be insufficient to cover the state deposit, the priority also is not an adequate guarantee of safety to state funds, therefore the state should be permitted to avail itself of both the depository bond and the priority.

2 *Tind's Practice* (9th ed. 1828) 1053.

A typical example is *Pa. Stat. Ann.* (Purdon, 1930) tit. 7 § 482. Under this act, the Secretary of Banking after investigating the condition of the closed bank applies to the Court of Common Pleas for the appointment of a receiver.


17 In Maryland Cas. Co. v. McConnell, *supra* note 1, the court upheld the state's priority because the "superintendent of banking has scarcely as much power as a chancery receiver." The older cases seem to draw a distinction between a chancery receiver and an assignee for the benefit of creditors holding that in former case, the priority remained because the receiver does not take title to the property involved, but only possesses as an officer of the court and to dispose thereof as the court directs. See American Bonding Co. v. Reynolds, 203 Fed. 356 (D. Mont. 1913).

18 In Aetna Cas. & S. Co. v. Moore, *supra* note 16, the court seized upon the fact that the remaining assets after payment of the bank's obligations were required to be distributed among the stockholders rather than to be handed back to the officers of the bank as a ground for holding that the title of the bank was completely divested when the state examiner took over the closed bank.

NOTES

at that time, and at that time only, does the right become of value.\textsuperscript{20} If the right is to be recognized, it must be permitted to survive after the assets of the insolvent bank have been transferred for purposes of liquidation.

The proper conclusion is that the state's right to a priority should be recognized as a common law incident of sovereignty for the protection of the public treasury. It should not be affected by legislation providing for alternative or supplemental ways of guaranteeing state deposits and it should continue until the assets, over which the priority is attempted to be asserted, find their way into the hands of a \textit{bona fide} purchaser against whom this equity must be unavailing. One who takes possession of assets for the purpose of liquidation is not such a \textit{bona fide} purchaser.

Having established this right in the state, what position does the surety attain upon paying the state? Under general principles of suretyship law the surety\textsuperscript{21} upon payment is entitled to be subrogated to all the rights of the obligee whom he pays.\textsuperscript{22} Accordingly, the right of a surety to assert a priority claim when it paid the state if the state itself could have exercised such priority was unquestioned.\textsuperscript{23}

However in \textit{South Phila. State Bank's Insolvency},\textsuperscript{24} the Pennsylvania Supreme Court, while conceding the prerogative of the state, denied the surety subrogation to this right because:

"When the bank failed the Commonwealth had all the rights of an ordinary depositor; those rights passed by subrogation to the appellant. The Commonwealth had also the sovereign's right to priority of payment over other depositors, but, owing to the peculiar nature of that right, it would not pass by subrogation to appellant."\textsuperscript{25}

The court in arriving at this conclusion inquired into the line of old English cases recognizing the prerogative of the Crown, and the privilege of a surety to be subrogated thereto, and concluded that subrogation was not automatic upon payment of the Crown's debt but, rather, was conferred as a privilege by the Crown by an order of the Court of Exchequer.\textsuperscript{26} This dis-

\textsuperscript{20} If the bank is solvent and able to pay all of its creditors, the priority is unnecessary for the protection of the funds. But when insolvency intervenes and the claims of creditors exceed the available assets, then the state requires protection. A claim for priority filed eleven months after the closing of the bank, and two months after the formal appointment of a receiver was allowed in \textit{People v. Marion T. & S. Bank}, \textit{supra} note 1.

\textsuperscript{21} Subrogation is permitted even though the surety is compensated for his services. \textit{Lewis, Adm'r v. United States Fid. & G. Co.}, 144 Ky. 425, 138 S. W. 305 (1911); \textit{Arnold, Suretyship} (1931) 366; \textit{Suretyship} (1927) 139.

\textsuperscript{22} Subrogation is the substitution of another person in the place of the creditor to whose rights he succeeds in the relation to the debt and gives to the substitute all of the rights, priorities, remedies, liens and securities of the party for whom he is substituted." \textit{United States F. & G. Co. v. Bramwell, supra note 1, at 277, 217 Pac. at 337.}


\textsuperscript{24} \textit{Id.} at 433, 145 Atl. 520 (1929).

\textsuperscript{25} \textit{Id.} at 440, 145 Atl. at 521.

\textsuperscript{26} In the Pennsylvania case, the state treasurer had executed a written assignment to the plaintiff surety company. Since the Exchequer Court in granting this priority to the surety, is exercising an administrative rather than a judicial function it would seem that the assignment by the state treasurer came very close to the "matter of sovereign grace" which the Pennsylvania court decided was required in the old law. The court, however, held that the assignment was invalid because made without "warrant of law", but assigned no reasons therefor.
tinction between the right of a surety to subrogation to the state’s rights as a creditor and to its rights as a sovereign is one which has not been established heretofore in this country.\textsuperscript{27} The Pennsylvania court recognized this fact but was of the opinion that the cases which permitted the surety to recover proceeded under a mistaken notion of the law as it existed in England.\textsuperscript{28} If the right of subrogation extends to “all rights, priorities, remedies, liens and securities”\textsuperscript{29} apparently there is no basis for a distinction between priorities as creditor and priorities in any other capacity. But, \textit{per} the court:

“Since the right of priority of the sovereign state exists \textit{pro bono} \textit{populo}, it follows that where a situation arises in which the state, having been paid in full, is not immediately concerned, and where the transfer of its right of priority would result in prejudice to one class of its citizens (the general creditors) for the benefit of another (the surety company), it cannot be held that the good of all the people would thus be served.”\textsuperscript{30}

The real ground upon which the \textit{South Philadelphia State Bank} case may be sustained is that:

“Subrogation is allowed only in cases where it will work equity and do no injustice. The right to subrogation is not a fixed legal right, but is an equitable one framed by courts of equity for the purpose of promoting the just administration of equitable principles. It is everywhere conceded that it cannot prevail in cases where its operation would violate ‘equity and good conscience.’”\textsuperscript{31}

Thus, balancing the equities of the parties, the court takes the position that, since the plaintiff surety company was being paid to bear the risk of the bank’s insolvency, equity was best served by denying the surety company any greater rights than were possessed by the other creditors of the bank.\textsuperscript{32}

A consideration of these conflicting equities suggests an investigation into the premium rates fixed by surety companies for the protection of state deposits. If the surety company charges a lower rate for protecting such deposits than it does for protecting deposits by private individuals, then this might indicate that the surety is relying on the right to be subrogated to the state’s priority.\textsuperscript{33} But

\textsuperscript{27} “We think the doctrine is well established by a decided preponderance of the cases, that a surety, who has paid the debt of his principal obligor, is subrogated in equity by the act of payment, not only to the securities of the creditor, but to all his rights of priority. . . . It is not necessary to inquire how, or in what manner the State’s right to rank as a preferred creditor is derived, whether it is a prerogative right derived from the common law or whether it has been conferred by statute.” Orem, Ex’r v. Wrightson, 51 Md. 34, 45, 46 (1878). In United States Fid. & G. Co. v. Carnegie Trust Co., 161 App. Div. 429, 432, 146 N. Y. Supp. 804, 807 (1914), the court stated that: “. . . it appears to have been invariably held, save in the case of bail given for a person charged with crime, that a surety, paying a debt to the state for which the latter would have been entitled to a preference, takes by subrogation a like preferential right against his principal.”

\textsuperscript{28} \textit{Supra} note 23. The court also criticizes several text-writers.

\textsuperscript{29} All the text-writers so state. \textit{Arnold}, \textit{op. cit. supra} note 21, § 130; \textit{Stearn, Suretyship} (2d ed. 1915) 363; \textit{I. Brandt, Suretyship} (3d ed. 1905) § 324. However, the surety may not avail himself of the peculiar advantages enjoyed by the sovereign, as, for example, immunity from the bar of the statute of limitations. See \textit{Note} (1923) 37 HARY. L. REV. 259.

\textsuperscript{30} \textit{Supra} note 24, at 439, 145 Atl. at 521. These words might be construed as creating a qualified right of priority in the state with absolute subrogation to the surety, rather than unqualified priority and limited subrogation.

\textsuperscript{31} Pence v. Armstrong, 95 Ind. 191, 205 (1883).

\textsuperscript{32} The court permitted the surety to participate in the distribution of the proceeds of the liquidation of the assets of the bank \textit{pro rata} with the other depositors.

\textsuperscript{33} Whether or not the surety is justified in so relying is another matter. In passing, it should be noted that the Pennsylvania Court had, in two previous cases, granted to the surety subrogation to the state’s priority. \textit{Shaeffer’s Estate} (No. 1), 281 Pa. 138, 126 Atl. 205 (1924); \textit{Booth & Flinn v. Miller, supra} note 11.
if lower rates are charged on state deposits, then the denial of the right of subrogation might result in the removal of this rate differential, since the risk of loss to the surety company will be as great in state deposits as in private deposits. If this consequence followed, then the denial of the right of subrogation would defeat the purpose for which the prerogative was created—protection of the public treasury. However, it appears that the surety companies fix the same premiums for private and public deposits and also state deposits in states which refuse the surety subrogation as in those states which grant the right. Therefore, it would seem that the result of the decision in the *South Philadelphia Bank* case was eminently just.

The *South Philadelphia Bank* case has produced some very interesting recent litigation in Pennsylvania. In *Stewart v. National Surety Co. et al.*, a stockholder of a surety company filed a bill in equity to restrain the company from satisfying its obligation on depository bonds so long as the state Secretary of Banking had sufficient funds realized from the liquidation of the assets of a defunct bank to satisfy the claim of the state. It was admitted that sufficient funds were available to extinguish completely the liability to the state if the priority were exercised. Counsel for the plaintiff argued that a provision in the Pennsylvania Constitution prohibiting the releasing of any obligation owed to the state prevented the state from relinquishing its priority and relying upon payment by the surety under its bond. The court refused to give any relief because it was shown that the Secretary of Banking had set aside a fund sufficient to reimburse the state and had paid dividends to depositors only from proceeds remaining after the creation of the fund, thus maintaining the constitutional safeguard to the State Treasury. The federal court, therefore, refused to issue an injunction compelling the state, after the insolvency of the depository bank, to proceed first against the principal and then, if unsuccessful, to pursue its remedy against the surety.

In another recent case the Pennsylvania Supreme Court held that the defendant surety company was liable to the state on its bond notwithstanding the fact that it had given notice to the state to withdraw its deposits in the bank, more than thirty days prior to the insolvency of the bank. The defendants contended

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84 This fact was brought out in the testimony in *Stewart v. National Surety Co.*, U. S. Dist. Ct. E. D. Pa., decided Dec. 8, 1932.
85 See letter of Towner Rating Bureau (which agency fixes premium rates for leading surety companies) quoted in Note 36 W. Va. L. Q. 278, 282.
86 For a vigorous criticism of the West Virginia cases granting subrogation to the surety see a note by Professor Arnold entitled *An Inequitable Preference in Favor of Surety Companies*, supra note 35.
87 Supra note 34.
88 The bill also sought: (1) to restrain the Secretary of Banking from paying out any moneys to depositors until he had satisfied the claim of the state; (2) to compel the State Treasurer to enforce the state's right of priority against the Secretary of Banking, and (3) to restrain the Attorney-General from entering judgment on a warrant of attorney contained in the suretyship agreement.
89 Art. III § 24: "No obligation or liability of any railroad or other corporation, held or owned by the Commonwealth, shall ever be exchanged, transferred, remitted, postponed or in any way diminished by the General Assembly, nor shall such liability or obligation be released, except by payment thereof into the State Treasury."
90 Counsel for the plaintiff advanced the opinion that since the *South Philadelphia Bank* case decided only that the surety could not have any preference if the state failed to demand its priority, the question is still open as to the surety's right where the state claims such priority and then payment is made by the surety.
91 The court, however, admitted that the surety might, by provision of contract, require the state to proceed first against the defunct bank. It is extremely unlikely that the state would accept such contracts which place upon it the *onus* of prosecuting a lawsuit as a condition precedent to the liability of the surety company.
that, under the rule of *Pain v. Packard*,\(^4\) which is followed in Pennsylvania,\(^4\) the failure of the state to remove the deposits upon written request of the defendant surety released it from liability on the bond. The court admitted the force of the rule but held that the defendant had waived this right of release because the suretyship agreement held the surety liable whether the state proceeded against the bank or against the surety first, and to recognize the contention of the defendant would be to ignore this provision entirely.\(^4\)

Having leaped this hurdle, the court then went on to show that to allow the surety to avoid liability by giving the state notice to withdraw its deposits would cause very serious consequences. The state, upon receiving such notice, would be required either to withdraw its deposits, since otherwise it would lose the surety's guarantee of payment, or it would be required to maintain its deposit and forego this protection. Withdrawal of state funds at a critical moment would result in serious impairment of the liquid assets of the bank and would create a strong public feeling that the bank was in an unhealthy condition. There is no reason in law or in fact why the surety should be both a barometer and arbiter of banking conditions in general, or of the condition of any particular bank. Bank confidence is so delicate a matter that to countenance any such supervision by surety companies would be extremely unwise.

On the other hand, it would be equally undesirable for the state to keep its deposits in the bank without the protection of the surety's bond.\(^4\) In tense situations, it would be well nigh impossible for the state to obtain another surety company to assume any liability on a bond in view of the recent withdrawal by its fellow surety.

The protection which Pennsylvania decisions give to the state and to the banking interests has not been given at the expense of the defendant surety because:

> "Surety companies must accept the burdens as well as the benefits of their business. For many years they have been insuring State deposits in the banks of the Commonwealth with only negligible risk and with considerable profit to themselves. Now when the funds of the Commonwealth deposited in the banks most need the protection which the surety companies have been paid to supply, these companies propose to withdraw this protection." \(^4\)

The case contains a *dictum* to the effect that the surety company would not be liable to reimburse the state for any deposits made in the defunct bank subsequent to the receipt of notice to withdraw. This provision is at once consistent with the rule of suretyship which prohibits an obligee from enlarging the liability of the surety, with the public policy which requires that state funds be protected, and the public policy in favor of keeping banks in business.

\(^4\) 13 Johns 173 (N. Y. 1816). This case holds that it is the duty of the creditor, upon receiving notice after maturity, to proceed in the collection of the debt and his failure to do so discharges the surety if the principal debtor was solvent at the time of giving notice. In the case of state bank deposits upon which, being demand deposits, the obligation of the bank matures immediately such a rule would give the surety an immediate and continuing right to terminate his liability on the bond.\(^4\)


\(^4\) *Quære* as to whether there was such a waiver since such a condition is implied in every contract of suretyship.

\(^4\) The continuance of such deposit would not necessarily be unlawful even though the bond required by law is not present, since as alternative security the bank may deposit with the State Treasurer municipal or county bonds. *Pa. Stat. Ann.* (Purdon, 1930) tit. 7 § 482.

\(^4\) Concurring opinion of Maxey, J.
In summary, the present state of the law in Pennsylvania is that, while the state is entitled to priority in payment over other creditors of a defunct bank, such preference does not extend to the surety who pays the state immediately upon the insolvency of the bank. The surety may not, upon insolvency, compel the state to prosecute its claim against the bank first and then to go against the surety nor may it, prior to insolvency, compel the state to withdraw its money from any bank which the surety may believe to be unsound.

D. H. R.

Effect of Insolvency Upon Rights of Shareholders of Building and Loan Associations—Insolvency, as applied to ordinary corporations, exists when assets are insufficient to pay creditors, exclusive of stock subscriptions. The creditors of a building and loan association are necessarily few, and it is almost inconceivable that there would ever be a time when its assets would not be sufficient to pay its debts, exclusive of the claims of its members. It is obvious, then, that insolvency has a peculiar meaning when applied to this type of organization. In attempting to define insolvency, the courts have said that a building and loan association is insolvent, not when it has insufficient assets to pay its debts, but when it cannot pay its members; or when its available and collectible assets have fallen below the amount of stock paid in; or “when it cannot pay back to its stockholders the amount of their actual contributions, dollar for dollar,” after having paid its creditors, considering not merely the money in the treasury but also all the assets and resources of the association. The difficulty with such a hard and fast definition is that the value of “available and collectible assets” cannot really be determined until the association attempts to convert its securities into cash which, in turn, can only be effectively done upon liquidation. The better treatment of the subject seems to come through a realization that insolvency is not a matter of bookkeeping, of attempting to marshal assets and liabilities, but is a matter of sound business judgment exercised by the courts to “best conserve the interest of the parties and of the public.” By adopting this viewpoint, the courts are enabled, when a problem arising out of alleged insolvency comes before them, to decide the question in favor of the greatest protection to the greatest number of shareholders, thus furthering mutuality and equality between shareholders, which are essential principles of these organizations.

Many associations issue “full-paid” (or “pre-paid”) stock. In some the full face value is paid in advance with a right to receive a stipulated rate of interest, or share in dividends, or both; in others, an amount equal to the total number of monthly installments that it is anticipated will be paid by installment holders in a

4 Cf. Sjoberg v. Security Sav. etc. Soc., 73 Minn. 203, 75 N. W. 1116 (1898) (where a statute named insolvency as a ground upon which one or more stockholders might petition the court for the appointment of a receiver, inability to pay back the amount paid in on stock, where there were no creditors or other liabilities, did not constitute insolvency in the sense used in the statute).
5 “Insolvency is not alone determined from the amount of money on hand or cash coming in, but from a comparison of assets and resources, including all kinds of property, real and personal, with liabilities.” Rogers v. Ogden Bldg. etc. Ass’n, 30 Utah 188, 203, 83 Pac. 754, 759 (1905).
particular series is paid in advance with the right to receive interest and the right to receive the face value of the shares after this anticipated time has elapsed.

A holder of such stock, if he has given notice of withdrawal, is subject to the same regulations as the holder of ordinary installment stock and the same law governs his right to priority upon insolvency. Where there is no question of a withdrawal, the holder of full-paid stock, upon liquidation is entitled only to a pro rata share with other members.\(^9\)

Statutes provide for the right of a member to withdraw from the association and receive the "withdrawal" value of his shares, provided he complies with the necessary statutory requirements.\(^8\) The courts have imposed on this right certain other limitations and restrictions. None of these statutes provide for or prohibit withdrawals after the association is insolvent, but most courts lay down the general proposition that insolvency is incompatible with the right to withdraw.\(^9\) It

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2 Pa. Act of 1874, P. L. 73, § 37, pt. 2, PA. STAT. ANN. (Purdon, 1921) tit. 15, §§ 917, 991, provides: that any stockholder wishing to withdraw shall have the power to do so by giving thirty days' notice; that he shall be entitled to receive the amount paid in, less all fines and other charges, and after the expiration of one year from the issuing of the stock he shall be entitled, in addition, to legal interest thereon; that at no time shall more than one-half of the funds in the treasury be applicable to payment of withdrawals without the consent of the board of directors; and that no stockholder shall be entitled to withdraw whose stock is held in pledge as security for a debt. N. J. COMP. STAT. (1910) 347, §§ 38, 39, provides: such notice must be given as is provided for in the constitution and by-laws of the association, but it must not exceed 30 days; if the withdrawal is made within the first year, the withdrawal value shall not be less than the dues paid on the shares less all unpaid fines and a proportionate share of any loss, if made after the first year a reasonable share of the profits shall be included; if shares are pledged as security for a loan the amount of such loan shall be deducted from the withdrawal value and only the difference paid to the member (practically this provision is the same as the corresponding one in the Pennsylvania statute since it means that pledged stock cannot be withdrawn unless its value exceeds that of the debt, and in this latter case it actually amounts to appropriating the withdrawal value to the debt, the latter being thus extinguished and the stock no longer being held in pledge). MASS. GEN. LAWS (1932) c. 170, § 16, provides: withdrawals of unpledged shares may be made by giving 30 days' notice in writing, provided that directors may require 90 days' notice in the case of unpledged matured shares; withdrawing shareholders shall be paid the amount standing credited to the shares plus such part of the profits as the by-laws may prescribe less fines and other legal charges, no more than one-half of the funds in the treasury shall be applicable to this purpose without the consent of the directors; all withdrawals shall be paid in the order in which notice is given. ILL. REV. STAT. (Cahill, 1931) c. 32, par. 387, provides: by-laws may require the withdrawing shareholder to make a written application upon which payments will be made in the order filed; he shall be entitled to receive the full amount of dues paid in and such interest as is fixed by the by-laws or such proportion of the profits as the directors may determine, less any legal charges, provided, that such interests or profits shall not exceed the actual amount earned by these shares; no more than one-half of the funds in the treasury shall be applicable without the consent of the directors; where shares have been pledged as security for a loan "without other security, he may withdraw the same and receive the evidence of indebtedness . . . and such balance in cash, if any, as may be to the credit of such shares. N. Y. CONS. LAWS (Cahill, 1930) c. 3, §§ 397, 398, provides: sixty days' notice must be given; shareholder is to receive the withdrawal value as determined at the last declaration of dividends before such notice, together with the dues paid since that declaration, less fines and other obligations; no more than two-thirds of the receipts shall be applied to the payment of matured shares and withdrawals without the consent of the directors, except where payment has not been made within six months after notice, then all the receipts shall be applicable, after payment of expenses and general indebtedness; where payment has been delayed in whole or in part for two years after notice the superintendent of banks may take possession of the association. OHIO GEN. CODE (Tarlockmorton, 1920) § 5651, provides: withdrawals shall be permitted upon such terms as the by-laws provide; those withdrawing shall receive all dues paid in and dividends declared thereon, less fines, assessments, and a pro rata share of the losses.
seems obvious that this should be so where the association is actually insolvent when the notice of withdrawal is given or when it matures. Otherwise there would be a preference in favor of those shareholders who happened to have given a withdrawal notice after the association was already unable to pay back to its shareholders what they had paid in, and such a result would be in direct conflict with the essential characteristic of this type of corporation—that all shareholders are equal and that one should be given no preference over another.10

It is argued that even if, in an action of assumpsit by a shareholder who has given notice of withdrawal to an insolvent association, the courts will not permit him to recover the withdrawal value of his shares, nevertheless, he should be given judgment for their actual or admitted value, at least in going concerns.11 The Pennsylvania court, however, has decided that if the association is insolvent, a notice of withdrawal is of no effect and gives the member no right of action against the association "for any amount".12 This would seem to be the correct view because as the Pennsylvania Supreme Court points out in Stone v. Schiller Building Etc. Association13 "if the Association were liable to judgment and execution at the hands of every withdrawing shareholder, it would result in a race for judgment whereby the assets would be eaten up through forced sales". This reason is equally applicable to the case of judgment for the actual value. A further reason why judgment for the actual or admitted value should not be entered is that to do so would require the court to act as an accountant to marshal the items of assets and liabilities, usually from information contained in the pleadings alone, in order to determine what percentage of loss the plaintiff should suffer.14

In the case where an association has not been declared insolvent or is not in the hands of a receiver, but is "potentially" insolvent when notice is given, the rule is the same as in the case where it is actually insolvent.15

The situation giving rise to the more difficult problem is that in which the notice of withdrawal is given and matures while the association is still actually solvent, but by the time suit is brought or a claim of priority is asserted it is actually or potentially insolvent. Dicita, in some of the cases, say that a withdrawing shareholder is not obliged to share losses suffered by the association after a notice of withdrawal has been given to it when it was solvent.16 This statement evidently means that where a shareholder has given notice to a solvent association,
he will be entitled to the withdrawal value of his shares upon liquidation or a judgment in his favor, if, before he has been paid, the association became insolvent as a result of causes not existing when he gave his notice. Endlich says that the right of withdrawing members to claim payment is not jeopardized by causes of insolvency arising after notice of withdrawal.\(^7\) Therefore, the rule should be, where the association is actually solvent when notice of withdrawal is given and matures and there were sufficient applicable funds in the treasury according to statute to pay such withdrawals, but insolvency intervenes before payment is made, then, upon liquidation, the withdrawing shareholder is entitled to priority over other members to the extent of the withdrawal value as of the time of giving notice, provided that the causes of insolvency arose after he had given this notice. While the majority of decisions\(^8\) uphold such a priority,\(^9\) most of them do not make specific mention of the time when the causes of the insolvency arose. If the decision in *U. S. Building Etc. Ass'n v. Silverman*\(^10\) were carried to its logical conclusion, this same result would be reached even where there were not sufficient applicable funds in the treasury when the notice matured. That case held that where notice of withdrawal has been given and matured and there were insufficient applicable funds, judgment may, nevertheless, be entered, but execution may be restrained until the association has been given a reasonable time within which to pay the judgment. This result, as the case points out, was reached in order to prevent the association from deliberately keeping the funds in the treasury down to the point where it could evade payment of withdrawals. If, upon the subsequent insolvency of the association through causes that arose after the notice was given and, therefore, after the cause of action accrued upon which judgment was entered, the holder of such judgment could not be preferred to the extent of his judgment, it would be a hollow protection of his rights.\(^2\)

The real difficulty in this situation, and, indeed, in all cases involving the question of the solvency of a building and loan association is, not so much the difficulty of ascertaining what the law is, but of determining the question of solvency itself. Since insolvency, as has been pointed out,\(^22\) is not a matter of bookkeeping, but of sound business judgment under all the circumstances, it is obviously impossible to settle the question by an examination of the books. When an attempt is made to convert its securities into cash, which is really the only accurate test, it may be discovered that, while no one was actually aware of the fact, the association had been insolvent for some time past. If this is true, then

\(^7\) *Endlich, Building Associations* (2d ed. 1895) § 108.

\(^8\) Note (1914) 49 L. R. A. 1142, 1144.

\(^9\) Wise v. Zazoo Bldg. etc. Ass'n, 105 Miss. 78, 62 So. 1 (1913); Gray v. Active etc. Ass'n, 80 Mo. App. 585 (1899) (where notice was given and matured while the association was solvent, but insolvency occurred before payment it was held that if the association was solvent when notice was "given and accepted", the acceptance of the notice terminates the membership and the stockholder *eo instanti* becomes a creditor of the association and is entitled to preference upon liquidation); cf. Silvers v. Merchants etc. Ass'n, 56 Atl. 294 (N. J. Eq. 1903) (where notice was given and matured while the association was solvent but insolvency intervened before payment, one of the shareholders who had given notice and who had consistently ever since demanded payment and asserted priority and proved his claim before the receiver was given a preference, while four others who had given notice at the same time but did not later assert their right and did not present their claim to the receiver were held to have abandoned their claims and were cut off by the decree approving the receiver's accounts); cf. French v. Wolfson, *supra* note 9 (here a statute permitted a withdrawing shareholder to sue at the end of six months after notice. The association was solvent when notice was given and matured but was turned over to receivers before the six months' period ended; shareholders were not entitled to a preference). *Contra*: Miers v. Columbia etc. Ass'n, 157 Fed. 940 (C. C. S. D. N. Y. 1907); Vinton v. Natl. etc. Ass'n, 112 Ky. 622, 66 S. W. 510 (1902).

\(^10\) 85 Pa. 394 (1877).


\(^12\) *Supra* note 3.
notices of withdrawal given during this period will not be effective to give the shareholder preference upon liquidation if the causes of this insolvent condition arose before he gave his notice; and if he has been paid the withdrawal value of his shares under a mistaken belief that the association was solvent at the time, this money may be recovered back from him.28

Generally, no distinction has been made by the courts regarding insolvency between the cancellation of matured shares of a non-borrowing member and withdrawals before maturity.24 Where the shares were declared matured while the association was solvent but their value was not paid, the holders of such stock, in the absence of a provision in the by-laws to the contrary, are not entitled to a preference over other shareholders.25

Where the association is admitted to be solvent when the shares were declared matured, the holder is entitled to payment, but if the solvency of the association may be seriously impaired by this payment, equity may control execution under a decree rendered for the value of the shares until the association has had a reasonable time within which to pay the shareholder.26 The court in a recent Pennsylvania case27 said:

"... in cases of actual insolvency, the holders of stock declared to have matured, are not creditors in the ordinary sense, but are only entitled to share pro rata with the holders of unmatured stock, after the payment of what may be termed outside creditors, provided, of course, that the losses which caused the insolvency did not arise after plaintiff's shares matured." 28

Here the court is suggesting a hindsight method of determining the rights of shareholders in an association which, at the time the determination of these rights comes before the court, is actually insolvent. It is suggesting that the real basis of determining the rights of shareholders is not solvency or insolvency at the time a notice of withdrawal matured or at the time the particular series of stock matured, but that the real question is: were there conditions existing at the time of such notice or when such shares matured which, looking back on the whole financial situation, have actually caused or materially contributed to the present state of insolvency? If this question is answered in the affirmative, no priority shall be permitted; if in the negative, priority should be allowed. In view of the fact that it is practically impossible to determine insolvency until liquidation and because of the mutual relation existing between shareholders which demands that there be an equitable settlement between them, this seems to be the most just and at the same time the most sensible way of determining their rights in situations of this sort. Such a rule places a proportion of the losses incurred on a shareholder on the basis that the cause of those losses was existent while he was still reaping the benefits of membership and, therefore, he should share in them, rather than that his right to priority should depend merely upon the time when he gave notice or when his shares matured.29

28 Aldrich v. Gray, supra note 9, at 457.
24 Note 49 L. R. A., supra note 18, at 1142.
26 Sperling v. Euclid etc. Ass'n, supra note 25, at 149, 162 Atl. at 203.
27 Ibid.
28 Italics inserted.
29 In Sklar v. Maxwell Bldg. etc. Ass'n, 16 Pa. D. & C. 269 (1932) it was decided upon a case stated in assumpsit which admitted the solvency of the association at the date of maturity, that the holder of the matured shares was entitled to preference upon subsequent insolvency. An appeal of this case is pending before the Pennsylvania Superior Court, No. 97, October Term, 1932. One reason given in the appellant's brief why the lower court's decision should be reversed is that the association did no business from the time the shares were de-
Some associations permit and encourage members whose stock has matured to allow the money due them to remain in the association at a certain rate of interest. If this is done, providing the shares matured before the causes of insolvency arose, it obviously creates a deposit and a relation of debtor and creditor between the association and such former shareholder, so that, upon insolvency, he is entitled to priority along with other creditors. It follows that if the association was actually insolvent or causes of a later insolvency were existing when the shares were declared matured and the money was left at interest, the money was improperly turned into a deposit and the "depositor" would not be entitled to priority.

The final problem presented here is what part of the money that a borrowing shareholder has paid into the association is to be credited to his debt when the association is in process of liquidation.

It is generally held that he occupies a dual relation to the association, i.e., that of a shareholder and that of a debtor, each being separate from the other. Thus, in the absence of a specific agreement, payments on the stock are not credited against the loan as they are made. It is possible, however, for the parties to agree to an appropriation of the payments made on behalf of the stock to the loan. The courts hold that such an agreement, to be effective, must be made while the association is still solvent and if so made, subsequent insolvency will not affect the appropriation.

If there has been no agreement for appropriation and the association is in liquidation, there is a wide variety of opinion expressed by the courts as to just what payments should be credited to the debt. While the decisions are far from harmonious, still, they have tended to group themselves under one of three holdings known as the Pennsylvania, Maryland, or Illinois (sometimes called Grosscup) rules.

The Pennsylvania rule, briefly, charges the borrowing member with the amount of his debt plus interest and credits him with the amount of interest paid on the debt and with the amount of premiums paid. As to his payments of dues, he is considered to have made them as a shareholder, and not a borrower, and is not entitled to credit on his loan for the amount so paid, but is only entitled to a pro rata distribution with other shareholders of this amount.

The Maryland rule charges the borrower with the amount of his loan plus interest and credits him with all sums paid as dues, premiums and interest. This rule is based on the theory that the dual relation originally existing between a stockholder and the association ceased when the shares matured until it became insolvent. Since the case stated in the lower court admitted insolvency at the time of maturity, this is evidently a contention that the causes of the present insolvency existed when the shares matured and that, therefore, there should be no priority.

A depositor is not strictly a member of the association. Statutes, in some jurisdictions, permit associations to receive deposits [OHIO GEN. CODE (Throckmorton, 1926) § 9648], in much the same manner as a bank or trust company, at a fixed rate of interest, which deposits may be made or withdrawn, with a few restrictions, at the will of the depositors. SUNDEHEIM, op. cit. supra note 10, at § 30; ENDLICH, op. cit. supra note 17, at § 56; THOMPSON, BUILDING ASSOCIATIONS (2d ed. 1899) § 282. Depositors are entitled to share pro rata with creditors in preference to shareholders, even where there is no authorization. Chriswell's Appeal, 100 Pa. 488 (1882). The rights of such depositors are comparatively unimportant because this type of business is so seldom entered into by the association, it being considered "a dangerous embarkation in the banking business for which building and loan associations are unfitted". SUNDEHEIM, op. cit. supra note 10, at § 30.

Cooper v. Newton, 166 Fed. 190 (C. C. S. D. Ga. 1908); (1928) 77 U. OF PA. L. REV. 534 and authorities cited there.

Haspel v. McLaughlin-Lyons, 38 Pa. Super. 334 (1909) (held there could be no appropriation when the association was on the eve of insolvency); see Haspel v. Moffit, 32 Pa. Super. 344, 348 (1906).


Strohan v. Franklin etc. Society, 115 Pa. 273, 8 Atl. 843 (1887).
borrowing member and the association is destroyed by insolvency which destroys the mutuality of the contract by making its fulfillment impossible and hence, a settlement must be made just as if there were only a contract of loan.\footnote{Low Street Bldg. Ass'n v. Zucker, 48 Md. 448 (1877).}

The Illinois rule is essentially like that of Pennsylvania except that credit is allowed for interest and only so much of the premium as is said to be "un-earned" by the association, \textit{i.e.}, the amount of the premium to be credited is in the same ratio to the whole premium paid as the ratio between the unexpired term of the loan and the whole period the loan was run. No credit is given for dues paid on the stock but all shareholders get a \textit{pro rata} portion on distribution.\footnote{Towle v. American etc. Society, \textit{supra} note 3.}

The overwhelming majority of courts follow the Pennsylvania rule.\footnote{Strohan v. Franklin etc. Society, \textit{supra} note 34.} It has been contended that this rule, while being more equitable than the Maryland rule is less so than the Illinois rule, because it ignores the fact that the borrower has had the advantage of the loan for part of the time during which dividends have been declared and stocks matured out of earnings of which the premiums were a part used for this purpose.\footnote{Cameron v. Riggle, 14 Pa. D. & C. 547 (1930). The court said (at p. 550), since the Act of 1913, P. L. 205, which permits the issuance of stock up to the limit set by the charter to any person at any time thus no longer necessitating series stock, "the only way in which the affairs of a building and loan association, as they have been conducted since 1913, can be equitably adjusted is to consider the periodical payments of premium exactly as interest, and allow the receiver to recover from the borrower the amount received from the association with interest at six per cent, deducting therefrom only the interest paid by the borrower. If that is done all the shareholders are treated fairly and the borrower receives upon a distribution of the assets, the value of his stock as increased by his dividends and dues \textit{pro rata}".}

In the leading case upholding the Pennsylvania rule the entire premium was deducted in advance from the amount loaned to the borrower.\footnote{SUNDHEIM, \textit{op. cit. supra} note 10, at §§ 126, 128; (1928) \textit{77} U. OF PA. L. Rev. 534-535.} A more recent Pennsylvania case, decided, however, in a lower court\footnote{Strohan v. Franklin etc. Society, \textit{supra} note 34.} has made a distinction between cases where the premium is deducted in advance and where it is paid in installments (as is the almost universal practice today) and held that in the latter case no credit was to be allowed for the premium.

The Pennsylvania rule is the most desirable in that more equity is done by allowing a credit for the entire premium whether deducted in advance or paid in installments. Ordinary lenders are not permitted to charge usurious interest; a building and loan association is given this special privilege by permitting it to charge premiums on its loans because of its peculiar operation, \textit{i.e.}, these premiums go into a common fund which is distributed among the members, permitting them to share in these premiums and allowing borrowing members to pay off their indebtedness in small installments and before the time they would be able to do so if they were required to pay the full amount of their loan. When the association becomes insolvent this fundamental purpose is destroyed; the shares will never mature and the members will never get the benefit of the peculiar operation of the association. Since this purpose cannot be accomplished and the members cannot reap this benefit from its operation, the only reason why the association is allowed to charge usurious interest has disappeared. The borrowing member is required to pay legal interest on his loan and upon insolvency is required to pay the loan itself. He only gets a \textit{pro rata} share of the value of his stock as do non-borrowing members and there is no reason why he should be penalized to the extent of the amount of the premium he has paid in addition.

In fact, the very practice of \textit{pro-rating} the claims of unpreferred shareholders on an equal basis, under present conditions, seems to be highly inequitable. When associations issued only a single series of stock as they did when they first became

\footnote{For a complete discussion of these three rules, their relative merits, and the cases decided under them, see Note (1913) \textit{43} L. R. A. 874 at 885.}
prevalent, all members, upon insolvency, were in the same position and equity between them could readily be achieved by a *pro rata* distribution on an equal basis; but now that they are multiple series associations it seems highly unjust, upon insolvency, to pro-rate holders of a series which, let us say, has already run ten years and holders of a series which has run only six months on the same basis. If the association can only pay fifty per cent. to its shareholders, those who have paid in for ten years suffer a fifty per cent. loss on their investment exactly as do those who have paid in only six months although the sum which the former have paid materially increases the assets that are now pro-rated while the sum the latter have paid in adds comparatively little. This difficulty is undoubtedly recognized by the courts but no practical method of working it out has yet presented itself. The law regarding problems arising out of insolvency is now being accorded a more thorough treatment than it has ever received before and the courts should feel no hesitancy in molding it to fit present conditions. It is not unlikely that some proportionate method of distribution, based on the length of time a particular series has run when insolvency occurs, will be satisfactorily worked out.

*G. W. K.*