

Banks - State Deposits - Preferred Claims

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NOTES

BANKS—STATE DEPOSITS—PREFERRED CLAIMS.—Whether the deposits of the state in banks which have been designated state depositories are to be classified as preferred claims upon the insolvency of the bank, in the absence of statute, and whether, if they are so denominated, a surety company is entitled to subrogation thereunder to the extent of the preferred claim, is the interesting problem presented in *Fidelity & Deposit Co. of Maryland v. Brucker, et al.*¹ The problem is particularly pertinent in view of the large number of banks which became insolvent during the recent economic depression, and the large amount of states' funds which became "tied up" thereby.

It is readily seen that whatever is the decision on the above statement of facts, that decision must of necessity be based on public policy,²

¹ (Ind. 1933), 183 N.E. 668.

² In *United States v. Prescott, et al* (1845), 3 How. 578, Justice McLean said, "Public policy requires that every depository of public money be held to strictest accountability." In *United States v. State Bank of No. Carolina* (1832), 6 Pet. 29, 8 L. Ed. 308, the court said, "The right of priority due to the government . . . is founded upon the motive of public policy in order to secure an adequate revenue to sustain the public burdens."

and this was the basis in the early Roman law.³ And it was because of this "public policy" that a number of states incorporated provisions in their statutes specifically stating that a right of preference for state funds deposited in state depositories would exist upon the insolvency of such depositories.⁴

In the early Roman law the government was a privileged creditor and entitled to priority in the payment of debts.⁵ This was true also under the common law of England; the king was entitled to be paid out of the assets of his debtor subjects, in preference to other creditors not secured by prior lien on the debtor's property.⁶ Coke on Littleton⁷ says "* * * as to the third protection cum clausula nolumus, the king by his prerogative⁸ regularly is to be preferred in the payment of his duty or debt by his debtor before any subject, although the king's duty or debt be the latter."⁹ This right of the crown was first recognized in the United States by Chancellor Kent respecting the problem in question.¹⁰

³ 1 Kent Comm. 247: "The government was a privileged creditor, under the Roman law, and entitled to priority in the payment of debts. The *cessio bonorum* was made subject to this priority for the good of the people." And see La. Civ. Code 2166; 2 Mart. La. N. S. 108; 5 id 299; and *Sturges v. Crowninshield*, 4 Wheat. 122, 4 L. Ed. 529 (1819).

⁴ *Booth v. State* (1908), 131 Ga. 750, 63 S.E. 502, cf. Stats. (1784); *In re Marathon Sav. Bank* (1924), 198 Iowa 696, 196 N.W. 729, 200 N.W. 199, cf. Sec. 3825 a, Code Supp. 1913; *Bent v. Inhabitants of Hubbardston* (1884), 138 Mass. 99; *Campion v. Village of Graceville* (1930), 181 Minn. 446, 232 N.W. 917, cf. Minn. Stats. par. 1880-1906; *State v. Ord State Bank* (1928) 117 Neb. 189, 220 N.W. 265, cf. Comp. Stats. 1922, par. 5996, Laws 1923, c. 191, par. 24; *Baxter v. Baxter* (1885), 23 S.C. 114.

In the Iowa case it was held that the state, county and municipal governments were entitled to a preference over other depositors or creditors. In the Minnesota case the court held substantially the same, except that the rule did not apply to municipal governments, saying,

"It seems to carry too far the effect of our wholesale adoption of the common law at the creation of our state."

⁵ Kent Comm., see n. 3.

⁶ 2 Tidd, Pr. 1053; *Rex ex rel. Braddock v. Watson* (1860), 3 Price 7, 146 Eng. Repr. 174; *Giles v. Grover* (1832), 9 Bing. 128, 131 Eng. Repr. 562, 11 Eng. Rul. Cas. 550; *Rev v. Cotton* (1751), 145 Eng. Repr. 729.

⁷ 1 Co. Litt., Butler & Hargrave's notes, par. 199, p. 1316.

⁸ Under the English law the royal prerogative is an arbitrary power vested in the executive to do good and not evil. Rutherford, Inst. 279; 1 Co. Litt. 90; Chitty, Prerog. Bac. Abr. "It is frequently used to express the uncontrolled will of the sovereign power in the state and is applied not only to the king but also to the legislative and judicial branches of the government." 1 Halleck, Int. L. 147. See *Att'y. Gen. v. City of Eau Claire* (1875), 37 Wis. 400.

⁹ This was restricted by 33 Hen. 8, according to *Giles v. Grover*, see n. 6, and *Att'y. Gen. v. Andrew*, 145 Eng. Rep. 360 (1656) to only where the king had obtained judgment on crown process first.

¹⁰ 1 Kent Comm. 248 n. (b). "The common law prerogative of the king, to be paid in preference to all other creditors . . . prevails in the government of the United States, Maryland, North Carolina, Indiana, and Connecticut." While Chancellor Kent was immediately taken as an authority on this statement, there is some doubt as to the rule respecting the federal government, since the holding in *United States v. State Bank*, supra n. 2, is exactly contra, to the effect that the right rests solely on statute. See R. S. par. 3466. The wording in this federal statute is so broad that it would seem the federal government has a priority in any case, including the subject here discussed.

Having settled the point whether the right existed at common law,¹¹ the weight of authority seems to be that the common law as adopted by the states included this preferential right as it existed in the sovereign in England,¹² and where statutes do exist, they are a codification of the common law rule.¹³ In one of the leading cases on the subject¹⁴ the court said,

"Under our constitution we have no king. The king, therefore, and the prerogatives that were personal to him, being repugnant to our constitution, are abrogated, but his sovereignty, powers, functions, and duties, insofar as they pertain to civil government, now devolve upon the people of the state, and consequently are not in conflict with any of the provisions of our constitution.¹⁵ Inasmuch, therefore, as the claims or monies due the king for the support and maintenance of the government, whether derived from taxes or other sources of income, were preferred over the claims of others, it follows that under the first sub-

See *People v. Metropolitan Surety Co.* (1916), 161 N.Y.S. 616, 175 App. Div. 43; *Beaton v. Farmers' Bank* (1838), 12 Pet. 102, 9 L. Ed. 1017.

The only limitation upon this general priority is expressed in 13 Op. Atty. Gen. 528, that the United States has no priority in the assets of an insolvent national bank. But in the light of some recent decisions this would not seem to be the rule. See *Bramwell v. U. S. F. & G. Co.* (1926), 269 U. S. 483, 46 S. Ct. 176.

¹¹ See n. 6.

¹² Georgia: *Booth v. State* (1908) 131 Ga. 750, 63 S.E. 502, where the court said, "We know of no law that contravenes this general proposition"; *Central Bank & Trust Co. v. State* (1912), 139 Ga. 54, 76 S.E. 587, where the court said, "This right of priority is not inconsistent with the principles or spirit of our institutions, but is necessary for the protection of a public revenue"; Illinois: *People v. Farmers' State Bank* (1929), 335 Ill. 617, 167 N.E. 804, 65 A.L.R. 1327; *People v. Marion Trust & Sav. Bank* (1932), 347 Ill. 445, 179 N.E. 893, where the court said, "This preference is founded on the inherent right of a sovereign to have its revenue protected for the general public good"; Montana: *Aetna Acc. & L. Co. v. Miller* (1918), 54 Mont. 377, 170 Pac. 760, L.R.A. 1918C, 954; *American Bonding Co. v. Reynolds* (D.C. Mont. 1913), 203 Fed. 356, where the court said, "Montana adopted the crown's prerogative with respect to public debts"; New York: *Matter of Carnegie Trust Co.* (1912), 206 N.Y. 390, 99 N.E. 1096, 46 L.R.A. (NS) 260; *U. S. F. & G. Co. v. Carnegie Trust Co* (1914), 161 App. Div. 429, 146 N.Y.S. 804, where the court said, "The claim of the state was entitled to a preference and priority of payment over general creditors"; Oregon: *U. S. F. & G. Co. v. Bramwell* (1923), 108 Ore. 261, 217 Pac. 332, 32 A.L.R. 829; *Fidelity, etc. Co. v. State Bank* (1926), 117 Ore. 1, 252 Pac. 823. See, also Iowa: *Beuna Vista County v. American Sav. Bank* (1924), 198 Iowa 692, 196 N.W. 729, 200 N.W. 199. Tennessee: *Maryland Cas. Co. v. McConnell* (1924), 148 Tenn. 656, 257 S.W. 410; *Fidelity etc. Co. v. Rainey* (1908), 120 Tenn. 357, 113 S.W. 397; *University of Tennessee v. People's Bank* (1928), 157 Tenn. 298, 6 S.W. (2d) 328. W. Virginia: *Central Trust Co. v. Bank of Mullens* (1929), 107 W. Va. 679, 150 S.E. 221; *U. S. F. & G. Co. v. Cental Trust Co.* (1924), 95 W.Va. 458, 121 S.E. 430; *Woodyard v Sayre* (1922), 90 W.Va. 295, 110 S.E. 689, 24 A.L.R. 1497.

¹³ See n. 4.

"In the absence of statute, the right of priority of debts due the state would exist at common law. Our statute is simply declaratory of the common law." In re *Marathon Sav. Bank*, supra.

¹⁴ In re *Carnegie Trust Co.*, supra.

¹⁵ U. S. Const. Art. X. "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

division of the * * * constitution of 1777, quoted, such preference became a part of the common law of our state, and is so continued under our present constitution."¹⁶

Some limitation, however, has been placed on this so-called prerogative of the state in the exercise of its sovereignty in those jurisdictions which have admitted the right,¹⁷ e.g., this right obtains only so long as the debtor bank retains title to the property out of which payment is to be made;¹⁸ or only until the assets pass into the hands of the State Banking Commissioner, at which time the state loses its right;¹⁹ or only to the extent that the claim attaches, from and as of the time when it was properly claimed or asserted,²⁰ and does not take precedence over claims which were fixed on the property prior to that time and were in force;²¹ or only until the assets pass into the receiver's hands.²²

The courts in some states have recognized the existence of such prerogative right of preference for the state from the common law, but for the reasons indicated have not enforced such preference: Connecticut, because of a statute concerning the marshalling of claims;²³ Maryland, because such right does not constitute a lien,²⁴ or because it was lost by the assignment for the benefit of creditors;²⁵ Michigan, because it was not enforceable in favor of the surety;²⁶ Pennsylvania, because the surety company which sought to force the preference was held not subrogated to the right of the state to do so;²⁷ New Mexico, because the right of preference existed only as long as title remained in the debtor, and was lost when the receiver was appointed;²⁸ Texas, because the right of preference was waived by the enactment of the state de-

¹⁶ This priority has been enforced by the courts of New York under a great variety of circumstances in an unbroken series of cases. *Matter of Receivership of Columbian Ins. Co.*, 3 Abb. (N.Y. Ct. App.) Dec. 239, 242 (1866); *Central Trust Co. v. N. Y. City & No. R. R. Co.* (1888), 110 N.Y. 250, 259; *Matter of Atlas Iron Construction Co.* (1897), 19 App. Div. (N.Y.) 415, 419; *Matter of Niederstein* (1912), 154 App. Div. (N.Y.) 236, 246; *Matter of Wesley* (1913), 156 App. Div. (N.Y.) 403, 405; *People v. Metropolitan Surety Co.* (1913), 158 App. Div. (N.Y.) 647, 650; *Mixer v. Mohawk Clothing Co. Inc.* (1915), 155 N.Y.S. 647.

¹⁷ See n. 12.

¹⁸ *State v. Madison State Bank of Virginia City* (1923), 68 Mont. 342, 218 Pac. 652.

¹⁹ *National Surety Co. v. Pixton* (1922), 60 Utah 289, 208 Pac. 878, 24 A.L.R. 1487.

²⁰ This is directly in accord with the English case of *Giles v. Grover*, *supra*.

²¹ *City and County of Denver v. Stenger* (C.C.A. 8th, 1924), 295 Fed. 809.

²² *State v. Carlyon* (Wash. 1932), 7 P. (2d) 572.

²³ *Basset v. City Bank & Trust Co.* (1932), 115 Conn. 393, 161 A. 852.

²⁴ *Public Indemnity Co. v. Page* (1931), 161 Md. 239, 156 A. 197, 792.

²⁵ *State v. President, etc. of Bank of Maryland* (1834), 6 Gill & J. 205, 26 Am. Dec. 56.

²⁶ *Comm'r. of Banking v. Chelsea Savings Bank* (1910), 161 Mich. 691, 125 N.W. 424, 127 N.W. 351.

²⁷ *In re So. Philadelphia State Bank's Insolvency* (1929), 295 Pa. 433, 145 A. 520.

²⁸ *State v. First State Bank* (1918), 22 N.M. 661, 167 Pac. 3, L.R.A. 1918A, 394; *State v. People's Savings Bank & Trust Co.* (1917), 23 N.M. 282, 168 P. 526.

pository law;²⁹ Wyoming, because the state's requirement of a surety bond waived whatever preference it might otherwise have had.³⁰

Some courts have declined to pass upon the existence of such prerogative common law right of preference, holding the same to be unnecessary for the reason that the state in making such a deposit exercises a private and not a sovereign function,³¹ and holding such preference, if it exists at all, to be lost because it was not asserted before the state bank examiner or receiver took charge of the insolvent bank.³²

In a number of states the courts have held that no such prerogative right of preference was ever derived, or that it ever existed at all.³³

Assuming then the rule to be that where a state has deposited funds in a state depository, in the absence of statute it has a common law right to a preferred claim against the bank in case of insolvency; the question then arises, is the surety company entitled to subrogation to the extent of the preferred claim?³⁴ The rule as to the company's subrogation to the preferred claims of the federal government,³⁵ and to the

²⁹ *Shaw, Banking Comm'r. v. U. S. F. & G. Co.* (Tex. Com. App. 1932), 48 S.W. (2d) 974, 977.

³⁰ *National Surety Co. v. Morris (U. S. F. & G. Co. v. Elliott)* (1925), 34 Wyo. 134, 241 Pac. 1063, 42 A.L.R. 1290.

³¹ *Fidelity, etc. Co. v. Union Savings Bank Co.* (1928), 119 Ohio St. 124, 162 N.E. 420.

³² *Aetna, etc. v. Moore* (1919), 107 Wash. 99, 181 Pac. 40; *State v. Carlyon* (1932), 166 Wash. 498, 7 P. (2d) 572.

³³ Arkansas: *Maryland Casualty Co. v. Rainwater* (1927), 173 Ark. 103, 291 S.W. 1003, 51 A.L.R. 1332. Arizona: *In re Central Bank of Wilcox* (1922), 23 Ariz. 574, 205 Pac. 915. Colorado: *U. S. F. & G. Co. v. McFerson* (1925), 78 Colo. 338, 241 Pac. 728; *Board of County Commissioners v. McFerson* (1932), 90 Colo. 408, 9 P. (2d) 614. Florida: *Lake Worth, etc., v. First American Bank & Trust Co.* (1929), 97 Fla. 174, 120 So. 316. Kentucky: *Denny v. Thompson* (1930), 236 Ky. 714, 33 S.W. (2d) 670, 673. Minnesota: *Campion v. Village of Graceville* (1930), 181 Minn. 446, 232 N.W. 917. Mississippi: *Potter v. Fidelity etc. Co.* (1911), 101 Miss. 823, 58 So. 713. North Carolina: *Board of Chosen Freeholders v. State Bank* (1878), 29 N.C. 513. South Carolina: *State v. Haris* (1832), 2 Bailey (18 S.C. Law) 598. United States: *United States v. State Bank of North Carolina* (1832), 6 Pet. (31 U. S. 19) 29, 8 L. Ed. 308; *Marshall v. New York* (1920), 254 U. S. 380, 41 S. Ct. 143, 65 L. Ed. 315; *Central Trust Co. of New York v. Third Ave. R. Co.* (1911), 186 Fed. 291, 110 C.C.A. 1 (2d Cir.); *Brown v. American Bonding Co.* (1914) 210 Fed. 844, 848, 127 C.C.A. 432 (9th Cir.).

³⁴ " * * * equity in applying the doctrine of subrogation looks not to form, but to the substance and essence of the transaction. It looks to the debt which is to be paid, and not to the hand which may happen to hold it, and will see that the fund charged with its payment shall be so applied." *Orem v. Wrightson* (1878), 51 Md. 34, 34 Am. Rep. 286. "The equitable doctrine of subrogation contemplates full substitution." *U. S. F. & G. Co. v. Burrough Bank* (1914), 146 N.Y.S. 870, 161 App. Div. 479. In *Hayes v. Ward* (1819), 4 Johns. Ch. 123, 8 Am. Dec. 54, Kent, C., says, "It is equally a settled principle in the English chancery, that a surety will be entitled to every remedy which the creditor has against the principal debtor." In *U. S. F. & G. Co. v. Carnegie Trust Co.*, *supra* n. 12, the court said, "It is familiar law that a surety who pays the debt of the principal is entitled to be subrogated to all of the creditor's rights."

³⁵ See U. S. Rev. St., par. 3468 which provides in comprehensive terms complete subrogation by a surety to any claim of the United States against an insolvent bank. Also: *United States v. Brock* (D.C. La. 1925) 5 F. (2d) 265; *Bramwell v. U. S. F. & G. Co.*, *supra*; *In re Meinst* (C.C.A. 2d, 1923) 289 Fed. 229. See also: *Fouts v. Maryland Casualty Co.* (C.C.A. 4th, 1929), 30 F.

preferred claims of those states in which the courts have held that they have a common law preferential right,³⁶ is that the surety will be subrogated to the general right of the state to collect losses from the assets of the depository.³⁷ This seems to be the overwhelming weight of authority.³⁸ A few courts, however, are disposed to a dislike for a rule which permits a surety, who has been paid to assume the risk, to assert a right of priority to the prejudice, or exclusion, of general depositors and creditors, and have held that the state's prerogative right of priority is not a right to which a surety can be subrogated.³⁹

CLEMENS H. ZEIDLER

ENTRAPMENT IN CRIMINAL CASES.—Out of the struggles between the forces of law and order and the criminal elements in our society have developed many legal problems. Not the least interesting of these is the question of what inducements to and opportunities for the commission of crime may be offered by agents of the government to those suspected of violations of the criminal law, without such "entrapment" being judicially regarded as a defense to prosecution for the alleged offense. There is, of course, rather general agreement that the fact that officers of the government merely afford opportunities or facilities for the commission of the offense does not defeat the prosecution.¹ Artifice and strategem may be used to catch those engaged in criminal enterprise.² Courts are also, however, in substantial accord, although there is some judicial disapproval of the doctrine,³ that where the officers

(2d) 357; *Strain v. U. S. F. & G. Co.* (C.C.A. 8th, 1924), 292 Fed. 694; *U. S. F. & G. Co. v. Union Bank and Trust Co.*, 143 C.C.A. 30, 228 Fed. 448 (1915).

³⁶ See n. 12.

³⁷ The court said in the Bramwell Case, *supra* n. 12, "Subrogation is the substitution of another person in place of the creditor to whose rights he succeeds in relation to the debts, and gives the substitute all of the rights, priorities, remedies, liens, and securities of the party for whom he is substituted."

³⁸ See cases n. 12, n. 16, and also: *National Surety Co. v. Morris*, *supra* n. 30; *In re Farmers' State Bank of No. Branch* (1928), 174 Minn. 583, 219 N.W. 916; *State v. Thurston State Bank*, (Neb. 1931), 237 N.W. 293; *State v. Liberty Bond & Trust Co.* (1932), 165 Penn. 40, 52 S.W. (2d) 150.

³⁹ *Comm'r. of Banking v. Chelsea Savings Bank*, *supra* n. 26; *In re So. Philadelphia State Bank's Insolvency*, *supra* n. 27; *U. S. F. & G. Co. v. McPerson*, 78 Colo., 338, 241 Pac. 728 (1925).

¹ "It is not unlawful entrapment to afford a person an opportunity to voluntarily and deliberately do what there was reason to believe he would do if opportunity offered." 1 Bishop, *Criminal Law*, sect. 926.

² *Grimm v. United States* (1895), 156 U.S. 604, 15 S. Ct. 470; *Goode v. United States* (1895), 159 U.S. 663, 16 S. Ct. 136.

³ "Even if inducements to commit crime could be assumed in this case, the allegation of the defendant would be but the repetition of the plea as ancient as the world, and first interposed in Paradise, 'The serpent beguiled me and I did eat.' That defense was overruled by the Great Lawgiver, and whatever estimate we may form or whatever judgment pass upon the character or conduct of the tempter, this plea has never since availed to shield crime or give indemnity to the culprit, and it is safe to say that under any code of civilized, not to say, Christian, ethics it never will." *Excise Com'rs. v. Backus* (1864), 29 How. Pr. 33 (N.Y.). "He cannot now say, 'I was tempted and did eat.'" *French v. State* (1928), 149 Miss. 684, 115 So. 705. "The courts do not look to see who held out the bait but to see who took it." *People v. Mills* (1904), 178 N.Y. 274, 67 L.R.A. 131, 70 N.E. 786, affirming (1904) 91 App. Div. 331, 86 N.Y. S. 529.