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Banks and Banking--Insolvency--Preference of County Funds Where Merger Causes Deposits to Exceed Legal Maximum

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RECENT CASE COMMENTS

BANKS AND BANKING — INSOLVENCY — PREFERENCE OF COUNTY FUNDS WHERE MERGER CAUSES DEPOSITS TO EXCEED LEGAL MAXIMUM. — In West Virginia the legal maximum of county deposits permitted in one bank is \$100,000. Two banks, each having county deposits within the maximum, merged, leaving the surviving bank with county deposits of \$160,000. This bank failed and on suit by the county the circuit court held that since the county funds in the surviving bank exceeded \$100,000 at the time of the appointment of a receiver, they were there in violation of law and constituted a trust fund belonging to the county, just as though the entire amount had been originally deposited in the existing bank. A preference for the excess was granted and the decision affirmed by the Supreme Court of Appeals. *Monongalia County Court v. Bank of the Monongahela Valley.*¹

State governments are usually allowed a preference over individual creditors where the two are otherwise equal because the state succeeded to the prerogative possessed by the king at common law.² Political subdivisions of the state such as counties and municipal corporations do not have this priority. They may obtain a preference only (1) by special statute or (2) where the money is unlawfully deposited, on the theory of a constructive trust.³

One line of cases holds that where a deposit of public funds is made under such circumstances as to constitute a trust in the hands of the bank, it is still essential, to establish a preference on the trust theory, to show that the general assets of the bank have been augmented by such deposit and, in addition, to trace the money deposited by it into the general residue now in the hands

¹ 164 S. E. 659 (W. Va., 1932).

² Page County v. Rose, 130 Ia. 296, 106 N. W. 744, 5 L. R. A. (n. s.) 886 (1906).

³ San Diego County v. Cal. Nat'l Bank, 52 Fed. 59 (S. D. Calif. 1892); Knighton v. Curry, 62 Ala. 404 (1878); Singleton v. United States Fidelity & G. Co., 194 Ala. 506, 70 So. 169 (1915); Richeson v. Crawford, 94 Ill. 165 (1879); Bunton v. King, 80 Ia. 506, 45 N. W. 1050 (1890); Page County v. Rose, *supra* n. 2; Brown v. Sheldon State Bank, 139 Ia. 83, 117 N. W. 289 (1908); Myers v. Board of Education, 51 Kan. 87, 32 Pac. 658, 37 Am. St. Rep. 263 (1893); Fidelity & D. Co. v. Wilkinson County, 109 Miss. 379, 69 So. 865 (1915); State v. Midland State Bank, 52 Neb. 1, 71 N. W. 1011, 66 Am. St. Rep. 484 (1897); Watts v. Cleveland County, 21 Okla. 231, 95 Pac. 771, 16 L. R. A. (n. s.) 918 (1908); Boltz's Estate, 133 Pa. 77, 19 Atl. 303 (1890).

of the receiver.⁴ It has been held that no constructive trust can be raised on such deposits unless they can be traced,⁵ and the burden of tracing is on the party seeking the preference.⁶

Another line of cases, however, supports the rule that where public funds are illegally deposited a constructive trust is established and such funds constitute a preferred claim *without* any proof of augmentation or tracing of the *res*.⁷ Should this rule be applied both where the excess is created by one original deposit and where a merger of several banks caused it, as in the principal case? It is submitted that this is a rational extension of the rule since the reason for giving the preference exists equally in both situations — the illegality of the deposit of public funds.⁸ But is the rule itself sound?

The idea underlying the requirement that the *res* be traced is

⁴The courts are confused as to just what constitutes tracing, however, as the following cases show. *Crawford County v. Strawn*, 157 Fed. 49, 84 C. C. A. 553, 15 L. R. A. (n. s.) 1100 (1907); *Primeau v. Granfield*, 184 Fed. 480 (1911); *Fiman v. South Dakota*, 29 Fed. (2d) 523 (C. C. A. 8th, 1928); *First National Bank v. Fidelity & Deposit Co. of Md.*, 48 Fed. (2d) 585 (C. C. A. 9th, 1931); *Schumacher v. Harriett*, 52 Fed. (2d) 817 (C. C. A. 4th, 1932) (no preference where funds were used to decrease existing liabilities of bank since no augmentation); *Hill v. Miles*, 83 Ark. 486, 104 S. W. 198 (1907); *Myers v. Federal Reserve Bank of Atlanta*, 134 So. 600 (Fla., 1931); *State v. Bruce*, 17 Idaho 1, 102 Pac. 831 (1909); *Bellevue State Bank v. Coffin*, 22 Idaho 210, 125 Pac. 816 (1912); *Officer v. Officer*, 120 Ia. 389, 90 N. W. 826 (1902); *Murray v. North Liberty Sav. Bank*, 196 Ia. 729, 195 N. W. 354 (1923); *Hudspeth v. Union Trust & Sav. Bank*, 197 Ia. 913, 193 N. W. 279 (1923) (no preference in absence of showing that the fund had not been dissipated and had come into receiver's hands as a traceable account or a distinct augmentation of the whole); *Andrew v. Eddyville Sav. Bank*, 204 Ia. 431, 215 N. W. 635 (1927) ("The absence of pleading and proof of the traceability of the fund to the receiver is fatal to the claimant's case even though a trust was properly pleaded and established").

⁵*Daughtry v. International Bank*, 18 N. M. 119, 119 Pac. 220 (1913); *Shute v. Hinman*, 34 Ora. 578, 56 Pac. 412, 58 Pac. 882, 47 L. R. A. 265 (1899).

⁶*Schuyler v. Littlefield*, 232 U. S. 707, 34 S. Ct. (1914); *Com'rs. v. Strawn*, 157 Fed. 49 (C. C. A. 6th, 1907); *Waddell v. Waddell*, 36 Utah 435, 104 Pac. 743 (1909); *Chase and Baker Co. v. Olmsted*, 93 Wash. 306, 160 Pac. 952 (1916); *BOGERT, TRUSTS* (1921) 521.

⁷*San Diego County v. California Nat'l Bank*, *supra* n. 3 (county funds); *Farmers' Savings Bank of Hamburg v. City of Hamburg*, 204 Ia. 1083, 216 N. W. 748 (1927) (city funds). See also annotations in (1927) 51 A. L. R. 1336 and (1930) 65 A. L. R. 690.

⁸The logical difficulty with this extension is that on merging, the excess of the total account with the surviving bank over the legal amount is simply a general indebtedness and the bank has no funds of the county. The effect of the statute is the creation of a duty to pay out the excess above the legal maximum. How is it that such a duty can be said to give rise to a proprietary interest in the liquid assets of the bank where none existed before?

that the claimant has an equity in a specific thing which is in the hands of someone else — either his actual property or its proceeds. Hence, tracing the property he claims into the property from which such preference is sought is quite naturally a prerequisite to the granting of a preferred claim. "Following the *res*" does not mean that the specific dollars deposited must be traced, but only that the deposited sum must be substantially identified as part of that now in the hands of the receiver.⁹ A showing that the funds coming into the possession of the receiver as general assets of the defunct institution were never, after the original deposit, less than the amount of the trust funds is usually held a sufficient augmentation and tracing.¹⁰ Practical difficulties explain the looseness of the rule as applied in bank cases. Absolute tracing there may be impossible since, for example, the funds deposited may be paid out at once without having been physically mingled with other funds of the bank and yet there would be no record of the fact.

It does not appear from the opinion in the principal case whether the general assets of the bank fell below the amount claimed as a trust fund, between the time of depositing and the insolvency of the bank, but the decision is broad enough to imply that a preference would be allowed if tracing were impossible. Such a rule is just another discrimination against the much neglected general depositor. Since the trust notion is only a formula with which to dress a preference, in this instance would it not be better to declare the preference openly as a protection for public funds? To clothe the preference in trust language is to give it the effect of a specific lien which takes priority over a general preference¹¹ not based on a proprietary theory. This

⁹ *Lathrop v. Bampton*, 31 Cal. 17, 89 Am. Dec. 141 (1866); *Davenport Plow Co. v. Lamp*, 80 Ia. 722, 45 N. W. 1049 (1890); *Peak v. Ellicott*, 30 Kan. 156, 1 Pac. 499 (1883); *Neely v. Rood*, 54 Mich. 134, 19 N. W. 920 (1884); *Farmers' Nat'l Bank v. King*, 57 Pa. St. 202, 98 Am. Dec. 215 (1868); *McLeod v. Evans*, 66 Wis. 401, 28 N. W. 173, 214 (1886).

¹⁰ *Leach v. Farmers' Sav. Bank*, 205 Ia. 114, 217 N. W. 437 (1928) (showing by use of bank records that fund coming into hands of receiver was never, between time of deposit and insolvency of the bank, less than amount of trust funds, held a sufficient tracing and augmentation); *Chapman v. First Nat'l Bank*, *supra* n. 4; *In re State Bank of Portland*, 110 Ore. 61, 222 Pac. 740 (1924); *Hitt Fireworks Co. v. Scandinavian American Bank of Tacoma*, 121 Wash. 261, 209 Pac. 680 (1922).

¹¹ While immaterial to general depositors since their rights are secondarily considered in either event, to designate this preference as a trust fund arbitrarily prejudices the rights of those having *bona fide* trust claims and also injures the prospects of those holding genuine ordinary preferences

result should and can be obviated by deliberately allowing a simple preference.

—KINGSLEY R. SMITH.

CONSTITUTIONAL LAW — TAX-EXEMPTION OF REALTY PURCHASED WITH WAR INSURANCE PAYMENTS. — With money received from the United States Government under provisions of the War Insurance Act of 1924,¹ the petitioners, husband and wife, purchased a home located in Atlanta, Georgia. The city assessed taxes against this property, and an action was brought to restrain tax sale. Petitioners sought exemption under § 22² of the War Insurance Act, providing: "The compensation, insurance, and maintenance and support allowances payable under Parts II, III, and IV, respectively, shall not be assignable, shall not be subject to the claims of creditors of any persons to whom an award is made . . . and shall be exempt from all taxation." The Georgia court held that realty, purchased with money so received, was tax-exempt. *City of Atlanta v. Stokes*.³

The petitioners' claim for exemption did not arise from any implication of dual sovereignty or federal supremacy, as the court declared, but was based on an express statutory provision, so that only a question of statutory construction was before the court. It is a well-established rule that provisions exempting property from taxation must be construed *strictissimi juris*, and that no exemptions can be made by implication.⁴ Clearly, the

since trust claims must first be paid in full before satisfaction of general charges.

¹The Insurance Act is a part of the Veterans' Relief Act, 38 U. S. C. A. §§ 421-576 (1926).

²38 U. S. C. A. § 454 (1926).

³165 S. E. 270 (Ga., 1932). This decision follows *Rucker v. Merck*, 172 Ga. 793, 159 S. E. 501 (1931). These two decisions stand alone. *Contra*: *State v. Wright*, 140 So. 584 (Ala., 1932); *State v. Board of Com'rs.*, 132 Kan. 253, 294 Pac. 915 (1931), Cert. denied, 283 U. S. 855, 51 S. Ct. 648 (1931); *Martin v. Guilford County*, 201 N. C. 63, 158 S. E. 847 (1931); *Lambert v. Guilford County*, 201 N. C. 67, 158 S. E. 849 (1931). For a criticism of *Rucker v. Merck*, *supra*, see (1931) 10 N. C. L. REV. 103; (1932) 6 CN. L. REV. 248. But see (1932) 17 CORN. L. Q. 259.

⁴*Memphis Ry. Co. v. Berry*, 112 U. S. 609, 5 S. Ct. 299 (1884); *Chicago Ry. Co. v. Mo.*, 120 U. S. 569, 7 S. Ct. 693 (1886); *Winona Land Co. v. Minn.*, 159 U. S. 526, 16 S. Ct. 83 (1895); *Bank v. Tenn.*, 161 U. S. 134, 16 S. Ct. 456 (1885); *Phoenix Ins. Co. v. Tenn.*, 161 U. S. 174, 16 S. Ct. 471 (1895); *Yazoo Ry. Co. v. Adams*, 180 U. S. 1, 21 S. Ct. 240 (1900); *Morris Canal Co. v. Baird*, 239 U. S. 126, 36 S. Ct. 28 (1915); *Pacific Co. v. Johnson*, 285 U. S. 480, 52 S. Ct. 424 (1931).