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Creditors' Rights: Conveyances in Fraud of Subsequent Creditors

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of water use, such as the theory of prior appropriation[32] prevalent in Western states.

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CREDITORS' RIGHTS: CONVEYANCES IN FRAUD OF SUBSEQUENT CREDITORS

One of the earliest and most perplexing problems encountered in the field of jurisprudence was that of aiding creditors in the collection of their just debts. The axiom that "necessity is the mother of invention" might here be changed to read, "necessity is the mother of protection" That debtors early acquired habits and methods of putting their property beyond the reach of creditors is indicated by the fact that even the Romans found a need for regulations to prevent such fraud.[1] Later, in England, several statutes designed to prevent this evil were passed.[2] The most famous of these was the Statute of 13 Elizabeth,[3] which provided that every conveyance made to the end, purpose and intent to delay, hinder or defraud creditors *and others* of their just and lawful actions would be void.[4] At the common law, in jurisdictions that did not have statutes such as this, only those creditors whose claims were in existence at the time a conveyance was made could attack it.[5] One whose claim came into existence after the conveyance could not complain. Not until the advent of statutes like the English statute, which included the words "and others," did the courts bring subsequent creditors within the rule.[6] At a glance it is ap-

c. 262. There are of course obvious difficulties for the individual farmer under this method, such as inability to secure the agreement of interest of his neighbors or the lack of other farmers in the area where he may be, etc.

[32] The doctrine of prior appropriation was adopted by most of the states in the arid and semiarid western states because the common law of riparian rights was not suited to their region. Under this doctrine the one who first diverts and applies to a beneficial use the water of a stream has a prior right to the use therein to the extent of his appropriation. Seven Lakes Reservoir Co. v. New Loveland & Irrg. & Land Co., 40 Colo. 382, 93 P 485 (1807). For historical explanation of law of prior appropriation, see In re Hood River, 114 Ore. 112, 227 P. 1065 (1924).

[1] BUCKLAND, THE MAIN INSTITUTIONS OF ROMAN PRIVATE LAW 339 (1931).

27 Eliz. C. 4 (1585); 3 Henry VII C. 4 (1486); 50 Edw. III C. 6 (1376).

[3] 13 Eliz. C. 5 (1570). It has been stated that this statute and those above, are merely declaratory of the common law. See Springer v. Drosch, 32 Ind. 486 (1870).

[4] *Ibid.*

Burgett v. Burgett, 1 Ohio 469 (1842).

[5] 1 GLENN, FRAUDULENT CONVEYANCES 554 (rev. ed. 1940); 24 AM. JUR. 164 (1939). The circumstances under which a conveyance can be said to be fraudulent were first set out in Twyne s Case, 3 Co. Rep. 80 b (1601), which has been frequently quoted and discussed where the problem of this type of transfer has arisen.

parent that the Kentucky statute[7] is very much like the statute of 13 Elizabeth, so that subsequent creditors may be brought within its purview The language is: "Every gift, conveyance, assignment or transfer of, or charge upon, any estate, real or personal, or right or thing in action, or any rent or profit thereof, made with the intent to delay, hinder or defraud creditors, purchasers or other persons, and every bond or other evidence of debt given, action commenced or judgment suffered, shall be void as against such creditors, purchasers and other persons. "[8]

No detailed exposition of the growth and principles of the law of fraudulent conveyances will be attempted herein, but rather an analysis of the Kentucky law with regard to those principles governing fraud upon those creditors known as subsequent or future creditors. However, first it might be well to examine a few fundamental concepts of the law of fraudulent conveyances, particularly as pertaining to existing creditors. It is an established principle that one who alleges fraud must prove it.[9] Thus where a conveyance is attacked as fraudulent, the complainant has the burden of proving that the transaction was tainted in any way,[10] the presumption being against, rather than in favor of the existence of any fraud.[11] The question is one of fact which may be established, if necessary, by circumstantial evidence.[12]

If a conveyance is made "without valuable consideration",[13] such conveyance is declared by statute to be void as to all existing creditors and may be set aside by them.[14] A question arises as to what the rule

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[7] KY. REV. STAT. sec. 378.010 (1948).

[8] *Ibid.*

[9] 1 JONES, EVIDENCE 365 (4th ed. 1938); 20 AM. JUR. 146 (1939).

[10] Taulbee v. First Nat'l Bank of Jackson, 279 Ky. 153, 130 S.W 2d 48 (1939); Whitaker v. Davidson, 209 Ky. 698, 273 S.W 485 (1925); Hickman Bank and Trust Co. v. Pickard and Mayberry, 207 Ky. 772, 270 S.W 30 (1925). *See* Stewart v. Wheeler, 220 Ky. 687, 689, 295 S.W 991, 992 (1927).

[11] Hickman Bank and Trust Co. v. Pickard and Mayberry, 207 Ky. 772, 776, 270 S.W 30, 32 (1925), wherein the court stated: "Fraud is never presumed. It must be established by the weight of the evidence, but nevertheless it must be convincing."

"The rule is that in every case there must be such legal evidence as is sufficient to overcome in the mind the legal presumption of innocence, and beget a belief of truth of the allegation of fraud."

[12] *Ibid.*

[13] KY. REV. STAT. sec. 378.020 (1945) provides: "Every gift, conveyance, assignment, transfer or charge made by a debtor, of or upon any of his estate *without valuable consideration* therefor, shall be void *as to all his existing creditors, but shall not, on that account alone, be void as to creditors whose claims are thereafter contracted.* " (Italics of writer.)

[14] Hays v. Cyrus, 252 Ky. 435, 67 S.W 2d 503 (1934); Hatcher-Powers Shoe Co. v. Sparks, 237 Ky. 321, 35 S.W 2d 564 (1931). This seemingly "obsolete" gift-by-debtors law has been severely criticized. See Marks, *Kentucky's Obsolete Law on Gifts by Debtors,* 39 KY. LAW JOURNAL 456. See also 3 WILLISTON, SALES 462 (1948).

in Kentucky would be in a case where the debtor has conveyed for inadequate consideration, but was not at the time either insolvent, or rendered so by the transfer. The majority of states ,in this situation, have made solvency, rather than the mere owing of some debts by the debtor, the important consideration, and permit a conclusive presumption only where the debtor was in fact insolvent or rendered so thereby.[15] Where the debtor is not insolvent, any presumption in favor of the attacking creditor is made to depend upon the amount of the indebtedness. If the debt is small, there is only a slight presumption of fraud. If the debt is large, there is a *prima facie* presumption established. Any such rationalization under the Kentucky gift-by-debtor law, however, appears precluded by the stringent rule of law that indebtedness coupled with inadequate consideration is fraudulent. In so far as consideration is concerned, the only possible controversy in a case of transfer by a debtor is whether or not what he received in return is in fact inadequate consideration.[16] If it is, the transfer is what is termed "without valuable consideration,"[17] and is absolutely void as to pre-existing creditors.[18]

Anyone whose claim arose after the voluntary transfer is not protected by the above statute, and must show actual intent to defraud him.[19] As one textwriter[20] has stated:

> "The law draws a sharp distinction between the rights of creditors whose claims existed at the time when the transfer was made, and creditors whose claims arose subsequently."[21]

The distinction itself is not difficult to make. A subsequent creditor has been defined in Kentucky as one whose debts were both potentially and actually created after the fraudulent transaction.[22] The real problem arises in determining what principles of law are to be followed in the process of determining the debtor s intention to de-

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[15] 1 GLENN, FRAUDULENT CONVEYANCES 458 (rev. ed. 1940); Uniform Fraudulent Conveyances Act, Sec. 4 (1918).

[16] Carter & Co. v. Richardson & Co., 22 K. L. R. 1204, 60 S.W 397 (1901).

[17] See note 15, *supra.*

[18] *Ibid.*

[19] Kentucky-Tennessee Light & Power Co., for Use and Benefit of Tri-City Utilities Co. v. Fitch, 63 F Supp. 989 (W D. Ky. 1946); Farmer s Bank of Dry Ridge v. Ashcraft's Admr., 281 Ky. 758, 137 S.W 2d 422 (1940); Liberty Bank & Trust Co. v. Davis, 281 Ky. 51, 134 S.W 2d 988 (1939); Harlin v. Calvert's Admx, 253 Ky. 752, 70 S.W 2d 524 (1934); Combs v. Poulos, 241 Ky. 617, 621, 44 S.W 2d 571, 573 (1931). Where the language used is that: "In such case the immediate parties to the transaction may not have intended to defraud, nor entertained an evil motive, but the law denounces such acts as obstructive to the creditor of the transferer and permits him to nullify the transaction in an appropriate proceeding."

[20] 3 WILLISTON, SALES 464 (1948).

[21] *Ibid.*

[22] Combs v. Poulos, 241 Ky. 617, 44 S.W 2d 571 (1931).

fraud his subsequent creditor. As stated earlier, it is the accepted rule in Kentucky that in order for a voluntary conveyance to be set aside by a future creditor, an actual fraudulent intent on the part of the debtor must be shown.[23] But suppose that at the time the transfer is attacked, some of the debtor's old obligations remain unpaid? This is of no avail in the cases involving voluntary conveyances for the rule will permit a showing of nothing less than an actual fraudulent intent to avoid as against future creditors.[24] Some states, following the contrary English rule, allow a presumption of fraud on the debtor's part, in favor of future creditors, where old debts existing at the time of the transfer still remain unpaid.[25]

To be distinguished from the above questions arising under the "gift-by-debtors" law, K.R.S. 378.020, are questions involving actual fraud. It is an unquestioned general rule that where *actual intent* to defraud a subsequent creditor is shown, he may always set a conveyance aside.[26] This holds true whether the question is one concerning a voluntary conveyance or otherwise. Whether or not the subsequent creditor may never set a conveyance aside unless he shows actual intent to defraud his class is open to question. There appears to be one situation in Kentucky and in those states which have adopted the Uniform Act, in which a subsequent creditor is aided by a presumption without a showing of actual fraud directed toward his class.[27] Where actual fraud toward existing creditors is proved under K.R.S. 378.010,[28] by the subsequent creditor the conveyance is presumed to be fraudulent as to the latter.[29] Thus for all practical purposes, the status of the two types of creditors is equal in cases of actual fraud. The principle has been stated generally that a subsequent creditor can never set aside a conveyance unless he shows fraud upon his class. This is an entirely correct statement if it be qualified by the further principle that fraud as to existing creditors may sometimes

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[23] See note 19, *supra.*

[24] It was stated in one Kentucky case that: " there will be no presumption of a fradulent intent on the part of the grantor in a voluntary conveyance either to his wife or other in favor of a subsequent creditor, but if the proof shows actual fraudulent intent on the part of the grantor to place his property beyond the reach of subsequent creditors, equity will interfere and assist the creditor in the collection of his debts." See Marcum v. Marcum, 177 Ky. 186, 197 S.W 655, 656 (1917).

[25] 1 GLENN, FRAUDULENT CONVEYANCES 560 (rev. ed. 1940); BIGELOW, FRAUDULENT CONVEYANCES 98 (rev. ed.) 1911). Both authorities point out that a few states in applying the English rule, ignored the question of whether or not the old debts were still owing, but were clearly wrong in such application.

[26] 3 POMEROY, EQUITY JURISPRUDENCE 879 (5th ed. 1943). In Kentucky this general principle receives statutory codification in KRS 378.020.

[27] Wyan v. Raisin Monumental Co., 243 Ky. 431, 48 S.W 2d 1050 (1932); James v. Stokes, 203 Ky. 127, 261 S.W 868 (1924).

[28] See note 9, *supra.*

[29] See note 27, *supra.*

carry over so that fraud on the subsequent creditor is thereby considered proved. But suppose the subsequent creditor can show no such actual fraud toward existing creditors. It is here that his lot becomes a hard one.

The ease of proving fraud, an issue in every fraudulent conveyance case, has brought about a difference in the rights of the two principal types of claimants. It is easy to see why this is true. The task of showing the effect of a debtor's diminution of his present estate upon his ability to meet existing obligations is relatively simple. But once the transaction is completed, it is much more difficult to connect it with some future liability If the subsequent debt arose a great length of time afterward, the connection is especially difficult to show [30] Something must be found which justifies the statement that the debtor intended to injure the future creditor.[31]

Proof of fraudulent intent in cases involving existing creditors is not nearly as difficult since such proof is governed by the so-called "badges of fraud" [32] In the language of the Kentucky Court of Appeals:[33]

> "There are circumstances which so frequently attend upon conveyances intended to hinder, delay and defraud creditors, that they are denominated 'badges of fraud' and while they do not raise a conclusive presumption of fraud, their effect is to impose certain duties upon the grantee in the conveyance upon which such badges of fraud attend.
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> "So, where badges of fraud attend upon a conveyance, their effect is to shift to the grantee the burden of evidence; and he must rebut the inferences thereby created, and sustain the bona fides of the transaction."[34]

Some of the badges of fraud enumerated include: (1) fictitiousness of consideration and false statements; (2) inadequacy of consideration; (3) concealment or failure to record a conveyance; (4) insolvency of grantor or considerable indebtedness; (5) transfer of all the debtor's

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[30] Marler v. A. L. Greenburg Iron Co., 216 Ky. 682, 288 S.W 676 (1926); 28 ILL. L. R. 673 (1927).

[31] Two instances where the future creditor may often if not invariably justify his claim are: (1) where the debtor has conveyed without fair consideration in contemplation of embarking upon a new business, or it is sometimes called a "hazardous undertaking" and, (2) where the debtor has conveyed without fair consideration just before he incurred new debts. Uniform Fraudulent Conveyances Act, sec. 5 and 6. See also 1 GLENN, FRAUDULENT CONVEYANCES 579 (rev. ed. 1940); 3 POMEROY, EQUITY JURISPRUDENCE 880 (5th ed. 1948). See also 24 AM. JUR. 286 (1939); 37 CORP. JUR. SECUN. 962 (1947).

[32] 24 AM. JUR. 173 (1939).

[33] Magic City Coal & Feed Co. v. Lewis, 164 Ky. 454, 455, 175 S.W 992, 993 (1915).

[34] *Id.* at 456, S.W at 993. See also, Myers Dry Goods Co. v. Webb, 297 Ky. 696, 181 S.W 2d 56 (1944).

property when he is embarrassed or insolvent; (6) failure of parties to testify If the creditor can show any of the above then he has shifted upon the defendants a burden of explanation.[35]

In conclusion, the rights of a subsequent creditor to set aside a conveyance in Kentucky may be set out as follows: (1) The fact that a conveyance is voluntary under K.R.S. 378.020 – that is, the gift-by-debtors law – affords him no protection at all; he must still show actual fraudulent intent, directed toward his class, subsequent creditors. His problem is mainly one of proof; (2) If a conveyance is attacked by a future creditor under K.R.S. 378.010, on the ground that it was made to "hinder, delay and defraud creditors", he may sometimes win his case by showing actual fraud directed toward present creditors. But, if he is unable to do this, his problem again becomes one of proving actual fraudulent intent directed against his particular class of creditors. In such case the right of these future creditors, in Kentucky as elsewhere, depends upon the salient facts of the individual case.[36] If these facts show an intent to defraud such creditors, protection is in order. If not, there can be no protection. In the final analysis, the entire problem involves a weighing of the debtor's interest in the free use and disposal of his property as opposed to the future creditor's interest in protecting his claim.

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FEDERAL TORT CLAIMS ACT AS APPLIED TO MILITARY PERSONNEL

The Supreme Court of the United States has decided in a recent case[1] which included two other actions[2] that servicemen cannot recover under the Federal Tort Claims Act,[3] for injuries which arise out of or are in the course of activity incident to military service. This

[35] Campbell v. First National Bank of Barbourville, 234 Ky. 697, 701, 27 S.W 2d 975, 977 (1930).

[36] Peyton v. Webb, 29 Ky. L. R. 1151, 1153, 96 S.W 839, 840 (1906) where the court said that each creditor who attacks a conveyance has the burden of showing "by facts or circumstances that the conveyance was made with a fraudulent intent before the property can be subjected. It is the intent and purpose with which the debtor acts that renders the conveyance fraudulent, and this must be determined by the facts of each particular case."

[1] Feres v. United States, 340 U.S. 135, 71 S. Ct. 153 (1950).
Jefferson v. United States, 178 F 2d 518 (C.C.A. 4th 1949); United States v. Griggs, 178 F 2d 1 (C.C.A. 10th 1949).

[2] 60 Stat. 842 (1946), 28 U. S. C. secs. 921-46 (1946). Now contained in the newly revised Judicial Code in secs. 1291, 1346 (b), 1402, 1504, 2110, 2401, 2402, 2411, 2412, 2671-2680 (1948).