[Vanderbilt Law Review](https://scholarship.law.vanderbilt.edu/vlr)

Volume 19
Issue 4 *Issue 4 - A Symposium on Restitution*

Article 8

10-1966

Bankruptcy as an Occasion for Restitutionary Claims

William F. Young Jr.

Follow this and additional works at: https://scholarship.law.vanderbilt.edu/vlr

Part of the Bankruptcy Law Commons

Recommended Citation

William F. Young Jr., Bankruptcy as an Occasion for Restitutionary Claims, 19 *Vanderbilt Law Review* 1255 (1966)
Available at: https://scholarship.law.vanderbilt.edu/vlr/vol19/iss4/8

This Symposium is brought to you for free and open access by Scholarship@Vanderbilt Law. It has been accepted for inclusion in Vanderbilt Law Review by an authorized editor of Scholarship@Vanderbilt Law. For more information, please contact mark.j.williams@vanderbilt.edu.

Bankruptcy as an Occasion for Restitutionary Claims

*William F. Young, Jr.**

I. Introduction

Judge Joseph S. Lord III, of the Eastern District of Pennsylvania. has recently given us a glimpse of a recurrent ideal for bankruptcy administration[1]—one that may fairly be called a restitutionary ideal. If there were bankruptcies in Utopia they would presumably be run along the lines he envisaged; according to this ideal, claims against a bankruptcy estate would be recognized solely on the ground that otherwise the estate would be unjustly enriched. In pursuing that goal Judge Lord was following a certain tradition, and he flew the banner that is always flown on these occasions: "Courts of bankruptcy are courts of equity."[2] What is more natural for a court in that great tradition than to treat each claimant according to his just deserts? What one of them gains, the others lose—for it is characteristic of bankruptcy that there is not enough to go around. We may, therefore, easily conceive of *all* bankruptcy claims problems as problems in restitution. "The conception of unjust enrichment as ordinarily defined includes not only gain on one side but loss on the other, with a tie of causation between them."[3] Under a restitutionary regime of bankruptcy, we would allow to each claimant his exact contribution to the community of interests called the estate.

Secured claims can stand no differently: "A bankruptcy claimant . . . which relies on its security is 'asking a favor' of the bankruptcy court."[4] If the claim is inequitable, the fact that it is valid and perfected by state law is not controlling. The "favor" is not to be refused altogether, of course, if the claimant has made a substantial contribution to the estate. To assess his contribution accurately requires the court to make a strenuous effort of judgment: it must take into ac-

* Professor of Law, Columbia University.

1. See *In re* Elkins-Dell Mfg. Co., 253 F. Supp. 864 (E.D. Pa. 1966).

2. Young v. Higbee Co., 324 U.S. 204, 214 (1945). What Judge Lord actually cited was Local Loan Co. v. Hunt, 292 U.S. 234, 240 (1934): "[C]ourts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity."

3. Dawson, *Restitution or Damages?*, 20 Ohio St. L.J. 175, 176 (1959).

4. *In re* Elkins-Dell Mfg. Co., *supra* note 1, at 869. The "asking a favor" phrase was derived from Fosdick v. Schall, 99 U.S. 235, 253 (1878), via Manufacturers' Fin. Co. v. McKey, 294 U.S. 442, 449 (1935). *Fosdick* was part of what has been called "the Supreme Court's railroad jurisprudence." 2 Gilmore, Security Interests in Personal Property § 28.3, at 756 (1965).

count such things as the risk he ran in giving credit, the effect of the security agreement on the borrower's business, the other sources of credit that the borrower might have found, the custom of lenders, and the requirements of commerce.

The propositions and factors just mentioned were expressed by Judge Lord in a thoughtful and witty opinion dealing with contracts between two bankrupts and a finance company ("Fidelity"), under which the latter received assignments of accounts receivable. The contracts fixed a high rate of interest and contained several very harsh terms, leading the bankruptcy referee to call them unconscionable.[5] Judge Lord remanded for further hearings; but he gave general approval to the remedy applied by the referee: requiring that Fidelity pay into the estate the excessive interest it had collected prior to bankruptcy, and all money collected by it from the assigned accounts after the date of bankruptcy. He said that the referee should determine what was a reasonable rate of interest by considering the same elements (the custom, the risks, the setting) that might require condemnation of the security agreement. The object of the remedy suggested would be to prevent unjust enrichment of the finance company at the expense of other creditors:

> [I]nasmuch as claims arising from quasi-contractual obligations are provable in bankruptcy . . . once the referee had refused to enforce the contracts it would also have been entirely appropriate, in achieving 'a balance of equities between creditor and creditor' . . . to scale Fidelity's claims for interest down to a reasonable rate to prevent it from profiting at the expense of others from its unconscionable contracts.[6]

I consider that Judge Lord staked out too large a claim for the equitable discretion of bankruptcy courts, and that the issues he posed for the referee are unmanageable.[7] There is no general mandate in the Bankruptcy Act to calculate the benefit conferred on the estate by creditors, secured or unsecured, and so far as benefits conferred on the bankrupt are concerned, it is non-bankruptcy law that determines whether or not they give rise to claims. So far from directing the courts to grant occasional "favors" to secured parties by recognizing their interests, the Act "simply does not authorize a trustee to distribute other people's property among a bankrupt's creditors."[8]

5. *In re* Dorset Steel Equip. Co., 2 UCC REP. SERV. 1016 (E.D. Pa. 1965) (referee's opinion); *In re* Elkins-Dell Mfg. Co., 2 UCC REP. SERV. 1021 (E.D. Pa. 1965) (referee's opinion). In these proceedings the trustee sought to make something of § 2-302 of the UCC: Unconscionable Contract or Clause. (The Code was applicable state law.) Article 9 of the UCC, on Secured Transactions, has no corresponding provision, and Judge Lord did not claim support for his decision in local law.

6. *In re* Elkins-Dell Mfg. Co., *supra* note 1, at 875.

7. "The ultimate question for the referee," he said, "will be whether these contracts were, in the light of all the circumstances, reasonable commercial devices." *Id.* at 874.

8. Pearlman v. Reliance Ins. Co., 371 U.S. 132, 135-36 (1962). See also Polish v. Johnson Serv. Co., 333 F.2d 545 (3d Cir. 1964).

Whether or not these views are correct,[9] it is useful to reflect upon the restitutionary ideal of bankruptcy. It is well, for one thing, to have clear ideas about how far the commands of the Bankruptcy Act disregard the ideal, so as to be on guard against appeals to the justice of the moment.[10] It is well also to consider how the scheme of bankruptcy might be brought into closer conformity to concepts of restitution. A leading feature of the existing scheme is the distinction between benefits conferred on the bankrupt and benefits conferred on the estate. It is true that these two notions cannot be entirely abstracted, one from the other; but it is probably true also that no administratively feasible bankruptcy law could be constructed without some mechanism for sorting out claims along that line of division. A thoroughgoing program for putting bankruptcy claims on an "equity" footing would have no premise other than benefit to the estate. It would also purge the Bankruptcy Act of many of its references to state law, replacing them with doctrines devised for use only in bankruptcy proceedings. Such a program is out of the question; therefore, it is a continuing challenge to place the non-bankruptcy law of restitution (hardly cognizant of benefits to a bankruptcy estate) in proper relation to bankruptcy law.[11]

Although the concept of unjust enrichment is not a cornerstone of bankruptcy law, there is hardly any principle of the law of restitution that might not figure decisively in an appropriate bankruptcy matter. The claims and property interests coming to the bar of bankruptcy courts have to be assessed quite regularly according to non-bankruptcy law, chiefly state law;[12] and these courts have "the law of

9. These criticisms of Judge Lord's decision are of course argumentative, but this is not the place to pursue the argument. He was partly misled, I think, by a decision of his Court of Appeals: *In re* Laskin, 316 F.2d 70 (3d Cir. 1963). The general context of the question is sketched in GILMORE, *op. cit. supra* note 4, §§ 13.1, 45.2. See Guerin v. Weil, Gotshal & Manges, 205 F.2d 302 (2d Cir. 1953) for a useful caution: "Although it has been broadly stated that a bankruptcy court is a court of equity, . . . the exercise of its equitable powers must be strictly confined within the prescribed limits of the Bankruptcy Act . . . ." *Id.* at 304. See also 3 COLLIER, BANKRUPTCY ¶ 63.03(3) (14th ed. rev. 1965) [Hereinafter cited as COLLIER]; Hill, *The Erie Doctrine in Bankruptcy*, 66 HARV. L. REV. 1013 (1953).

10. Judge Lord was himself well on guard against "impassioned appeals to equity": "It would be unsound to encourage bankruptcy trustees or general creditors to attempt to escape lawful factoring debts . . . unsound because it would be inconsistent with the scheme of the Bankruptcy Act and because it would tend to dry up the credit of businesses which need it most." *In re* Elkins-Dell Mfg. Co., *supra* note 1, at 871. In this and other passages Judge Lord shows that he does not think of bankruptcy law as simply a branch of the law of restitution. All that he said on that subject I have quoted.

11. "There is no boundary line, capable of being precisely located and mapped, between the domains of federal and state law." 2 GILMORE, *op. cit. supra* note 4, at 1286.

12. 3 COLLIER ¶¶ 63.02, 63.03(3), 63.07; 4 COLLIER ¶ 70.04; MACLACHLAN, BANKRUPTCY §§ 133, 168 (1956) [Hereinafter cited as MACLACHLAN].

This is so, notwithstanding the fact that "bankruptcy law in this country has a federal

restitution," broadly conceived,[13] as part of their ordinary equipment. It would be tedious business to demonstrate the truth of this statement. What would be interesting and useful instead is a survey, yet to be made, of the instanees in which (federal) bankruptcy law overrides state (or other) rules of restitution, and in which the Bankruptcy Act radiates its own principles of restitution.

Restitutionary principles in relation to creditors' claims against the estate make up one field of inquiry—a relatively narrow one. Another field of inquiry, much harder to exhaust, is the use of such principles in relation to the trustee's power to avoid transfers of the debtor's property. As will be seen, a trustee's power of avoidance may be facilitated by a restitutionary concept; but more commonly, it is the case that a transferee makes defensive use of such a concept, attempting to show that avoidance of his transfer would entail unjust enrichment of the bankruptcy estate. The trustee's powers of avoidance give rise also to claims that, as between two persons interested in the estate, one has been unjustly enriched at the expense of the other; these claims are particularly interesting for the light they throw on the scheme of the Bankruptcy Act, and the connection between bankruptcy and non-bankruptcy law. Fruitful inquiry might also be made into the interaction of bankruptcy and restitutionary rules in such areas as suretyship,[14] priority of claims,[15] and tracing,[16] but this paper is confined to the topics mentioned, as they appear in "straight" bankruptcy proceedings.

Whether we are concerned with claims against the estate or with voidable transfers, it is essential to note that the Bankruptcy Act

---

character and a degree of uniformity which distinguishes it from most of the other subjects in the field of commercial law." MacLachlan, § 23, at 18. Note the references to Texas law in Segal v. Rochelle, 382 U.S. 375 (1966). *But see* the citations in note 9 *supra*.

13. Very general references are to be understood by "restitution" and "restitutionary" principles and concepts, as used here. For a warrant of the usage see the Restatement, Restitution § 7 (1937); See also Dawson, *supra* note 3, at 175 (describing the restitutionary remedies as a "litter of Topsies"); Seavey & Scott, *Restitution*, 54 L.Q. Rev. 29 (1938).

14. See 3 Collier ¶ 57.21; MacLachlan §§ 145, 270.

15. See Home Indem. Co. v. F.H. Donovan Painting Co., 325 F.2d 870 (8th Cir. 1963); Lawrence v. Delta Metals, Inc., 280 F.2d 86 (5th Cir. 1960); Note, *Subrogation to Government Priorities in Bankruptcy*, 65 Colum. L. Rev. 895 (1965).

16. See Cunningham v. Brown, 265 U.S. 1 (1924); Central States Corp. v. Luther, 215 F.2d 38 (10th Cir. 1954); *In re* Rhine, 241 F. Supp. 86 (D. Colo. 1965).

I have sought to stay clear of the controversies whirling about § 60 and equitable liens and article 9 security interests, although the participants in this exercise have freely used the concepts of restitution as counters. See Honnold, Cases on Sales & Sales Financing, ch. 8, § 3 (2d ed. 1962); Farnsworth & Honnold, Cases on Commercial Law, ch. 11, § 3 (1965); 2 Gilmore, *op. cit. supra* note 4, §§ 45.5 -.7, 45.9 (1965), and references given there. In this, I should say, they are quite justified, for the reception accorded to state tracing rules in bankruptcy is in some sense the measure of the trustee's avoiding powers.

makes the filing of a bankruptcy petition a decisive event: a transaction occurring after the filing is likely to have consequences far different from what would have ensued if it had occurred before. The date of filing is, indeed, one of the very meanings of the word "bankruptcy" as it appears in the act.[17] This point of distinction must be observed in each part of the discussion that follows. In the main, Part II concerns restitutionary principles in relation to claims against the estate; and Part III concerns certain of the trustee's powers to avoid transfers by the debtor, as affected by concepts of restitution. It is undesirable to be rigorous in this division of the subject, however.

II. Restitutionary Principles in Relation to Claims Against the Estate

After the filing of an involuntary petition, there is a period of time in which a provable claim may arise "by reason of property transferred or services rendered by the creditor to the bankrupt for the benefit of the estate." The conditions are stated in section 63b of the act.[18] During somewhat the same period of time the act affords protection to persons who deal with the bankrupt "in good faith"—not ordinarily including those who know of the bankruptcy proceedings. The conditions are stated in section 70d of the act.[19] Neither of these pro-

17. Bankruptcy Act § 1 (13), 52 Stat. 841 (1938), 11 U.S.C. § 1 (13) (1964) (formerly Bankruptcy Act § 1 (10), 30 Stat. 544 (1898)). See 1 Collier ¶ 1.13; MacLachlan § 169. *But cf.* Segal v. Rochelle, *supra* note 12.

18. Bankruptcy Act § 63b, 52 Stat. 873 (1938), 11 U.S.C. § 103b (1964). The section reads:

"In the interval after the filing of an involuntary petition and before the appointment of a receiver or the adjudication, whichever first occurs, a claim arising in favor of a creditor by reason of property transferred or services rendered by the creditor to the bankrupt for the benefit of the estate shall be provable to the extent of the value of such property or services."

19. Bankruptcy Act § 70d, 52 Stat. 881-82 (1938), 11 U.S.C. § 110d (1964). So far as relevant to this paper, the section reads:

"After bankruptcy and either before adjudication or before a receiver takes possession of the property of the bankruptcy, whichever first occurs—

(1) A transfer of any of the property of the bankrupt, other than real estate, made to a person acting in good faith shall be valid against the trustee if made for a present fair equivalent value or, if not made for a present fair equivalent value, then to the extent of the present consideration actually paid therefor, for which amount the transferee shall have a lien upon the property so transferred;

(2) A person indebted to the bankrupt or holding property of the bankrupt may, if acting in good faith, pay such indebtedness or deliver such property, or any part thereof, to the bankrupt or upon his order, with the same effect as if the bankruptcy were not pending . . .

(4) The provisions of paragraphs (1) and (2) of this subdivision shall not apply where a receiver or trustee appointed by a United States or State court is in possession of all or the greater portion of the nonexempt property of the bankrupt;

(5) A person asserting the validity of a transfer under this subdivision shall have the burden of proof. Except as otherwise provided in this subdivision . . . , no transfer

visions concerns benefits conferred on the estate directly, as by administrative services. Benefits of that character commonly give rise to claims having a priority position. In discussing such claims, the Collier treatise on Bankruptcy lists "The Benefit Principle" as one of several controlling factors,[20] and traces it to Holmes' opinion in *Randolph v. Scruggs*.[21] The restitutionary aspect of this matter would be a part of a comprehensive survey of our subject, but will not be examined here. For present purposes it is enough to say that the Benefit Principle carries little weight in connection with post-bankruptcy dealings *with the bankrupt*. A lawyer named Myers learned this to his sorrow when he arranged for a client to purchase some accounts receivable from a bankrupt. After the client collected some 7,000 dollars of them, the bankruptcy trustee (Kohn) successfully called it to account for the receivables and their proceeds in *Kohn v. Myers*.[22] The purchase price—more than 16,000 dollars—had been applied to priority claims against the estate. In rejecting an appeal against the trustee's recovery, the court said: "It will not avail a transferee to argue that the estate was not depleted, that there has been no fraud and that the estate has been benefited. The appellants here assumed the burden of dealing with the bankrupt and all the attendant risks."[23] The court did suggest, however, that Myers and his client "would seem entitled to file a claim" under section 63b.[24]

Nevertheless, it is not entirely true that general ideas of restitution are irrelevant to post-petition dealings with a bankrupt. The same court that decided *Kohn v. Myers* had later to consider a bankrupt's payment of indebtedness incurred after the petition was filed, and succeeded in protecting the payee under section 70d.[25] One of the criteria provided by that section is "present fair equivalent value." The court showed its allegiance to the underlying principle of resti-

---

by or in behalf of the bankrupt after the date of bankruptcy shall be valid against the trustee . . . ."

20. 3 COLLIER ¶ 62.05(2). For a suggestion as to the status of claims for benefit conferred through extensions of credit to the unadjudicated bankrupt, see MACLACHLAN § 140. *Contra*, 3 COLLIER ¶ 63.34.

21. 190 U.S. 533 (1903). See Treister, *The Effect of Bankruptcy on the Administrative Expenses of a Superseded General Assignment*, 17 BUS. LAW. 332 (1962). As to the quantum of allowance to a landlord, and the significance of the date of bankruptcy, see S & W Holding Co. v. Kuriansky, 317 F.2d 666 (2d Cir. 1963). A restitutionary claim based on the trustee's use of another's premises was made in *In re* Seatrade Corp., 345 F.2d 785 (2d Cir. 1965), and rejected as leading to a windfall for the claimant; the court came close to characterizing him as a volunteer. For a suggestion that restitutionary rights may accrue to the trustee because of his sharing of leased premises with another, see Lama Co. v. Union Bank, 315 F.2d 750 (9th Cir. 1963).

22. 356 F.2d 353 (2d Cir. 1959).

23. *Id.* at 357.

24. *Ibid.*

25. Kass v. Doyle, 275 F.2d 258 (2d Cir. 1960).

tution by shaping that expression in conformity to the general concept "enrichment." Taking an enlarged view of "present . . . value," the court protected the transferee because his services were of "aid in the protection of the assets available for creditors";[26] it rejected the "assumption that the statute protects only those transactions which result in an immediate balance sheet increase in the assets of the debtor."[27] Evidently the court was persuaded that the estate would be unjustly enriched if the trustee were to recapture the debtor's payment for the post-bankruptcy services.

Moving back to the period before bankruptcy, we may find that benefit to the estate results from some exertion that does not yield a claim against the bankrupt. Let us say that a creditor's pursuit of the debtor prior to bankruptcy was so efficient and extraordinary that benefits accrue to the estate as a result. Is a claim against the estate warranted, under bankruptcy law, by reason of such a benefit? No one has suggested (and presumably no one will) that proof and allowance of a claim of this genre could be authorized by nonbankruptcy law. If the claim exists, we may be sure that it is based on general considerations of bankruptcy law—upon what may be called restitutionary emanations from the act; and the rule will be couched in the rhetoric of "equitable power" vested in the courts of bankruptcy. The act does not explicitly authorize proof of the claim in question, not being one chargeable to the bankrupt himself,[28] and it is possible that this is a conclusive objection to its allowance.

A case that came somewhere near to forcing the issue was *In re Billelo*.[29] John Krauss, Inc., apparently a trade creditor of Billelo's, employed a lawyer and a detective to prosecute its claim. During the week before the bankruptcy petition was filed, it commenced suit and levied attachment. The cost to the creditor was said to exceed 1,200 dollars, and the effect of its action, as found, was to "preserve the assets at the bankrupt's premises for the benefit of the estate." The court disallowed Krauss' claim:

> Despite the fact that the fruits of the creditor's efforts inured to the benefit of the bankrupt estate, the creditor's expenditures are viewed to have been

26. *Id.* at 262. The court referred for support to the mention of "services rendered" in § 63b of the act, quoted in note 18 *supra*. A contrary view had been expressed in *In re* Autocue Sales & Distrib. Corp., 167 F. Supp. 672 (S.D.N.Y. 1958). Compare the bankrupt's own claim based on the post-bankruptcy payment of an attorney's fee. Kolb v. Berlin, 356 F.2d 269 (5th Cir. 1966). A benefit conferred on the bankrupt, in the form of services rendered before the date of bankruptcy, is of course not "present fair equivalent value" for a payment thereafter—not being a benefit for *the estate*. Schilling v. McAllister Bros., 310 F.2d 123 (2d Cir. 1962).

27. Kass v. Doyle, *supra* note 25, at 262.

28. Section 63a of the Bankruptcy Act, 52 Stat. 873 (1938), 11 U.S.C. § 103a (1964), begins: "Debts *of the bankrupt* may be proved and allowed against the estate . . . ." (Emphasis added.) See 3 COLLIER ¶ 63.03.

29. 171 F. Supp. 69 (E.D.N.Y. 1959).

> made in its own interests to such an extent as not to warrant the application of any equitable power which may rest in the Court.[30]

The court expressed doubt that it had any such power in the premises, except as specifically authorized in the act. Note well, however, that the court discounted the "equity" of the creditor's demand. By combining a doubt as to the injustice of his loss with a doubt as to its own power, the court avoided making an abstract pronouncement that a restitutionary claim against an estate cannot be allowed. It is well not to be doctrinaire about the matter.[31]

Yet it does not seem probable, or desirable, that the allowance of such claims under the present act will ever become more than a freakish departure from general practice. The Bankruptcy Act criteria for allowing and disallowing claims are not vague prescriptions for doing justice.[32] They are concrete specifications designed to compromise a set of discordant aims: to give the bankrupt a clear field for future effort, to deal "equally" with creditors, to simplify administration, to make proceedings uniform and predictable. As a sacrifice to these and other legislative aims, nice judicial calculations of enrichment—not to speak of justice—are often ruled out.

To be distinguished from benefit to the estate as a basis for a claim is benefit conferred on the bankrupt. To the extent that the latter gives rise to a restitutionary claim under applicable state (non-bankruptcy) law, such a claim will generally be allowed in bankruptcy as a matter of course. It cannot be said that the books are full of illustrations; presumably, they are not because unsecured claims in bankruptcy are not worth much.[33] The principle is usually manifested in relation to discharge of the bankrupt's debts; it has been held many times in that context that "a liability upon quasi-

30. *Id.* at 70. See also Guerin v. Weill, Gotshal & Manges, *supra* note 9; *In re* Siegel, 252 Fed. 197 (S.D.N.Y. 1918), *rev'd on other grounds,* 256 Fed. 226 (2d Cir. 1919) (creditor's services, although of benefit to the estate, "merely volunteered").

31. "In an atypical situation, however, equitable considerations may still afford sufficient flexibility to authorize a court to allow costs and expenses. Likewise considerations of equity still have their field of application, for instance, with regard to expenses incurred in pre-bankruptcy proceedings . . . ." 3 COLLIER ¶ 62.21, at 1551. Compare the "equitable lien" supposed by Professor MacLachlan to exist for one who preserves assets prior to the petition. MACLACHLAN § 141 n.7. See generally 3 COLLIER ¶ 64.102(2). As to pre-bankruptcy proceedings, see 3 COLLIER ¶ 62.03(4), and note 21 *supra.*

32. See the Bankruptcy Act §§ 57, 63 & 64, 52 Stat. 866, 873-74 (1938), 11 U.S.C. §§ 93, 103-04 (1964). See note 9 *supra.* The Act does provide that claims once allowed may be reallowed or rejected "according to the equities of the case" in certain instances—§ 57k (11 U.S.C. 93k); but this has been called "merely a procedural provision . . . [having] nothing to do with the substantive question of what claims are provable . . . ." 3 COLLIER § 57.23(3), at 363-64.

33. "General creditors recover only eight cents on the dollar in the 13% of the cases where creditors receive anything." Countryman, *The Bankruptcy Boom,* 77 HARV. L. REV. 1452, 1454 (1964).

contract is one upon an 'implied contract,' and so provable in bankruptcy . . . ."[34] A better illustration is a non-discharge case, such as *In re Petroleum Carriers Co.*[35] The bankrupt company had received a sort of prepayment under an executory contract that proved to be unenforceable under the Statute of Frauds. The other party, Gamble, filed a claim based on the payment, and the bankruptcy court allowed it, saying:

> The payment made by Gamble certainly conferred an immediate benefit upon the bankrupt to the amount of the overcharge. All of the circumstances of the transaction, in view of bankrupt's admittedly urgent need for cash, generates (sic) an inference that the real and only purpose of the exaction was to swell the coffers of bankrupt.
>
> . . . .
>
> Where, as here, money is paid or property transferred under an unenforceable agreement, equity and good conscience require that the recipient, to the extent that he is unjustly enriched thereby, be compelled to disgorge.[36]

The claim described here, unlike the one in *Billelo's* case, must be rooted in and limited by non-bankruptcy principles of restitution.[37]

III. TRUSTEE'S POWERS TO AVOID TRANSFERS BY THE DEBTOR AS AFFECTED BY CONCEPTS OF RESTITUTION

The Bankruptcy Act provides a trustee with various powers of avoiding transfers made by a debtor both before and after the "date of bankruptcy." The general conception is that the estate available for distribution to creditors ought not to be depleted by "fraudulent" transfers, or by last-minute transfers and seizures of assets that prefer one creditor over another.[38] The idea of loss—depletion—diminution of assets—is a recurrent theme in the literature concerning these powers; and unwarranted gain is a note also frequently sounded, although perhaps less often. Occasionally the reverberation of these ideas, so characteristic of the law of restitution, drowns out the subtle harmonies (or disharmonies) of the Bankruptcy Act. So it happened, I believe, in the Fourth Circuit case *Aulick v. Largent.*[39] The court

34. Brown v. O'Keefe, 300 U.S. 598, 607 (1937), 176 (1904); see 3 COLLIER ¶ 63.25(2)(5); MACLACHLAN § 134.

35. 121 F. Supp. 520 (D. Minn. 1954).

36. *Id.* at 527. Actually, it was found that what is called here a prepayment "was not a premium but was merely a device whereby [the president of the bankrupt] sought to unjustly enrich the corporation."

37. But see text accompanying note 2 *supra.*

In re Kolber, 49 F. Supp. 378 (E.D. Pa. 1942), *aff'd mem.*, 134 F.2d 615 (3d Cir. 1943), reduced an otherwise provable claim of $159,750 to a fraction of $1,000 by reason of state law as to rights of contribution among co-obligors.

38. See 3 COLLIER ¶ 60.01, 4 COLLIER ¶ 70.04; 2 GILMORE, *op. cit. supra* note 4, §§ 45.1-.10; MACLACHLAN, §§ 201-10, 221-77, 282-87 (compare especially § 202).

39. 295 F.2d 41 (4th Cir. 1961).

held there, on a third appeal, that Mrs. Aulick had received a voidable transfer in the nature of a preference. (The act defines "preference" in section 60a.[40]) She had been given the bankrupt's note, indorsed by a third person, Lemley, in circumstances that would have been preferential if payment had then been made. Unknown to her, Lemley had received a pledge of the bankrupt's property as an inducement for his indorsement. On an earlier appeal in the case, the court thought that *someone* must have received a preference: "Clearly, the transfer of the security and Lemley's subsequent payment to Mrs. Aulick . . . did deplete the estate."[41]

It will be argued here that generalized notions of gain or loss will not serve, when the reach of the trustee's avoiding powers is in question. In a degree, it is true that his statutory recoveries are restitutionary in character;[42] but the conditions for avoiding transfers are nowise congruent with the basis of liability for unjust enrichment. The act prescribes rather rigid—even mathematical—tests for the bankruptcy court to apply, and they may or may not achieve the ideal of restitution in favor of the estate. On a general view, one might think that courts attuned to restitutionary considerations might be biased against the exercise of the trustee's avoiding powers, in close cases, out of concern for the stability of transactions.[43] The law of

40. Bankruptcy Act § 60a, 52 Stat. 869 (1938), 11 U.S.C. § 96a (1964). The relevant portion reads:

"(1) A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class." See also note 42 *infra*.

41. Largent v. Lemley, 272 F.2d 66, 68 (4th Cir. 1959). Here the court cited no authority. The ultimate result was foreshadowed as an "hypothesis" in Largent v. Lemley, 256 F.2d 446 (4th Cir. 1958).

42. This fact can be seen, for instance, in the provision made for the terms of an order avoiding a preferential transfer, under § 60b of the Bankruptcy Act, 52 Stat. 870 (1938), 11 U.S.C. § 96b (1964):

"Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona-fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value: *Provided however*, That where such purchaser or lienor has given less than such value, he shall nevertheless have a lien upon such property, but only to the extent of the consideration actually given by him. . . ."

See WEINSTEIN, THE BANKRUPTCY ACT OF 1938, 121 (1938): "Subd. b of the old Act provided that the trustee might recover the property or its value from the person receiving the transfer or to be benefited thereby. . . . This procedure was neither sound nor equitable, since the estate was primarily entitled to restitution . . . ."

43. See Pound, *A Survey of Social Interests*, 57 HARV. L. REV. 1, 17-20 (1943). The interest in maintaining bargains (see note 10 *supra*) is distinguishable, of course.

restitution, however, is rather careful to allow for that interest, particularly in applying the bona fide purchase doctrine in favor of creditors.[44] As the *Aulick* case shows, the bias favoring transferees (if it exists) is not so noticeable as a theoretician might conjecture; and there are practical explanations for this.[45] The opinion in that case was unduly favorable to the trustee, in my view, because there was no showing that property of the debtor was transferred on account of an antecedent debt. *His* property was transferred to one who then became a surety, and that is not a preference.[46]

Or is it? There is a rule of restitution—not adverted to by the court—by which collateral given to a surety is held in constructive trust for the creditor. This is the doctrine of *Moses v. Murgatroyd*.[47] Recalling that rule, and the inclusive bankruptcy definition of "transfer,"[48] the trustee might plausibly have argued that the interest of Mrs. Aulick in the pledged collateral was the vehicle for a preference.[49] Strange, sometimes, are the workings of restitutionary concepts in relation to bankruptcy law.

Although we shall hope to find yet another lesson in the *Aulick* case, it is time now to consider situations in which, for reasons at least analogous to principles of restitution, it may be desirable to restrict the trustee's avoiding powers. In order to isolate most cleanly the impact such principles may be expected to have, we must look

44. RESTATEMENT, RESTITUTION §§ 13, 14, 172-76 (1937). For references to the interest in security of transactions in the literature of restitution, see Macauley, *Restitution in Context*, 107 U. PA. L. REV. 1133, 1143-44 (1959); Patterson, *Equitable Relief for Unilateral Mistake*, 28 COLUM. L. REV. 859, 883 (1928).

45. "The central figure in the pattern of bankruptcy administration under the Act of 1898 was the bankruptcy trustee, who was conceived as being not merely the passive representative of the unsecured creditors but their champion. . . . He might have been designed as an official whose primary duty was to hold the scales in even balance between the creditors who claimed property interests and the creditors who had no such claims. . . . Instead, the trustee became a sort of devil's advocate, whose function was to resist, by every available device and stratagem, the assertion of such claims against the estate. . . . Bankruptcy law, in practice, is what the referees say it is. The referees are recruited, naturally enough, from the specialized bankruptcy bar. They are bankruptcy professionals . . . . Thus the bias of bankruptcy law in favor of the unsecured creditor, the inarticulate striving toward the ideal of equal distribution among all creditors, which is represented in the first instance by the trustee, is reinforced at the referee level." 2 GILMORE, *op. cit. supra* note 4, at 1286-88.

46. The cases cited in Aulick v. Largent, *supra* note 39, at 48 n.10, do not appear to have been distinguished effectively. The decision led the same court to an even more startling conclusion in Virginia Nat'l Bank v. Woodson, 329 F.2d 836 (4th Cir. 1964).

47. 1 Johns. Ch. R. 118 (N.Y. Ch. 1814). See HANNA, CASES ON SECURITY 545-48 (3d ed. 1959). The doctrine has been roundly criticized; see ARANT, SURETYSHIP § 80 (1931). *Cf.* Bankruptcy Act, § 1(28), 52 Stat. 842 (1938), 11 U.S.C. § 1(28)(1964).

48. Bankruptcy Act, § 1(30), 52 Stat. 842 (1938), II U.S.C. § 1(30).

49. A case of this nature has not been found, although the doctrine of Moses v. Murgatroyd has been invoked *against* a trustee. Grandison v. Nat'l Bank of Commerce, 231 Fed. 800 (2d Cir. 1916), *cert. denied*, 242 U.S. 644 (1916). *Cf.* Leo v. L & M Realty Corp., 228 F.2d 89 (4th Cir. 1955), *cert. denied*, 350 U.S. 969 (1956).

specifically to these situations rather than ones in which the gain-loss equation favors the trustee. We may be pretty sure that when the bankruptcy estate is said to be unjustly enriched there is a point of tension between the restitutionary ideal and the text of the act.

It sometimes happens that the trustee's avoiding powers can yield "cumulative" recoveries for the estate. That is to say, the trustee may find he has two transfers (and even two transferees) to shoot at, although the debtor's dealings, taken as a whole, have not depleted the estate in the aggregate amount or value of what has been transferred. Is it consistent with principles of restitution for him to avoid both transfers? And if not, what is to be done about the problem of "double recovery"?

In one situation, at least, the Bankruptcy Act expressly prohibits multiple recoveries by the trustee, where he has multiple remedies. Following an opinion written by Brandeis, in *Dean v. Davis*,[50] a provision was introduced into the act characterizing certain transfers as fraudulent—such as may be called "preference-enabling" transfers for convenience. The section is 67d(3).[51] Its details do not concern us here, but in loose paraphrase it voids a transfer made in contemplation of insolvency proceedings if, as the transferee knew, the debtor intended to use the consideration obtained to give a preference. The concluding sentence of section 67d(3) precludes cumulative recoveries: "The remedies of the trustee for the avoidance of such transfer or obligation and of any ensuing preference shall be cumulative: *Provided, however*, That the trustee shall be entitled to only one satisfaction with respect thereto." Here, in plain terms, is a recognition that the cumulative remedies of the bankruptcy trustee may—if not curbed—result in unjust enrichment of the estate. "The purpose of the draftsmen in adding the proviso was simply to obviate the

50. 242 U.S. 438 (1917). See also *In re* Beerman, 112 Fed. 663 (N.D. Ga. 1901), a case which gained currency through being narrowly distinguished in the Supreme Court. See Van Iderstine v. National Discount Co., 227 U.S. 575, 583 (1913); Marsh v. Walters, 220 Fed. 805 (6th Cir. 1915).

51. Bankruptcy Act § 67d(3), 52 Stat. 878 (1938), 11 U.S.C. § 107d(3) (1964). It is as follows:

"Every transfer made and every obligation incurred by a debtor who is or will thereby be rendered insolvent, within four months prior to the filing of a petition initiating a proceeding under this Act by or against him is fraudulent, as to then existing and future creditors: (a) if made or incurred in contemplation of the filing of a petition initiating a proceeding under this title by or against the debtor or in contemplation of liquidation of all or the greater portion of the debtor's property, with intent to use the consideration obtained for such transfer or obligation to enable any creditor of such debtor to obtain a greater percentage of his debt than some other creditor of the same class, and (b) if the transferee or obligee of such transfer or obligation, at the time of such transfer or obligation, knew or believed that the debtor intended to make such use of such consideration. The remedies of the trustee for the avoidance of such transfer or obligation and of any ensuing preference shall be cumulative: *Provided, however*, That the trustee shall be entitled to only oue satisfaction with respect thereto."

unjust enrichment that would result to the estate if satisfaction should be allowed under both remedies."[52] Some interesting inferences may be drawn from this brief proviso.

Before drawing inferences, however, it is best to comprehend more clearly what is meant, or may be meant, by the expression "double recovery"; and for that purpose an example will be in order. Section 60 of the Bankruptcy Act, concerning preferences, appears to yield recoveries by the trustee that are cumulative, in a sense, when the debtor has been refinancing his indebtedness prior to the bankruptcy. A suitable case can be made of the facts in the well-known bankruptcy of the Garden City Grain and Seed Company.[53] The now-bankrupt Company had been refinancing its indebtedness, and it seems that three bank loans were involved in transactions within a three-day period, less than four months before bankruptcy. Bank *A* held the Company's note for 50,000 dollars at the outset. On December 17, when the note matured, it was paid under instructions from a correspondent, bank *B*. That is, bank *A* debited the account of bank *B*, thereby creating an indebtedness of the Company to the latter.[54] On December 19, the Company borrowed 50,000 dollars from bank *C*, and the proceeds of this loan were credited to bank *B*.[55] The trustee was able to establish that by December 17 the Company was insolvent, and that bank *A* had reasonable cause to believe it. Let it be supposed also (which would not be surprising) that bank *B* had cause to believe the Company was insolvent. It follows from these facts alone, presumably, that the trustee is entitled to recoveries under section 60 aggregating 100,000 dollars, although the balance sheet of the Company was unchanged in substance by the transactions in question.

Professor MacLachlan has expressed doubt about this conclusion, saying: "It is arguable that borrowing without security from one creditor to pay another is not preferential, for the substitution of creditors does not affect the share of others."[56] He cited a district court decision where the judge wrote:

52. 4 COLLIER ¶ 67.38, at 394. See also WEINSTEIN, THE BANKRUPTCY LAW OF 1938, 149 (1938). In Roberts v. Norrell, 212 F. Supp. 897 (N.D. Ala. 1963), the court analyzed § 67d(3) and rejected the trustee's claim under it. He had previously compromised a "cumulative" claim under § 60. The court did not have to pass on the defense based on that settlement. On the theory advanced here, proof of an improvident settlement ought to limit the trustee's claim.

53. Inter-State Nat'l Bank v. Luther, 221 F.2d 382 (10th Cir. 1955), *cert. dismissed*, 350 U.S. 944 (1956). For background see First Nat'l Bank v. Luther, 217 F.2d 262 (10th Cir. 1954); Luther v. United States, 225 F.2d 495 (10th Cir. 1954).

54. The court observed that bank *B* "did not gratuitously pay the note" to bank *A*.

55. The referee remarked that the funds were "probably" used to reimburse bank *B*.

56. HANNA & MACLACHLAN, THE BANKRUPTCY ACT 89 (8th ed. 1965).

> I find from the evidence before me that the payments made by the Bankrupt and being questioned as preferential payments, were payments made from other loans secured by the Bankrupt, and that such payments did not in any way deplete or diminish the estate of the Bankrupt, since there was merely a substitution of one bank creditor for another.[57]

On appeal, however, this decision was reversed.[58]

The leading cases are a pair of Second Circuit decisions in which divergent conclusions were reached. The first one was *Grubb v. General Contract Purchase Corp.*,[59] favoring the transferee. The opinion was written, somewhat cryptically, by Learned Hand. The determinative fact seemed to be that the advances used to accomplish payment were made with an understanding—whether verbal or not—that they would be applied as they were. "Obviously, it was not an ordinary loan . . . especial motives controlled it. . . . [I]t is not necessary to raise a trust upon the credit. . . ."[60] Conditions were attached to the advance that restricted the borrower's general power of disposition of the proceeds. In the second case, *Smyth v. Kaufman*,[61] Augustus Hand wrote the opinion (L. Hand joining), and expressed doubt about the meaning of the earlier one. This time the court emphasized control of the proceeds by the lender.

> We believe the arrangement was such that Koplik [the borrower-bankrupt] rather than Childs [the lender] designated the creditor to be paid and controlled the application of the loan which it secured from its landlord. The existence of this control determines whether the payments were preferential transfers by the bankrupt or were payments by a third-party who did not make the loans generally but made them only on condition that a particular creditor receive the proceeds. . . .
>
> . . . .
>
> [W]e think that the loans by Childs to Koplik were unconditional, that the proceeds became part of the bankrupt's free assets, and that the employment of the loan from Childs to extinguish the indebtedness to the executors [defendant transferees] constituted a preferential transfer. Under these

57. Clower v. First State Bank, 227 F. Supp. 653, 655-56 (S.D. Tex. 1964). *Cf.* Chiarovano v. Buttnick, 57 Wash. 2d 542, 358 P.2d 305 (1961). In another context the idea has been picturesquely put as follows: "How the satisfaction of a debt by incurring another of equal amount either decreases one's liabilities or increases his assets can only be comprehended by the philosophic mind of a Micawber." Slater v. Oriental Mills, 18 R.I. 352, 355, 27 Atl. 443, 444 (1893).

58. 343 F.2d 808 (5th Cir. 1965). *Accord, In re* Rubin, 1 F.2d 157, 159 (7th Cir. 1924): "The fact that Rubin borrowed the money with which to pay the bank the $1,000 does not change the fact that it was a preference." The rather involved argument in Prudential Ins. Co. v. Nelson, 96 F.2d 487 (6th Cir. 1938), tends toward the same point.

59. 94 F.2d 70 (2d Cir. 1938).

60. *Id.* at 73. See also *In re* Zaferis Bros., 67 F.2d 140, 141 (9th Cir. 1933) ("merely a transposition of credits . . . at no time . . . at the complete disposal of" debtor).

61. 114 F.2d 40 (2d Cir. 1940).

circumstances, it does not matter that the money used to take up the second check never actually came into the hands of Koplik.[62]

Approaching these cases from the point of view of restitution, one might think that principles of tracing would yield the right solution. If Peter is robbed to pay Paul, other creditors of the robber may stand to gain by Paul's satisfaction except to the extent that the funds can be traced through the wrongdoer's hands;[63] and borrowing to effect a voidable preference is something like a robbery. On that rather loose reasoning, it might be argued that payment to a creditor is non-preferential to the extent that the funds can be traced as proceeds of unsecured loans. That is decisively rejected, however, by the holding in *Smyth v. Kaufman* and in like cases, if only by implication. (Conversely, there are certain indications that a payment, otherwise non-preferential, is within section 60 if the funds are traced to a lender who is effectively secured—a notion examined below.)

The justification for the *Smyth* case must be, in brief, that one cannot, consistently with the bankruptcy scheme, attribute enrichment to creditors, in an ascertainable amount, resulting from an advance to the debtor. Considering them singly, some creditors may have been misled into giving or continuing credit as a result, more or less direct, of the advance. Some may have received payments, reversible in bankruptcy, that the debtor was enabled to make by the advance, although the funds advanced are not traceable to the payments. The bankruptcy scheme does not permit an allowance based on these circumstances, generally speaking. Considering the creditors collectively, the advance may have staved off liquidation for a space of time during which the debtor's position deteriorated, thereby causing injury. Subvention of a financial derelict is conduct not to be rewarded; hence a lender shows no equity against the estate simply by tracing his advances into the hands of the trustee.[64]

62. *Id.* at 42-43. Compare Chiarovano v. Buttnick, *supra* note 57. Naturally, the "control" test is subject to manipulation to achieve a particular ideal. The rule has been stated very broadly: "In cases where a third person makes a loan to a bankrupt debtor specifically to enable him to satisfy the claim of a designated creditor, the proceeds never become part of the bankrupt's assets, and therefore no preference is created." 3 COLLIER ¶ 60.26. *But cf.* Shapiro v. Royal Indem. Co., 224 F.2d 89 (3d Cir. 1955), where an inclusive reading of the § 60 phrase, "the property of a debtor," served the court's purpose to redress depletion of the estate. Compare Polish v. Johnson Serv. Co., 333 F.2d 545 (3d Cir. 1964).

63. They stand to gain if the creditor, Paul, had security for his claim, or if it was entitled to priority over the claims of other creditors, or if the creditor gave a discharge for less than the amount of his claim. See 4 SCOTT, TRUSTS §§ 513, 513.1, 539 (2d ed. 1956). The victim of the robbery (or other conscious wrongdoing) is subrogated to the discharged claim. RESTATEMENT, RESTITUTION § 207 (1937). For criticism of departures from the principles of tracing see 4 SCOTT, TRUSTS § 540 (2d ed. 1956).

64. 4 COLLIER ¶ 70.25. See Fitzgerald v. W. F. Sebel Co., 295 F.2d 654 (10th Cir. 1961); Marks v. Goodyear Rubber Sundries, 238 F.2d 533 (2d Cir. 1956). In each

By parity of reasoning, a preferred creditor shows no equity by tracing the funds he received back through the debtor to another source. There is precedent for denying restitutionary relief to a lender because of the risks created by such conduct.[65]

After all, diminution of the estate is not, in so many words, an element in the section 60 definition of *preference:* "The law of preference, unlike the law of fraudulent conveyances, is directed not against increasing the debtor's deficit, but against shifting an undue share of the deficit onto the creditors not preferred."[66] If the extent of the deficit were a question in a section 60 case, it would be necessary to reconstruct the debtor's affairs on the assumption that the transaction giving rise to payment had not occurred; and if that is feasible, at least the Bankruptcy Act does not require it. So understood, the statute deprives the transferee of any objection that avoidance would enrich the estate unjustly. In the case of the three banks, previously mentioned, it is not "unjust" to permit the trustee to recover 50,000 dollars from bank *A* and also from bank *B*, and the recoveries are not "cumulative" in any pejorative sense. (It is assumed that the debtor controlled the payments to these banks, so that the *Smyth* rule controls.[67])

Candor requires me to add that the foregoing extrapolation from section 60 is very much at odds with certain decisions under another part of that section. Ever since the present Bankruptcy Act was enacted, section 60c has said:

> If a creditor has been preferred, and afterward in good faith gives the debtor further credit without security of any kind for property which becomes a part of the debtor's estate, the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy may be set off against the amount which would otherwise be recoverable from him.[68]

Evidently that provision was designed to conform the law of preferences, in a measure, to a concept of restitution: the set-off is a partial barrier to unjust enrichment of the estate. Now, it might have been interpreted narrowly, in a spirit of caution about enrichment of

case the trustee was permitted to recover merchandise sold to the bankrupt on credit, and returned to the seller. As to the hostility of bankruptcy to implied, and other, trusts, see *In re* Lord's Inc., 356 F.2d 456 (7th Cir. 1965).

65. A case wherein subrogation to a discharged security interest was otherwise appropriate, but was denied because a junior interest might have been foreclosed more seasonably if the claimant had kept his purse strings tied: Western United Dairy Co. v. Continental Mortgage Co., 28 Ill. App.2d 132, 170 N.E.2d 650 (1960). Compare Compania Anonima Venezolana De Navegacion v. A. J. Perez Export Co., 303 F.2d 692, 698 (5th Cir. 1962): "The loss was occasioned wholly and solely by the voluntary act of the Agent in gratuitously extending credit . . . ."

66. MACLACHLAN § 256, at 294. *But see* 3 COLLIER ¶ 60.20.

67. *But see* note 62 *supra.*

68. Bankruptcy Act § 60c, 52 Stat. 870 (1938), 11 U.S.C. § 96c (1964).

creditors. The phrase "in good faith" might have been thought to mean, "without knowledge that a preference had been given"; and "which becomes a part of the debtor's estate" might have been regarded as a requirement that the creditor trace the funds ("property") advanced into the hands of the bankruptcy court. On the contrary, in *Kaufman v. Tredway*[69] the Supreme Court said that the good faith requirement was satisfied if the creditor let the debtor have the money or property "for some honest purpose," and held that tracing was not required. "If the creditor has acted in good faith, extended credit without security, and the money or property has actually passed into the debtor's possession, why should anything more be required?"[70] This decision dates from 1904, long before the Court became a literalist about section 60, and if the question were new today one would not expect such generosity toward the transferee.

Taking their cue from *Kaufman v. Tredway*, some lesser federal courts have been even more generous. Without going into detail, we may note the creative spirit at work in the following passage:

> The right of offset as against the recovery of a preference given by section 60c is not exclusive. In any case in which the result of allowing the offset does not disturb, but promotes, equality of distribution among creditors of the same class, it is proper; and the effect of allowing it, in this respect, is to be determined by the entire transaction between the creditor and the bankrupt.[71]

Evidently the court that is quoted was prepared to test the trustee's powers against its own notions of unjust enrichment. It would be foolhardy to assert, or to deny, that the same spirit will carry over into the situation we have described as a "substitution of creditors." The range of situations in which a set-off obtains against the trustee is still astonishingly ill-defined;[72] we can only say that when (or if ever) it is authoritatively staked out, the relation between the trustee's avoiding powers and principles of restitution generally will come into new and clearer focus.

---

69. 195 U.S. 271 (1904).

70. *Id.* at 275.

71. Walker v. Wilkinson, 296 Fed. 850, 853 (5th Cir. 1924), *cert. denied*, 265 U.S. 596 (1924).

72. The case last noted indicates that the requirement that credit be given *afterward*—after the preference—is not essential to the set-off. See also Dinkelspiel v. Weaver, 116 F. Supp. 455 (W.D. Ark. 1953). There is also authority dispensing with the statutory requirement that the new credit remain unpaid at the time of the adjudication. *In re* Ace Fruit & Produce Co., 49 F. Supp. 986 (S.D.N.Y. 1943). These decisions are dubious, however. As indicating that the matter is not one for the application of general equities, see Grandison v. Nat'l Bank of Commerce, *supra* note 49, at 810: "[T]he right to offset a new credit given in good faith is restricted to the amount of the new credit remaining unpaid at the time of the adjudication." For general discussion see 3 COLLIER ¶ 60.67; MACLACHLAN § 274.

Allowing for all possible doubts, we shall do well to proceed on the assumption that *Smyth v. Kaufman*[73] is a sound starting point for solving a substitution-of-creditors problem, and that *Grubb v. General Contract Purchase Corp.*[74] illustrates a settled counter-principle. The *Grubb* case, it will be recalled, supports the proposition that it is not preferential to borrow without security from one creditor to pay another *if* the new lender controls the application of his advances to the old debt by appropriate conditions. The estate would be unjustly enriched if the trustee were to avoid the payment. Is this judgment affected if we assume that the new lender *also* takes security for his loan? Why should it be?—except, of course, in estimating the probabilities that the borrower's power of disposition was in fact restricted. On principle, one would think that a lender taking security might so condition and control his advances that the borrower's application of them to a debt comes within the *Grubb* rule.[75]

It has been held, however, that the rule of the *Grubb* case does not apply to secured borrowings. That was one of the holdings in *Stone v. Allied Clothing Corp.*,[76] a New Jersey case growing out of the bankruptcy of Tip Top Tailors, Inc. Tip Top was controlled by a firm that the court called "Limited," and Limited received a pledge of wooden goods from Tip Top shortly before bankruptcy to secure contemporaneous advances of nearly 20,000 dollars. Of this amount, some 9,000 dollars was paid by Limited directly to an unsecured creditor, "Dominion." Reasoning from section 67d(3) of the Bankruptcy Act, on preference-enabling transfers, the court concluded that "the lien on the woolens to the extent of the payment to Dominion must be set aside."[77] As to the bulk of the advances, however, the pledge was held good, because they were applied to the claim of a creditor, "Allied," who was thought by the parties to have a previous security interest of its own. In fact it did not, and the court held that the payment to Allied effected a voidable preference. "The money which was paid was the consideration for the pledge, and must be considered assets of the debtor Tip Top, *even though Limited controlled the transaction.*"[78]

73. *Supra* note 61.
74. *Supra* note 59.
75. If he takes both of these precautions, it is arguable that the situation should be treated in the same way as if he had gone surety for an antecedent obligation of the debtor, taking a contemporaneous security interest. In other words, the position taken in the text is perhaps inconsistent with the holding in Aulick v. Largent, *supra* note 39. For comment on that case, see text accompanying note 39 *supra*. Even more clearly, the extension of the *Aulick* rule in Virginia Nat'l Bank v. Woodson, *supra* note 46, seems to trench on the doctrine of the *Grubb* case. *Aulick* is presented as an exception to that doctrine in COUNTRYMAN, CASES ON DEBTOR AND CREDITOR 513 (1964).
76. 140 N.J. Eq. 224, 54 A.2d 625 (Ch. 1947).
77. *Id.* at 237, 54 A.2d at 634.
78. *Id.* at 238, 54 A.2d at 635 (Emphasis added.) Compare First Nat'l Bank v. 62 F.2d 21 (7th Cir. 1932), where the court said it was "not supposable" that money

Similarly, the payment to Dominion was "avoided": "This money [advanced by Limited] was assets of Tip Top, *since the pledge was good as against Tip Top,* though not as against the trustee."[79]

On the latter point the Stone case is contradicted by a district court decision, *In re Loring*,[80] which rejected a trustee's petition based upon section 60. It appeared that the defendant, creditor *A*, had been paid by check received from creditor *B*, and that the check represented part of the proceeds of a contemporaneous loan secured by a chattel mortgage. The court referred to an agreement by *B* to "take over" the debt to *A*. "The payment to [*A*] was made in compliance with that agreement. The bankrupt never had possession of the proceeds of the note, and the payment did not result in any diminution of the bankrupt's estate."[81] However, it also appeared that the mortgage was "invalid," for want of proper recording, and the court said: "If the mortgage had been upheld as a valid prior lien upon the assets of the bankrupt, a different conclusion might follow . . . ."[82] I submit that no different conclusion should follow.

By ruling against both the pledge to Limited (in part) and the payment to Dominion, the New Jersey court involved itself in a dilemma: where should the trustee's satisfaction come from? This is the sort of problem to which the general law of restitution can make a contribution, though all proper regard must be had for the Bankruptcy Act. The dilemma is built into the act, I hasten to say, even if the *Stone* case was not one in which it had to be faced.[83] The solution given there is at least a starting point. We have seen that the trustee successfully challenged the payment to Dominion as a preference, and to the same extent upset the pledge under section 67d(3). That section has been described above,[84] with special reference to the

---

advanced on the strength of a chattel mortgage was put in the borrower's hands as general assets.

79. Stone v. Allied Clothing Corp., *supra* note 76, at 238, 54 A.2d at 635 (Emphasis added.) Literally speaking, if the court had followed the rule of the *Grubb* case, as advocated here, it could not have held that the pledge to Limited was in any part voidable; for prior to 1952, § 67d(3) required that there be an intent to effect a voidable preference, and there could have been no such intent in a transaction controlled by the transferee. This logical impasse was broken by the 1952 amendment of § 67d(3), which now requires only the intent to enable a creditor "to obtain a greater percentage of his debt than some other creditor of the same class." Bankruptcy Act § 67d(3), as amended, ch. 579, 66 Stat. 428 (1952), 11 U.S.C. § 107d(3)(1964).

80. 30 F. Supp. 758 (D. Mass. 1939). *Cf.* Crosby v. Packer, 22 F.2d 611 (1st Cir. 1927).

81. *In re* Loring, *id.* at 759-60.

82. *Id.* at 760.

83. For cumulative remedies to exist under § 67d(3), one need only suppose that Limited took its pledge in circumstances described in the section, but permitted Tip Top to control the application of the proceeds ultimately (and preferentially) paid to Dominion.

84. See text accompanying note 51 *supra.*

provision that where the trustee has cumulative remedies under it and under section 60—as in *Stone*—he "shall be entitled to only one satisfaction with respect thereto." Recognizing this limitation, the court was naturally faced with back-biting controversy between the two transferees, Limited and Dominion. Each contended that the loss should ultimately fall on the other.[85] Initially, the court placed the loss on Limited: "The overriding interest of the estate requires that the trustee take the sum in question from the fund at hand [the court had in hand the proceeds of the pledged property, which had been sold], rather than attempt to collect it from Dominion."[86] Then it proceeded to ask: "Should Dominion be required to share the burden?" The discussion of this question was somewhat obscure, and the court gave only a partial answer. It said that Limited was "entitled to subrogation to any claim of Dominion against the estate, as a general creditor, up to the sum of $9,150 . . . . Whether or not Dominion has any valid claim is a question which does not concern Chancery."[87]

The easiest way to handle a dilemma is not to face it. The New Jersey court is to be praised for not taking the easy way in the *Stone* case. It was at least justified in trying to solve its difficulty with the doctrine of subrogation, a "powerful and pervasive idea."[88] One use of this doctrine is to dislodge unprincipled power from private hands, fulfilling one of the law's most urgent duties. If restitutionary relief were not available when a bankruptcy trustee exercises one of his cumulative remedies, he would be empowered to impose a loss upon either of two transferees at his whim. It is a function of subrogation to counter such power, and to suppress the "interesting and unwholesome opportunities for collusion"[89] that it creates. The trustee's choice of a remedy must not foreclose a claim in restitution

85. "Counsel on the one side press upon me that Limited was trying to rescue Tip Top, while Dominion was ruthlessly driving it into bankruptcy. And on the opposite side, that Limited voluntarily bought off Dominion in hope of saving its own investment in its subsidiary." Stone v. Allied Clothing Corp., *supra* note 76, at 239, 54 A.2d at 635.

86. *Ibid.*

87. *Ibid.* See also Cunningham v. Merchants' Nat'l Bank, 4 F.2d 25, 42 (1st Cir. 1925) (dissenting opinion), *cert denied*, 268 U.S. 691 (1925).

88. FARNSWORTH & HONNOLD, CASES ON COMMERCIAL LAW 933 (1965); HONNOLD, CASES ON SALES & SALES FINANCING 642 (2d ed. 1962).

89. Farnsworth, *op. cit. supra* note 88, at 934; Honnold, *op. cit. supra* note 88, at 643. Professor Honnold has described this function as vividly as anyone, in connection with a surety's right of subrogation. He describes a mortgagee (C) who has a right against an accommodation party (S), and explains that S is subrogated to the mortgage if C requires him to satisfy the debt. He points out that C might have foreclosed the mortgage, notwithstanding any objection by D's other creditors. Subrogation takes the sting out of C's arbitrary power. "If C's alternative choice to force payment from S should give the creditors the benefit of the mortgage, interesting and unwholesome opportunities for collusion could develop. Indeed, one with a lively imagination could visualize

in favor of his victim: it would be a scandal indeed to allow an arbitrary choice to an official under court supervision. If he pursues both remedies at once, as in *Stone,* the court in which he does so ought to entertain the restitutionary claim. Naturally, the claim should fail if it is found that the Bankruptcy Act authorizes cumulative recoveries; non-bankruptcy courts are perfectly competent to apply the act to that extent. If it exists, the right to restitutionary relief may or may not be found in the law of bankruptcy: the point is that in a proper case it must be found *somewhere.*

The question remains, Did the court apply subrogation properly in the *Stone* case? In the *Restatement of Restitution,* subrogation is given as a remedy, analogous to a constructive trust, designed to prevent unjust enrichment of an obligor[90]—and, of course, his creditors. In an appropriate case, the unjust enrichment of a bankruptcy estate ought certainly to be fended off by subrogating a person who has been in some way victimized to the position of a former creditor who has been paid out of his property. Perhaps that is what the court thought it was doing in *Stone,* when it subrogated Limited to Dominion's claim, but when it spoke of "sharing the burden" it did not seem to have in mind enrichment of the estate. What the court had set itself to do was to adjust "the equities between the defendants Dominion and Limited,"[91] having ruled that they were both obligors of the estate. Although they were at least potential obligees of the estate, as "creditors," they were also *obligors* in their capacity as defendants and recipients of voidable transfers. Possibly the court failed to attend sufficiently to this dual role in applying the remedy of subrogation.

If we may cast the trustee, or estate, as a "creditor," and the defendants as obligors, the possibility of subrogation emerges in another form—one that the court did not consider. "A person who unofficiously fully performs an obligation which should be performed by another is ordinarily entitled, in addition to an action at law for restitution, to be subrogated to the position of the creditor."[92] This suggests,

an auction held by C, with S and D's creditors bidding against each other for C's decision, the value of which would approximate the value of the mortgage." *Ibid.* Similarly, in the *Stone* case, if the trustee's choice of remedies should give the benefit of satisfaction to one creditor rather than another, "interesting and unwholesome opportunities for collusion could develop." See also Campbell, *Non-Consensual Suretyship,* 45 YALE L.J. 69 (1935).

90. RESTATEMENT, RESTITUTION § 162 (1937).

91. Stone v. Allied Clothing Corp., *supra* note 76, at 239, 54 A.2d at 635.

92. RESTATEMENT, RESTITUTION § 76, comment *g* (1937). There is a cross-reference here to § 162, but it is plain that the two sorts of subrogation are different. Subrogation to a bankruptcy claim, as to a secured position, has its impact on other creditors, or another secured party, preventing their unjust enrichment—and ordinarily subrogation

as applied to the *Stone* case, that Limited be subrogated to the trustee's power of avoiding the preference to Dominion—that *the court chose the wrong subrogee.* More simply, it suggests that Limited was entitled to indemnity from Dominion, as having "discharged a duty which is owed by him but which as between himself and another should have been discharged by the other . . . ."[93]

In my view, the error of the court was in requiring that Dominion share the burden, rather than *bear* it. That is to say, as between two transferees against whom the trustee has cumulative remedies under section 67d(3), the one from whom the "one satisfaction" for the estate ought to come is the one who was preferred. This proposition is offered as a deduction both from the scheme of the Bankruptcy Act and from principles of restitution; hence it cannot be said with assurance whether it is part of the proper law of bankruptcy or not. In either case, upon the facts of *Stone* it was pretty plainly within the competence of the New Jersey court to apply it.[94] Other commentators

---

to a simple, unsecured claim has (or should have) no utility. By contrast, subrogation to a trustee's avoiding power redresses unjust enrichment of the target of his power, and is an "equitable" alternative to a right of indemnity. Subrogation of this genre, quite unlike the first, works only if the bankrupt's transfer or obligation is defeasible. *Nota bene,* the distinction is *not* suitably indicated by the terms "legal" and "conventional" subrogation. *Compare* United States Fid. & Guar. Co. v. Maryland Cas. Co., 186 Kan. 637, 352 P.2d 70 (1960), *with* Martin v. Hickenlooper, 90 Utah 150, 59 P.2d 1139 (1936).

93. Restatement, Restitution § 76 (1937). Obviously, the problem of restitution presented when a preference-enabling *transfer* is made is different from the problem arising when a preference-enabling *obligation* is incurred. The *Stone* case is in the former category inasmuch as Limited made a secured loan (upon a pledge). Section 67d(3) declares both transfer and obligation to be voidable. Foolishly, it has been assumed that an indebtedness is voided by the section, whether or not it is fully secured. See Note, 24 N.Y.U.L.Q. 604 (1949). What should be understood is that avoiding the transfer (pledge), while recognizing the indebtedness, fully compensates the estate, except to the extent that the collateral is inadequate. To that extent, the *obligation* is voided.

If *L* lends *D* $100 without security, knowing what must be known to make the obligation fraudulent under § 67d(3), and *D* pays it preferentially to *C*, the trustee may or may not be able to recapture the payment under § 60b. If he may, he has cumulative remedies. Now, it may not be entirely clear what "one satisfaction" means with respect to a remedy like avoidance of an obligation, but the most natural supposition is that the trustee may not *both* disavow *L's* claim *and* recover from *C*. If he chooses the former course, and does not pursue *C*, then according to the views expressed here, *C* is unjustly enriched and *L* should have a restitutionary right against him. The measure of it might be (for a starter) the dividend on a $100 claim.

94. If the trustee had brought his action against one of the transferees alone, the competence of the court to ascertain his possible remedies against others might be doubted. See Eau Claire Nat'l Bank v. Jackman, 204 U.S. 522 (1907); 2 Collier ¶ 23.19. Problems of jurisdiction are beyond the scope of this paper. See generally Mussman & Riesenfeld, *Jurisdiction in Bankruptcy,* 13 Law & Contemp. Prob. 88 (1948). If inter-creditor restitution were granted in a proceeding to which the trustee is not a party, the remedy that suggests itself is a judgment for the loan proceeds that were preferentially paid over, less the dividends that the payee would have received in bankruptcy if the payment had not been made. *But see* Comment, 68 Harv. L. Rev.

have both praised and rebuked the court for this portion of its opinion, but without touching the nerve of the matter. It is "obiter," said Professor Corker, "because the determination of who has a provable claim is for the bankruptcy court."[95] His remark does not reach the more interesting question whether the equities between Limited and Dominion are to be assessed by reference to state law or bankruptcy law. On the merits, the court's use of subrogation has been applauded, though not with abandon, and the law reviews overlooked the fact that it misfired.[96]

The way in which a bankruptcy court might implement one creditor's restitutionary claim against another is shown in *Aulick v. Largent*,[97] the Fourth Circuit case presented earlier. Mrs. Aulick, a preferred creditor, had obtained a judgment and satisfaction against Lemley, an indorser for the bankrupt, in the amount of 10,700 dollars, plus court costs and attorney fees. The bankruptcy court ordered Lemley to restore to the trustee a stock certificate pledged to him by the bankrupt to procure his indorsement—although Lemley had not been preferred. Then the court impressed a trust (in effect) on the avails of the trustee's action against Mrs. Aulick, giving judg-

---

1271 (1955). A simpler procedure might be to award the plaintiff the whole amount traced to the defendant, conditioned upon an assignment to the latter of the plaintiff's claim against the estate. In that form, of course, the relief amounts to subrogation to the trustee's power of avoiding the preference. There are difficulties, of course, in the path of either of these remedies: difficulties of calculation and difficulties having to do with bankruptcy jurisdiction. See 3 COLLIER ¶ 60.57(2). However, they are no worse (to say the least) than the difficulties encountered in granting the relief fashioned in the *Stone* case. See note 96 *infra*.

95. Corker, *Hazards of Doing Business with an Insolvent: The Dean v. Davis Amendment in the Chandler Act*, 1 STAN. L. REV. 189, 214 (1949). See also 4 COLLIER ¶ 67.38 at 395 n.37: "The New Jersey court's discussion concerned matters properly cognizable in a bankruptcy court."

96. The result has been termed "desirable and consistent with the statutory mandate . . . ." Note, 24 N.Y.U.L.Q. 604, 607 (1949). The writer suggests that some such phrase as "equitable substitution" be used in lieu of "subrogation," because of limitations commonly placed on the latter doctrine. No difficulty ought to be anticipated in respect of the name, certainly if the controlling principles are those derived from the Bankruptcy Act. See also Comment, 40 MINN. L. REV. 499, 501 (1956). The discussion in Collier is at least not disapproving. See 4 COLLIER ¶ 67.38.

At best, the relief granted to Limited could not exceed Dominion's share in the estate. But Dominion's claim was apparently a nonesuch, for the obvious reason that the trustee had his "one satisfaction" in the case at hand. Even if Limited was subrogated to a claim larger than zero, its reimbursement was only the dividends on the claim —an amount virtually arbitrary in relation to the controvery between them.

Subrogation to the preferred creditor's claim encounters an obstacle in § 57g of the Act (11 U.S.C. § 93g), making the claims of recipients of voidable preferences nonallowable. The obstacle might be gotten over, as suggested in Corker, *supra* note 95, at 214 and 4 COLLIER ¶ 67.38 at 393, n.31. Clearing that hurdle, however, does not automatically adjust the interests of the parties equitably—and if it is not cleared, oppressive conduct by the trustee is permitted, as shown in Corker, *supra* note 95, at 214 n.79.

97. See text accompanying note 39 *supra*.

ment against her, for the benefit of Lemley, in the amount of 10,700 dollars. Evidently the court conceived that it had plastic power to fashion a remedy for the needs of the whole situation, so that there should be no unjust enrichment of the estate, nor of Lemley, nor of Mrs. Aulick.[98]

As a test of the relation between preference law and section 67d(3), let us suppose a variation on the *Stone* case—and for simplicity's sake we shall take the Uniform Commercial Code as applicable law. Let us say that Limited never took possession of the "pledged" collateral, and failed to file a financing statement covering its security interest. The consequence is (under article 9 of the Code) that a subsequent lien obtained by legal proceedings upon the collateral, or the rights of a subsequent bona fide purchaser, would be superior to those of Limited.[99] The security interest remains (in both senses) unperfected at the time of bankruptcy. On these facts the transfer (pledge) "shall be deemed to have been made immediately before the filing of the petition."[100] The perfection clauses of the Bankruptcy Act tend to make transfers voidable by relating them forward to a time when the elements of voidability may readily be established. Since the payment to Dominion is voidable as a preference (it is assumed), we may summarize the position of the trustee in this case, with only the barest hesitation, as follows: (1) He has cumulative remedies against Dominion and Limited under section 60, upon showing that "immediately" before bankruptcy Limited had reasonable cause to

98. The court entertained the idea of restoring to the surety the whole amount he had paid on the contract—under legal compulsion—but rejected it on the following significant ground: "Equitable considerations should not be disregarded. . . . Since the costs and attorney fees incurred in the state court litigation were occasioned by Lemley's unwarranted and indefensible refusal to discharge his liability as an endorser, it is inequitable that Mrs. Aulick be required to refund to Lemley, by payment to and through the trustee, such costs and fees." Aulick v. Largent, 295 F.2d 41, 52 (4th Cir. 1961). (In the case as stated here, recoveries of interest are disregarded; and so is the circumstance, not now pertinent, that the pledge to Lemley was in minor part undoubtedly preferential.)

Yet the court expressed an odd limitation on its wide-ranging decree: it purported to leave the way open to a further action by Mrs. Aulick against Lemley. But what of merger by judgment? Would her action be one based on unjust enrichment caused by the bankruptcy court? The remark must signify something about bankruptcy jurisdiction; but it is hard to know what. Compare in that aspect, *In re* Wyse, 340 F.2d 719 (6th Cir. 1965); see Coogan, Kripke & Weiss, *The Outer Fringes of Article 9*, 79 Harv. L. Rev. 229, 251-52 (1965).

In a subsequent preference case, Virginia Nat'l Bank v. Woodson, 329 F.2d 836 (4th Cir. 1964), the court "followed" its decision in *Aulick*, and granted recovery for the trustee in the lesser of two sums: the amount paid to the creditor, or "what the bankrupt's estate has lost." In framing decrees in these cases the Fourth Circuit has manifested a restitutionary approach to the law of preferences much more clearly than the Bankruptcy Act does. *Compare* note 42 *supra*.

99. Uniform Commercial Code § 9-301.

100. Bankruptcy Act, §§ 60a(2), 67d(5), 52 Stat. 870, 878 (1938), 11 U.S.C. §§

believe that the debtor was insolvent.[101] (2) He has cumulative remedies under section 67d(3) upon showing that Limited knew what its advances were to be used for, and that Limited knew "immediately" before bankruptcy that insolvency proceedings were in contemplation.[102]

May the trustee have cumulative *recoveries* in either situation? We know that under section 67d(3) he is "entitled to only one satisfaction with respect to" his cumulative remedies. We have surmised, however, that he may have cumulative recoveries under section 60. On the face of it, this position does not seem to make much sense. In effect, we would be saying that if the trustee fights his way up the steeper hill of section 67d(3), the advantage to the estate is less than if he strolls up the gentler slope of section 60. On the other hand, there is no actual inconsistency. If the proviso about "one satisfaction" is in the right place in the act, it simply means that the trustee may not add to all his recoveries under section 60—possibly multiple ones, enriching the estate—an additional recovery for a preference-enabling transfer. In one important respect the equities of a transferee who can be challenged under section 67d(3) are superior to those of a preferred creditor: he has given consideration either at the time of or after the transfer, by hypothesis ("the consideration obtained for such transfer"). By contrast, a transfer cannot be preferential unless it is—or is at least "deemed"—one "for or on account of an antecedent debt." Hence there is some reason to regard the preference-enabling transfer with less alarm than the preference itself; the evil aimed at by section 67d(3) is ancillary to the main one. The use of the word "fraudulent" in that section, and the relatively pallid word "preference" in section 60, tends to distort a clear view of the designed relation between the sections.[103]

96a(2), 107d(5) (1964). "Such petition" is the wording of the latter section.

101. Bankruptcy Act, § 60b, 52 Stat. 870 (1938), 11 U.S.C. § 96b (1964); quoted in note 42 *supra*. Limited's security interest would almost surely be ousted by §§ 70c and 70e (11 U.S.C. §§ 110c, e) as well as by § 60. This thought reinforces the view that its validity has nothing to do with the preference issue respecting the payment to Dominion.

102. See 4 COLLIER ¶ 67.40. *In re* Loring, *supra* note 80, would be a similar case if the mortgagee had had such knowledge. It directed the application of the proceeds to a trade creditor—indeed, sent its own check.

103. See Marsh v. Walters, 220 Fed. 805, 808 (6th Cir. 1915). See also Corker, *supra* note 95, at 215: "[T]he judicial instinct seems to be sound in preferring that the burden be shifted where possible from the transferee to the preferred creditor." But as to the viciousness of a fraudulent, as opposed to a preferential, conveyance, see Van Iderstine v. National Discount Co., 227 U.S. 575, 582 (1913).

In 4 COLLIER ¶ 67.38 the view is expressed that a transferee would have a defense against a § 67d(3) attack if he could show that the consideration he gave was not used as intended—preferentially—but was still in the hands of the bankrupt at the date of bankruptcy, and so came into the estate. This is consistent with the view of the section taken here: that it is ancillary in character. In connection with the 1952

The possibilities of inter-creditor restitution, occasioned by bankruptcy, should be evaluated in light of transfers after the date of bankruptcy (filing of the petition) as well as before. To take a simple case, suppose that after a petition is filed the debtor withdraws funds on deposit in his bank and applies them to the payment of a trade creditor. And let it be supposed that under section 70 of the act the trustee has rights of recovery against both the payor and the payee. If he requires the bank to restore the bankrupt's account to its previous condition, the stage is set for a restitutionary claim against the creditor. The claim could be strengthened, as desired, by assuming various degrees of good faith and knowledge on the part of the bank and the trade creditor.

It may be that such a claim would have to be "pitched upon" non-bankruptcy law, or it may be that the claim would be controlled by emanations from the Bankruptcy Act; the question is an open one. The same uncertainty exists as in the situation previously hypothesized, where a restitutionary claim is occasioned by section 67d(3) of the act. In the present situation, the uncertainty runs even deeper, for it is not clear that the trustee is confined to "one satisfaction";[104] and if he is, there is more room for doubt whether the payor or the payee should be the one ultimately accountable. If the payor bank asserted, as against the estate, a right of subrogation to the discharged claim of the trade creditor, it might be met with various inferences, drawn from the Bankruptcy Act, that the estate is not unjustly enriched by a "double recovery." There is a basis for such an inference in section 63b of the act;[105] and it is a notable fact that section 70

amendment of § 67d(3), the relation between it and § 60 was suggested in the term "auxiliary transaction." H.R. Rep. No. 2320, 82d Cong., 2d Sess. 14, 15 (1952). Professor Corker thought there would be no such defense, it seems. See Corker, *supra* note 95, at 213.

104. That is, it may be that the trustee is entitled to have the payment to the creditor reversed *and* the bankrupt's account restored, while recognizing only one claim against the estate.

105. Bankruptcy Act § 63b, 52 Stat. 873 (1938), 11 U.S.C. § 103b (1964). If the proceeds of a pre-bankruptcy loan, fraudulently induced by security in collateral that the borrower had no power to encumber, were applied to satisfy a secured claim, the lender would have either a provable claim of his own or a secured position via subrogation—depending upon a complex of bankruptcy and non-bankruptcy rules. It has been said that a comparable (post-bankruptcy) transaction between a lender and a bankrupt gives the lender at least an offsetting credit against the trustee when he claims the collactral—gives him in effect a provable claim. Comment, 68 Harv. L. Rev. 1271 (1955). *But see* text accompanying note 18 *supra;* 3 Collier ¶ 63.34.

Varying the facts supposed in the text, suppose that the payor bank had misguidedly honored a "no-account" check, thereby acquiring a claim against the bankrupt. An inference from § 63b is, that if it did so after the prescribed interval it would not have a provable claim. To give it one by subrogation to the (paid) claim of another creditor would circumvent the Act. (The Comment cited above suggests otherwise, as shown in discussion of the case cited at note 106 *infra,* as first characterized. See also Comment, 40 Minn. L. Rev. 499 (1956).) Arguably it follows from this that the

does not contain a "one satisfaction" limitation on the trustee's rights and powers. The possibility of inferring such a limitation was raised in one well-known case, *Lake v. New York Life Insurance Co.*,[106] but the court's discussion was entirely inconclusive. The bankrupt had fraudulently obtained life insurance policy loans, and used the proceeds partly "to satisfy certain debts . . . and thereby the estate was benefited." When the trustee sued the companies for the cash surrender value of the policies, they claimed credits based on the satisfaction of debts. The issue was not ruled upon, however.

> [T]he evidence did not show which of the debts were entitled to priority and which were claims of general creditors and consequently additional evidence would be required if it should become necessary to determine the legal effect of the use of the money in the manner indicated.[107]

Cumulative remedies under section 70 were asserted by a trustee in an important case that is still *sub judice* at the time of this writing: *Bank of Marin v. England.*[108] Checks drawn by the bankrupt were presented to the bank six days after the filing of a voluntary petition, and it paid them without knowledge of the petition. The checks had been given to a creditor, shortly before bankruptcy, in payment of an account. The trustee sought a recovery in the amount of the checks against the payee, Eureka Fisheries, and against the bank, *in the alternative.* The referee ruled that the payee and the bank were *jointly* liable to the trustee for the amount he sought. (On review and appeal the ruling was sustained, insofar as the bank was concerned. Certiorari has been granted.) Two questions may be asked about the situation, neither of which has been adjudicated.

payor bank is not to be subrogated even if it was (as supposed in the text) *in funds.* But possibly subrogation is excluded as a remedy for persons so misguided as to give credit to the bankrupt, and not as to those paying over to him by error. *Cf.* Kohn v. Myers, 356 F.2d 353 (2d Cir. 1959), stated in the text accompanying note 22 *supra.* The Comment mentioned above differentiates the two situations in the two characterizations of the case in hand (the second one seems correct).

106. 218 F.2d 394 (4th Cir. 1955), *cert. denied,* 349 U.S. 917 (1955). In Comment, 68 HARV. L. REV. 1271 (1955), the case is interpreted as assuring the defendants of a credit, contrary to the view here expressed that it was inconclusive. The student writer says that "the trustee should not be allowed to realize an amount exceeding the cash surrender value of the policies by virtue of having two remedies. *Cf.* Bankruptcy Act § 67d(3) . . . ." *Id.* at 1272. The case is also commented on in 40 MINN. L. REV. 499 (1956). Compare May v. Henderson, 268 U.S. 111 (1925).

107. Lake v. New York Life Ins. Co., *supra* note 106, at 401. See also Feldmann v. Capitol Piece Dye Works, Inc., 293 F.2d 889 (2d Cir. 1961), where the court held a bank accountable to the trustee for post-bankruptcy withdrawals, and added: "We do not however pass upon the right of the bank to invoke any remedies which it may consider to be available to recover that portion of the funds, represented by the judgment to be entered, which have been used in the payment of the bankrupt's legitimate obligations." *Id.* at 892.

108. 352 F.2d 186 (9th Cir. 1965), *cert. granted,* 383 U.S. 906 (1966). As to the bank's liability, see COUNTRYMAN, CASES ON DEBTOR AND CREDITOR 414 n.3 (1964).

First, might the trustee have had cumulative recoveries against the payee and the bank, if he had been more grasping? Second, if the trustee has cumulative remedies against the payee and the bank, but is content with one recovery (or has to be), who should bear the ultimate loss?

If cumulative recoveries are allowed in the *Bank of Marin* case, it appears that the estate would be enriched by the amount of the checks. (The bank would not acquire a provable claim of its own, apparently, upon restoring the debtor's account.[109]) If a trustee were to seek such an effect on facts like these, it is submitted, his grasp would exceed his reach. The bankruptcy court could and should find a way to frustrate such an outrageous maneuver: subrogation of the bank to the trustee's power of avoiding the payment has been thought of;[110] and a constructive trust comes to mind. In the *Bank of Marin* case the court made it clear that no problem of cumulative recoveries was before it:

> We express no opinion as to whether the bank will, in fact, have to pay any part of these checks. As noted above, the order ran against the bank and Enreka Fisheries jointly, and Eureka Fisheries has paid the trustee the full amount of the checks in question. The rights as between the bank and Eureka Fisheries have yet to be determined.[111]

Thus the second question is reached: Is there a rule of law—bankruptcy or other—that determines the ultimate incidence of loss, as between the two persons liable to the trustee? If there is such a rule, it is obviously restitutionary in character. Having paid the trustee, Eureka Fisheries filed with the bankruptcy court, and served on

109. Because, in general, only debts of the bankrupt existing at the date of bankruptcy give rise to provable claims; and see note 105 *supra*. See also MacLachlan § 140.

110. Comment, 68 Harv. L. Rev. 1271 (1955). Also: "The bankruptcy court might grant a petition of the companies to compel the trustee to seek recovery from the creditors, thereby releasing the companies from at least part of their liability." *Id.* at 1272.

If cumulative recoveries are objectionable in this situation, it may be asked, why are they not equally so in the case of a "substitution of creditors"? (See text accompanying note 51 *supra.*) A short answer to this question would be that post-bankruptcy transactions are placed by the act in a world apart from pre-bankruptcy transactions. A full answer would require an essay in itself. Two points only can be noticed here, by way of comparing the creditor paid before bankruptcy and the one paid thereafter. First, the payment before bankruptcy is irreversible (so far as § 60 is concerned) if the creditor did not have, "at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent." By contrast, the post-bankruptcy transferee may be required to disgorge without a showing of any such involvement in the debtor's affairs. Second, insofar as outstanding credit serves as an inducing cause for third parties to confide in the debtor, credit given for a period before bankruptcy may sensibly be regarded as a greater commercial threat than credit outstanding after a petition is filed.

111. Bank of Marin v. England, *supra* note 108, at 193 n.12.

the bank, a demand for contribution. If the *bank* had made such a payment to the trustee, it might well have demanded contribution from Eureka Fisheries, and perhaps would have demanded reimbursement of the entire payment.[112] Restitutionary relief of *some* sort must be made available to one or the other of the judgment debtors upon satisfying the trustee, for the reason already indicated: the necessity of suppressing an unprincipled allocation of loss by the trustee.[113] An appropriate one, it seems, would be to indemnify the bank (if it had paid the judgment) to the extent of the trade creditor's net liability to the estate[114]—and conversely, to deny contribution in favor of the creditor. A right of contribution hardly seems to fit the case, since the equities are not equal.[115] The bank was in fact a debtor of the bankrupt, never having given him credit so far as appears. This circumstance, and the commercial advantage in promoting honor of checks, argue for the rule advanced. An argument to the contrary might be founded on the doctrine of bona fide purchase, however.

The resolution of these questions cannot be based directly upon section 67d(3)[116] of the act. It does not apply to the *Bank of Marin* situation because the bankruptcy petition was filed before the checks were presented. But might not the *idea* of the section apply to a post-bankruptcy transaction? The principle of section 70[117]—that one dealing with, or indebted to, a bankrupt *should* know of his adjudication—corresponds in a sense to the knowledge that brings section 67d(3) into play: that liquidation is in contemplation. If the analogy is at all persuasive, it supports the conclusion that the trustee is entitled to "one satisfaction" only. Unfortunately, the analogy also suggests, in light of *Stone v. Allied Clothing Corp.*,[118] that the bank be subrogated to the claim of the trade creditor. Subrogation to a creditor-position is an unfortunate remedy in a section 67d(3) case; but it remains to be considered as a possibility where the trustee obtains double recoveries.

---

112. In granting relief in either form, a bankruptcy court would necessarily be denying cumulative remedies to the trustee.

113. See text accompanying note 89 *supra*.

114. Full payment to the creditor is assumed. If he was paid only in part, his remaining share in the estate should be excluded from the computation. See RESTATEMENT, RESTITUTION § 80 (1937).

115. The *Restatement* field for contribution is the duty "as to which, between the two, neither had a prior duty of performance . . . ." RESTATEMENT, RESTITUTION § 81 (1937). "It is not within the scope of the Restatement of this Subject to state the circumstances under which, where two persons are subject to a duty, each of them is equally responsible therefor." *Id.*, comment *b*.

116. Bankruptcy Act § 67d(3), 52 Stat. 878 (1938), 11 U.S.C. § 107d(3) (1964).

117. Bankruptcy Act § 70, 52 Stat. 879 (1938), 11 U.S.C. § 110 (1964). See note 19 *supra*.

118. *Supra* note 76.

The prospect that bankruptcy law governs a restitutionary claim is enhanced, no doubt, if the relief sought will affect the size of the estate—the fund available for distribution to ordinary creditors—and it is enhanced if fraud on the estate is an element in the underlying transaction. In *Lake v. New York Life Insurance Co.*[119] both of these conditions obtained. The bankrupt committed a fraud upon the estate, as well as upon the defendant insurers—a double-edged *dolus*. In that respect, at least, the case can be distinguished from the more elementary situation wherein the estate is unjustly enriched: the bankrupt obtains money by fraud and pays it over the trustee. Whether or not the victim may hold the trustee accountable upon a constructive trust is a "local question," the Supreme Court has said, to be determined by state law.[120] On the other hand, it seems likely that subrogation to a creditor-position is governed by bankruptcy law if granting the relief would affect the dividends payable to ordinary creditors.[121] (As shown in the *Stone* case, subrogation may or may not have this effect.) Even if there is fraud on the estate, non-bankruptcy law might be adequate for some forms of restitutionary relief. After undoing the consequences so far as concerns the estate, the bankruptcy court might well permit another victim to turn the fraud to his own advantage, as an equity in his favor, so far as concerns competition for a share in the estate. Of course, if we assume wrong-doing by a debtor in collusion with a creditor, that is another story. Bankruptcy courts have made it their particular business to undo fraud of that character; and the usual remedy is to marshal the claims of creditors in favor of the innocent—or as it is usually put, to subordinate the guilty creditor's claim.[122]

In the *Bank of Marin* case there was no fraud, and a demand for contribution or idemnity as between the defendants does not affect the quantum of the estate. Therefore it would not be unnatural to test such a demand by state law. That would be so even if cumulative recoveries were granted to the trustee. In that case a provable claim would arise in favor of the creditor, Eureka Fisheries, but there would be at least a sympathetic argument for subrogating the bank to the claim. A similar argument could be made in other cases of double recoveries, canvassed earlier in this paper. In the "three bank" case used to illustrate the scope of section 60, each bank would have its own claim for 50,000 dollars, presumably, if the trustee succeeded

119. *Supra* note 106.

120. Jaffke v. Dunham, 352 U.S. 280 (1957). See also Gordon v. Spalding, 268 F.2d 327 (5th Cir. 1959); *cf.* Carpenter v. Southworth, 165 Fed. 428 (2d Cir. 1908).

121. As where a discharged claim that would have had priority is the one to which subrogatory rights are asserted. See references cited in note 15 *supra*.

122. Pepper v. Litton, 308 U.S. 295 (1939). See Herzog & Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 VAND. L. REV. 83 (1961).

in avoiding the two preferential payments. It might occur to bank *B* to file a "double claim": its own, plus that of bank *A* by way of subrogation. (And bank *C* might be inspired to file a *triple* claim! In point of fact, the third bank in the actual series of transactions sought to impose a constructive trust on the trustee's recovery from the first.[123]) The equity looking toward subrogation must be more, it seems, than the claimant's power to trace his funds into the hands of another. Even if the claimant shows that his funds were wrongfully obtained or applied by the debtor, an innocent payee would normally be excused from making restitution by the doctrine of bona fide purchase.[124] But possibly the equities of a post-bankruptcy payee are not weighty enough to warrant the application of this rule;[125] and the same might be said of a pre-bankruptcy payee, at least if he were conscious of being preferred.[126] On that basis one could justify subrogation for the payor in the *Bank of Marin* case, and in *Lake v. New York Life Insurance Co.*,[127] and possibly in the *Stone* case,[128] while denying it in an ordinary case of preferential transfer.

There is no necessity, it has been said, in disregarding state law precedents for and against this variety of subrogation. The bona fide purchaser defense is not a creature of bankruptcy law, and a bankruptcy court might well adopt the stance of a state court in reference to it. On the other hand, the restitutionary problem is a peculiar one as it arises in the bankruptcy context,[129] and for the most part the solution provided by non-bankruptcy law would have to be divined rather than discovered.[130] If the problem is divorced from

123. First Nat'l Bank v. Luther, 217 F.2d 262 (10th Cir. 1954). By pursuing a claim against the estate as secured, the bank became bound to an election of remedies, it was held.

124. See RESTATEMENT, RESTITUTION §§ 13, 14, 172-76 (1937).

125. "[S]ince the rule that satisfaction of an antecedent debt is value has generally been justified on the ground that creditors will rely on the payment . . . a court might well create an exception here, for the creditors would not rely to their detriment where the debtor is in bankruptcy." Comment, 68 HARV. L. REV. 1271, 1272 (1955).

126. Such was the fact in a number of the cases discussed herein, probably including those cited in note 46 *supra*.

127. *Supra* note 106. In substance, the credits claimed by the insurance companies may have been a premature assertion of distribution rights under potential claims of the creditors who were paid. Not knowing the character of those "claims," the court was well advised not to prejudge a subrogatory interest in them.

128. 140 N.J. Eq. 224, 54 A.2d 625 (Ch. 1947). The bona fide purchase defense was not mentioned by name here (in this connection), but the court gave reasons arguably sufficient to override it.

129. It would be awkward to have the choice of law depend upon whether cumulative recoveries may or may not be had by the trustee, because his position is so uncertain at present, in situations where the restitutionary problem exists.

130. A reference to state law in Bank of Marin, *supra* note 108, leads to Cal. Civ. Proc. Code § 709. The statute does not appear to be either a substantive basis or an exclusive procedure for allocating liability as between joint judgment debtors. See Tucker v. Nicholson, 12 Cal. 2d 427, 84 P.2d 1045 (1938); Stowers v. Fletcher, 84 Cal. App. 2d (Supp.) 845, 190 P.2d 338 (App. Dep't Super. Ct. 1948).

the bankruptcy issue of "double recovery," a skillful solution is not very likely to be reached. It would not be surprising, therefore, to find that, as to any claim arising when the trustee avoids a transfer, the only right of subrogation is "bankruptcy subrogation." It is at least plausible to say that state law of restitution is displaced, so far as concerns cumulative remedies of the trustee, by principles immanent in the Bankruptcy Act—themselves partly restitutionary in character.[131]

IV. CONCLUSION

Bankruptcy courts take the law of restitution as they find it, for the most part. Restitutionary rights asserted by the trustee as successor to the bankrupt should be assessed on the same basis as if the bankrupt were the plaintiff.[132] Similarly, such rights asserted against the estate as "debts of the bankrupt" should be evaluated by non-bankruptcy law. Nevertheless, special problems of restitution arise in amassing and distributing a bankrupt's estate, for which state law may not yield authoritative solutions. The components of the idea "unjust enrichment" are not constant for all situations in which the concept operates, and they should be carefully adjusted to fit the bankruptcy situation.[133] One cannot simply translate ordinary restitutionary concepts bodily into the context of bankruptcy; the rigidities of the act itself forbid it.

Many of the most striking features of the Bankruptcy Act are obviously inspired by a restitutionary ideal: the prevention of windfall gains by (or at the expense of) creditors at large. There is, for instance, a set of clauses introduced to cover the case of a junior security interest, effective in bankruptcy, which would be promoted in rank if the trustee succeeded in avoiding the senior security. The act provides, so as to prevent a windfall to the junior party, that "the court may on due notice order such [senior] lien to be preserved for the benefit of the estate . . . ."[134] Probably it was not necessary to

131. Particularly under § 67d(3) the problem of restitution is so heavily enmeshed in the objectives of the act that its solution probably lies in the interstices of the statute. The argument is by no means conclusive, however.

132. See *In re* ABC-Federal Oil & Burner Co., 290 F.2d 886 (3d Cir. 1961). (This case further adumbrates the career of Eugene M. Callis, whose bankruptcy gave rise to the case of Lake v. New York Life Ins. Co., note 106 *supra*).

133. "The conception of unjust enrichment as ordinarily defined includes not only gain on one side but loss on the other, with a tie of causation between them. . . . Actually, these components, appearing in an immense variety of situations, are highly variable both in their own content and in their interconnections." Dawson, *Restitution or Damages?*, 20 OHIO ST. L.J. 175, 176 (1959).

134. Or, such transfer, title, or obligation, as the case may be. Bankruptcy Act §§ 60b, 67a(3), 67c, 67d(6), 70e(2), 52 Stat. 870, 876, 877, 878, 882 (1938), 11 U.S.C. §§ 94b, 107a(3), 107c, 107d(6), 110e(2) (1964).

amend the act to cover such a case, for the law of bankruptcy is roomy enough to let in the ordinary remedies for preventing unjust enrichment.[135] As Judge Lord has recently reminded us, "courts of bankruptcy are essentially courts of equity."[136] Particularly it has been suggested that, where connected transactions give rise to "cumulative remedies" for the trustee, it is the province of bankruptcy law to regulate their employment.

We might even speculate that the trustee's powers and responsibilities may one day be founded largely on restitutionary principles. For instance, the law of preferences might be reformed so as to measure the trustee's power of recovery by the unjustified loss to the estate. Where there has been a mere substitution of creditors, it would follow that no voidable transfer has occurred. I have argued that this is not a proper deduction from the act as it stands. The restitutionary ideal is far from a trustworthy guide in bankruptcy matters generally, and the courts will do well to await a fresh legislative mandate before they try to strike some ultimate balance of equities between creditor and creditor.

Having these reservations in mind, we must acknowledge that certain "bankruptcy principles of restitution" exist. Cautiously developed, they can properly supplement and enrich the facilities for justice that bankruptcy courts administer.

---

135. The same effect was achieved on general "anti-windfall" principles, before these provisions were introduced (1952). "In Matter of Espelund, D.C., 181 F. Supp. 103, 112, it was stated that the rule then was that, upon invalidation of a senior mortgage as against a bankruptcy trustee, a junior lienor became elevated in rank as against the trustee, even though the junior lienor had acquired his lien with notice of the existence of the senior lien. However, the authorities relied on therein for that proposition do not in fact support it (White v. Steinman, 2 Cir. 120 F.2d 799; Matter of Andrews, 7 Cir., 172 F.2d 996). . . . The 1952 amendment settled the problem clearly in favor of the trustee and contrary to the supposed rule to which reference was made in Matter of Espelund (*supra*)." *In re* Edward Bibinger, Inc., 12 App. Div. 2d 237, 239-40, 210 N.Y.S.2d 319, 321-22 (2d Dep't 1961).

136. *In re* Elkins-Dell Mfg. Co., 253 F. Supp. 864, 867 (E.D. Pa. 1966).