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FRAUDULENT CONVEYANCES AND PREFERENCES IN VIRGINIA

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In *Surratt v. Eskridge*[1] the Virginia Supreme Court held that an insolvent debtor had the privilege of preferring[2] one creditor over another, and that the disfavored creditor could not attack the payment as a fraudulent conveyance. Preferences made by corporations also fall within the *Surratt* rule,[3] which has one well-recognized exception. In *Darden v. George G. Lee Co.*[4] the Virginia Supreme Court held that where the controlling director of a corporation is preferred over other creditors of the debtor, the preferential payment may be set aside as a fraudulent conveyance under section 55-80 of the Virginia Code.[5] In *Bank of Commerce v. Rosemary & Thyme,*[6] decided last term, the issue was whether preferential payments made by a corporation on debts for which the directors were sureties could be challenged under section 55-80. The plaintiff asserted that the case fell within the exception to the general rule stated in *Darden.* The defendant directors argued that since the preferred creditor qualified as a bona fide purchaser for the purposes of section 55-80, the transaction was valid. The court accepted the defendant's position, even though it implied that the directors had engaged in wrongful conduct. Since the preferred creditor had no knowledge of the debtor's fraud, the plaintiff failed to state a cause of action under section 55-80.

This article has two goals. The first is to indicate the essential factual differences between the situations presented in *Darden* and *Bank of Commerce,* and the simple preference found in *Surratt.* Once this distinction is recognized, it becomes apparent that the legality of the simple preference and the two factual situations involving corporate directors granting themselves preferences should be judged under different legal principles. The second goal is to demonstrate that unless *Darden* and *Bank of Commerce* are strictly limited to their facts, the cases either overrule or

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1 131 Va. 325, 108 S.E. 677 (1921).

2 As used in this article, the term "preference" is a transfer of money or property by an insolvent debtor to or for the benefit of a creditor in payment of, or as security for, an antecedent debt. There is no requirement that the creditor know or have reason to know of the debtor's insolvency. *Cf.* Bankruptcy Act §§ 60(a), (b), 11 U.S.C. § 96(a), (b) (1976).

3 Beck v. Semones' Adm'r, 145 Va. 429, 134 S.E. 677 (1926).

4 204 Va. 108, 129 S.E.2d 897 (1963).

5 VA. CODE § 55-80 (Repl. Vol. 1974). Section 55-80 provides in pertinent part:

> Every gift, conveyance, assignment or transfer of, or charge upon, any estate, real or personal, . . . with intent to delay, hinder or defraud creditors, purchasers or other persons of or from what they are or may be lawfully entitled to shall, as to such creditors, purchasers or other persons, . . . be void. This section shall not affect the title of a purchaser for valuable consideration, unless it appears that he had notice of the fraudulent intent of his immediate grantor or of the fraud rendering void the title of such grantor.

6 218 Va. 781, 239 S.E.2d 909 (1978).

significantly modify *Surratt* and similar decisions, thereby calling into question the validity of preferences generally. This latter change, which appears to have been inadvertant, may have far reaching implications.

To fulfull these goals, it is necessary to indicate the essential differences between fraudulent conveyances and preferences. With these differences in mind, the various rationales for permitting preferences at common law are more easily understood. Against this background, the article will examine the significant Virginia cases dealing with the question of whether a particular transfer should be characterized as a preference or a fraudulent conveyance. Finally, attention will be given to the special case in which a controlling director prefers himself over the debtor's other creditors.

I.

A careful consideration of the policies underlying the law of fraudulent conveyances and preferences reveals the essential differences between the two.[7] Of the two concepts the fraudulent conveyance is always considered the more serious since it involves an element of moral turpitude not present in a preference.[8] The purpose of the law of fraudulent conveyances is to assist creditors, both individually and collectively, in realizing on their debts from the assets of a debtor.[9] To carry out this purpose, the law of fraudulent conveyances declares void all transfers by a debtor which unfairly diminish his estate to the prejudice of his creditors. Unfairness in this context has been defined as follows:

> Unfairness is present (a) when there is a deliberate intention that a particular creditor or group of creditors shall not be paid; and (b) when the debtor has, with or without such intention, gratuitously disposed of so much of his property that he has not enough left to pay his debts.[10]

This definition of unfairness is embodied in all fraudulent conveyance statutes.[11] The Virginia statutes serve as illustrations. Section 55-81[12] voids

[7] *See* 3 COLLIER ON BANKRUPTCY § 60.3 (14th ed. 1975) [hereinafter cited as COLLIER].

[8] The United States Supreme Court stated the distinction between preferences and fraudulent conveyances as follows: "One is inherently and always vicious; the other innocent and valid, except when made in violation of the express provision of a statute. One is *malum pe se* and the other *malum prohibitum* — and then only to the extent that it is forbidden." Van Iderstine v. National Discount Co., 227 U.S. 575, 582 (1913).

[9] *See generally* 1 GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES Chapters I-V (Rev. ed. 1940) [hereinafter cited as GLENN]; Radin, *Fraudulent Conveyances in California and the Uniform Fraudulent Conveyance Act*, 27 CALIF. L. REV. 1, 1-3 (1938) [hereinafter cited as Radin]; *see also* Clark, *The Duties of the Corporate Debtor to its Creditors*, 90 HARV. L. REV. 505, 506-17 (1977) [hereinafter cited as Clark].

[10] Radin, *supra* note 9, at 7. The essence of the fraudulent conveyance, says Professor Glenn, "is not a thing of form, nor is our inquiry bounded by the technicalities that attach to the terms 'conveyance' or 'transfer.' The real test of a fraudulent conveyance . . . is the unjust diminution of the debtor's estate." 1 GLENN, *supra* note 9, at § 195.

[11] This conception of unfairness has been incorporated into the two principle operative sections of the UNIFORM FRAUDULENT CONVEYANCE ACT (UFCA). Section 7 provides that: "[E]very conveyance made and every obligation incurred with actual intent, as distin-

all transfers made without consideration by an indebted person when attacked by an existing contract[13] creditor. While this section goes beyond (b) above,[14] both are founded on the idea that a debtor ought to be just before he is generous. Section 55-80, which corresponds to (a) above condemns all transfers made with actual intent to hinder, delay, or defraud creditors. While the transactions to which section 55-81 applies are comparatively clear,[15] the courts have been forced to determine on a case by case basis when section 55-80 may be invoked by an attacking creditor.[16]

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guished from intent presumed in law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors." U.F.C.A. § 7; *see* text accompanying note 10 *supra*. This section corresponds with (a) of Radin's definition of unfairness. Section 4 of the UFCA, which corresponds with (b), provides that "[e]very conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a fair consideration." U.F.C.A. § 4.

[12] VA. CODE § 55-81 (Repl. Vol. 1974) provides that:

> Every gift, conveyance, assignment, transfer or charge which is not upon consideration deemed valuable in law, or which is upon consideration of marriage, shall be void as to creditors whose debts shall have been contracted at the time it was made, but shall not, on that account merely, be void as to creditors whose debts shall have been contracted or as to purchasers who shall have purchased after it was made; and though it be decreed to be void as to a prior creditor, because voluntary or upon consideration of marriage, it shall not for that cause be deemed void as to subsequent creditors or purchasers.

[13] As to the distinction between present existing contract creditors who may sue under VA. CODE § 55-81 and subsequent or future creditors who may not, see Consolidated Tramway Co. v. Germania Bank, 121 Va. 331, 93 S.E. 572 (1917). A creditor suing in tort has never been considered a present creditor until he has reduced his cause of action to judgment. *See generally* 1 GLENN, *supra* note 9, at § 84.

[14] The Virginia rule embodied in § 55-81 was stated initially in several English decisions from the mid-nineteenth century, *see, e.g.*, Spirett v. Willos, 46 Eng. Rep. 649, 651 (1865); Patridge v. Gopp, 27 Eng. Rep. 388, 389 (1758); Townsend v. Windham, 28 Eng. Rep. 1, 7 (1750), and subsequently followed in the United States by Chancellor Kent in Reade v. Livingston, 3 Johns Ch. 481 (N.Y. 1818). This rule is an extremely harsh one. Theoretically, it renders every gift by an indebted person conclusively fraudulent if the transaction is attacked by an existing contract creditor, regardless of any circumstances which indicate good faith and due regard for the interest of creditors when the gifts are made. Most states refused to accept this rule, however, opting for the position set forth in section 4 of the UFCA. *See* 1 GLENN, *supra* note 9, at §§ 268-270; McLaughlin, *Application of the Uniform Fraudulent Conveyance Act*, 46 HARV. L. REV. 404, 407-09 (1933). The Virginia Legislature recognized the difficulty just noted, but incorporated the harsh rule of Reade v. Livingston into § 55-81 nonetheless. *See* Morriss v. Bronson, 170 Va. 516, 197 S.E. 497 (1938). *See also* Note, 25 VA. L. REV. 862 (1939).

[15] Under VA. CODE § 55-81 the question is whether the debtor was indebted to the creditor when the conveyance was made. If the debtor was indebted, any transfer without consideration is a fraudulent conveyance. In contrast, under UFCA § 4, if the conveyance rendered the debtor insolvent or was made while the debtor was insolvent without due consideration, it is deemed a fraudulent conveyance. Under both sections the issue of whether the debtor received fair consideration would often be an issue subject to litigation.

[16] The focus of VA. CODE § 55-80 and similar statutes is on the word "defraud." That a creditor has been hindered or delayed merely amplifies the idea underlying the concept of fraud. When a court, such as the Virginia Supreme Court, states that each word — hinder, delay, and defraud — has a separate meaning under the statute, the court is recognizing that

Speaking broadly, the courts have found statutes like section 55-80 applicable to two types of transactions. The more common type deals with transfers by which the debtor attempts to defeat completely the claims of his creditors and gain an advantage for himself at the same time.[17] Two clear examples come to mind. The debtor sells his principal assets for cash with the intent to flee the jurisdiction,[18] or the debtor makes a payment on a valid obligation with the understanding that the grantee will hold the payment in secret trust for him.[19] In the second type of transaction the debtor does not attempt to defeat his creditors' claims completely, but rather to create impediments which hinder or delay creditors in exercising their remedies.[20] For example, if the debtor exchanges his only liquid asset, such as stock, for illiquid assets for the purpose of making it more difficult for the creditors to realize on his assets, his intent is fraudulent under section 55-80.

The remedy available to a creditor under these statutes must be stressed at this point. All states confer upon a judgment creditor the right to attack a fraudulent conveyance.[21] In addition, most states, including Virginia,[22] permit nonjudgment creditors to assail such transfers.[23] If the

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fraud can take many forms. *Cf.* Klein v. Rossi, 251 F. Supp. 1, 2 (E.D.N.Y. 1966) ("hinder" and "delay" distinct from "defraud").

[17] A conveyance is fraudulent under VA. CODE § 55-80 if made with actual intent on the part of the grantor to defraud creditors. Such a conveyance may not be set aside, how- -, if made to a bona fide purchaser. *See, e.g.,* Bruce v. Dean, 149 Va. 39, 140 S.E. 277 (1929), Note, *The Law of Fraudulent Conveyances in North Carolina: An Analysis and Comparison with the Uniform Fraudulent Conveyance Act,* 50 N.C. L. REV. 873, 889 (1972). The Bankruptcy Act makes the same distinction. Section 67(d)(2)(d) declares void a transfer made with actual intent to defraud creditors, but section 67(d)(6) protects a bona fide purchaser in such a transfer from attack by the trustee in bankruptcy. Bankruptcy Act §§ 67(d)(2)(d), 67(d)(6), 11 U.S.C. §§ 107(d)(2)(d), 107(d)(6) (1976).

[18] *See, e.g.,* Crowder v. Crowder, 125 Va. 80, 99 S.E. 746 (1919).

[19] *See, e.g.,* Irby v. Gardner, 157 Va. 132, 160 S.E. 81 (1931); Neff v. Edwards, 148 Va. 619, 139 S.E. 291 (1927). *See also* 1 GLENN, *supra* note 9, at § 229c. As is the case in most jurisdictions, the majority of Virginia decisions involving fraudulent conveyances concern fraud in intra-family transactions. *See* text accompanying notes 50-67 *infra.*

[20] Clark, *supra* note 9, at 512; *see, e.g.,* Klein v. Rossi, 251 F. Supp. 1 (E.D.N.Y. 1966). Consolidated Tramway Co. v. Germania Bank, 121 Va. 331, 93 S.E. 572 (1917); Young v. Willis, 82 Va. 291 (1886) (unreasonable postponement which hinders creditors).

[21] The original statute of fraudulent conveyances did not state the procedure to be used by a creditor in attacking a fraudulent conveyance. In fact, the English statute was a criminal statute and provided no civil remedy. Yet, the English Courts in Mannocke's Case, 3 Dyer 294 (1571), permitted a judgment creditor a remedy under the statute by permitting him to levy execution on property. The history of this transition is set forth in 1 GLENN, *supra* note 9, at §§ 58-62. This right of the judgment creditor to attack the fraudulent conveyance was accepted in the United States as part of the common law. *See, e.g.,* Van Hensen v. Radcliff, 17 N.Y. 580, 582-83 (1858).

[22] The Virginia rule, prior to the passage of VA. CODE § 55-82, *see* note 23 *infra,* required that a creditor have a judgment and execution returned nulla bona as a condition of maintaining a creditor's suit to avoid a fraudulent transfer. Tate v. Liggat & Matthews, 29 Va. (2 Leigh) 84, 90-91 (1830). *See generally* 1 GLENN, *supra* note 9, at Chap. VIIA.

[23] Under VA. CODE § 55-82 (Repl. Vol. 1974):

> [a] creditor before obtaining a judgment or decree for his claim may, whether such claim be due and payable or not, institute any suit which he might institute after

creditor is successful, the property which was the subject matter of the fraudulent conveyance may be sold to satisfy his underlying claim.[24] Thus, a creditor who successfully attacks a transfer as a fraudulent conveyance may set the transfer aside and gain a priority over unsecured creditors on the property involved.[25]

"The preference," Professor Glenn observes, "materially differs from the fraudulent conveyance, because it sins, not against the single creditor's right of realization, but only against the collective right of the creditors as a class, that arises when the debtor becomes insolvent."[26] The vice of such a transaction is that it treats creditors similarly situated differently. When an insolvent debtor pays off one unsecured creditor as opposed to another, he reduces his total assets and thereby shifts the risk of nonpayment from the favored party to the other creditor. In short, the preference constitutes an infraction of the policy favoring the equal distribution of a debtor's assets among creditors.

Although a preferential transfer might be regarded as unfair, it is not the kind of unfairness condemned by the law of fraudulent conveyances. The most vivid way to distinguish the two types of transactions is to note their different effects on a debtor's balance sheet. To be deemed fair under the law of fraudulent conveyances, a debtor must receive assets of value equal to those transferred. When this occurs, creditors are not prejudiced since they may satisfy their claims out of the assets the debtor received from the grantee. An unfair conveyance, on the other hand, is one in which the debtor fails to receive adequate consideration for the assets transferred.[27] Such a transaction results in an unjust diminution of the debtor's

obtaining such judgment or decree to avoid a gift, conveyance, assignment or transfer of . . . the estate that his debtor declared void by either of the two preceding sections (§§ 55-80, 55-81) and he may in such suit have all the relief in respect to such estate to which he would be entitled after obtaining a judgment or decree for the claim which he may be entitled to recover.

Section 10 of the UFCA provides a similar remedy. However, most states which have not adopted the UFCA have enacted legislation similar to VA. CODE § 55-82. For a further discussion of such statutes, see RIESENFELD, CREDITORS REMEDIES AND DEBTOR PROTECTIONS 365 (2d ed. 1975) [hereinafter cited as RIESENFELD].

[24] In many states, a judgment creditor may have property subject to a fraudulent conveyance sold without first upsetting the conveyance. Section 9(1)(b) of the UFCA provides that such a creditor may "disregard the conveyance and attach or levy execution on the property conveyed." Similar procedures may be employed in a non-UFCA state. *See, e.g.*, Wagner v. Law, 3 Wash. 500, 28 P. 1109 (1892). The property involved may be real or personal.

In Virginia, however, this remedy may not be employed with regard to real property. To sell land, a creditor must first upset the fraudulent transfer. Thereafter the land may be sold in satisfaction of the creditor's judgment. *See* 1 GLENN, *supra* note 9, at § 121.

[25] Initially, all general creditors of the debtor stand on equal footing. All have a claim against the debtor's assets. By obtaining a lien on the property, a creditor gains a specific interest in such property and may have it sold to satisfy his claim. In this sense, a creditor who upsets a fraudulent conveyance and acquires a lien on the debtor's property obtains a preference over all other general creditors.

[26] 1 GLENN, *supra* note 9, at § 1; *see* 3 COLLIER, *supra* note 7, at § 60.03. *See also* Palmer v. Clay Prod. Co., 297 U.S. 227 (1936).

[27] This is just another way of saying that past consideration is the good consideration

estate. The preference involves an exchange of equal values; the debtor uses current assets to pay off an antecedent debt. Since past consideration has long been regarded as adequate consideration, such an exchange of equal values demonstrates fairness to creditors under the law of fraudulent conveyances.[28] True the preferred creditor is better off than other creditors similarly situated, but no policy of fraudulent conveyance law has been offended. The purpose of that body of law has never been to require a debtor to treat creditors evenhandedly.[29]

There is a second, perhaps more significant, basis for refusing to characterize a preference as a fraudulent conveyance. To prevent the unequal treatment of creditors as a group caused by a preference, a system for complete distribution of the debtor's assets, such as bankruptcy, is necessary.[30] Only the use of such a system can assure equal distribution among

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required by all statutes prohibiting fraudulent conveyances which are based on the statute of Elizabeth including § 55-80. Such has been the established rule for over a century.

> Where creditors take no specific security from their debtor, they trust him upon the general credit of his property and a confidence that it will not be diminished to their prejudice. They have, therefore, an equitable interest in it which the law, under certain circumstances, recognizes and enforces. The statute is founded upon the principle of protecting this equitable right. When a transfer, however, is made to a creditor, his equity is the same as that of the others, and he is entitled to the benefit of the universal rule, that where equities are equal, the legal title must prevail. An existing indebtedness is, therefore, a good consideration in the proviso which saves the rights of *bona fide* purchasers. There being no equity prior to that of the vendee, the necessity which calls for a new consideration in other cases does not exist.

BUMP, FRAUDULENT CONVEYANCES 179 (3d ed. 1882) (emphasis in original) [hereinafter cited as BUMP]. This rule was accepted by the draftsman of the UFCA. *See* McLaughlin, *supra* note 14, at 412 where the author states:

> In accordance with the Act satisfaction of an antecedent debt has been duly recognized as fair consideration. It necessarily follows that preferences are not bad unless invalidated by some law other than the Uniform Act.

[28] When a preferential transfer is made, the unfavored creditors lose as a group. The assets paid to the preferred creditor are put beyond their reach, and the satisfaction of an antecedent debt does not replace assets which have been paid to satisfy such a debt. This explains why statutes prohibiting preferences benefit creditors as a group.

[29] 2 GLENN, *supra* note 9, at § 376; J. MACLACHLAN, BANKRUPTCY § 247 (1956) [hereinafter cited as MACLACHLAN]. MacLachlan has described the law of preferences as the most significant contribution to commercial law. He states that "the most significant effect of the law of preferences is not the value of the assets recovered in bankruptcy, but the weakening of the inducements to negotiate preferential arrangements with insolvent debtors." At the same time it promotes equitable distributions among creditors. *Id. See also* Clark, *supra* note 9, at 511-12 n.21.

[30] 1 GLENN, *supra* note 9, at § 289. The need for a system of distribution has been eloquently asserted by Professor Bump:

> Creditors generally trust a debtor upon the faith of his property, and look to it for payment. Their means, moreover, contribute equally to the fund with which it is acquired. They therefore have an equally equitable claim for remuneration out of it. The abstract principles of natural justice dictate that it should be applied for the equal benefit of all creditors, but this has been found impracticable without the aid of some artificial system. If the right to give a preference were to be denied while an insolvent debtor retains his property in his own hands, he could not pay anybody, for whoever he paid would receive a preference. Such a principle would take

creditors. Most creditors' remedies, including the fraudulent conveyance laws, may be used by individual creditors for their exclusive benefit. If these could be employed to set aside a preference, the court would face an insoluble remedial problem. As stated in one recent decision:

> True, a creditor who collects from an insolvent debtor fares better than other claimants. Yet, if the transfer were set aside in favor of another creditor, there would be but a substitution of one preference for another. For that reason a preference cannot be undone by a competing creditor whether the preference was obtained through judicial process or by a transfer from the debtor . . . .[31]

An example using the Virginia statutes illustrates the point. A creditor who attacks a conveyance as fraudulent under section 55-80[32] may initiate his action with either a general[33] or special[34] creditor's bill.[35] If a general

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> away a man's rights over his own property, and involve the necessity of vesting an inquisitorial power somewhere. The common law had no means or device to form such a power or to execute such a principle. It therefore adopted an altogether different set of principles.

BUMP, *supra* note 27, at 179-80.

[31] Smith v. Whitman, 39 N.J. 397, 402, 189 A.2d 15, 18 (1963).

[32] In Virginia, a judgment creditor attacks a fraudulent conveyance by means of a judgment creditors bill. Section 55-82 gives the creditor without a judgment the right to attack such a transfer. *See* LILE, EQUITY PLEADING IN PRACTICE §§ 412-422 (Mead ed., 1952) [hereinafter cited as LILE].

[33] VA. CODE § 55-82 (Repl. Vol. 1974). According to Professor Lile:

> Where the bill is . . . filed on behalf of the plaintiff and others who may come in, it is known as a *general creditors' bill.* But although filed on behalf of the *plaintiffs only,* if it appears that there are other creditors who are entitled to enforce specific charges upon the subject matter, they will be permitted, and sometimes required, to come into the suit, which will then, so far as that proceeding is concerned, be treated as a *general creditors' bill.*
>
> The reason for thus sanctioning the assertion of diverse claims in the same suit, in apparent violation of the strict and salutary rule of equity pleading that bills must not be multifarious — tantamount to a misjoinder at law — is, not that such a proceeding obviates a multiplicity of suits (as we are apt erroneously to assume) but that it enables the court *completely to administer the assets or estate against which the proceeding is directed; and hence all who are entitled to share in the distribution are proper, and in many instances necessary, parties to the suit.*

LILE, *supra* note 32, at § 424 (emphasis in original). *See also* Note, *Enforcement of Creditor's Rights,* 1975 U. ILL. L.F. 424, 438.

[34] A special-creditor's suit may be filed by a single creditor for his own benefit or several creditors may unite in the same bill. In the latter case, the several creditors may unite even though their claims against the debtor are separate, so long as they attempt to charge the same part of the debtor's estate. *See* LILE, *supra* note 32, at § 423.

[35] The ordinary common law remedies of writ of levari facias for a levy on real property or a writ of fieri facias for a levy on tangible personal property, were of no aid to a judgment creditor in satisfying his claim. First, such writs would not entitle a creditor to reach a debtor's tangible property such as choses in action and insurance policies. Second, a debtor's equitable interests such as property held in trust or the debtor's interest as a vendee of a contract of purchase of real property would be beyond the reach of these writs. Third, property which had been fraudulently conveyed could not be reached. To reach such property, the Court of Chancery provided a remedy in the form of a creditor's bill. However, since it

creditor's bill is used, all creditors of the debtor have a right to a pro rata share in the assets returned to the estate. Use of this procedure does not give rise to a preference. In contrast, a creditor bringing a special creditor's suit may obtain a lien on the property recaptured and acquire priority over all other creditors of the debtor as to that property.[36] Thus, a holding that a preference constituted a fraudulent conveyance necessarily would allow an attacking creditor to obtain a preference by suing in his own interest rather than as representative of the debtor's creditors generally. Such a holding also would mean that the insolvent debtor could never pay any of his creditors without violating the law of fraudulent conveyances.

II.

In concluding that preferences are valid when attacked as fraudulent conveyances, the courts, including Virginia's, have generally relied on principles different from those set out above. Most decisions upholding preferences were sustained on the ground that the right to prefer was a necessary consequence of ownership.[37] The mere existence of a debt did not create in the creditor any interest in his debtor's property. As the courts often stated, the debtor did not hold his assets as a trustee for his creditors.[38] Until a lien was obtained on the assets, the debtor, in the absence of fraud, could dispose of them as he saw fit. If he chose to favor one creditor over another, such was his right.[39] Dovetailing nicely with this rationale was the theory that the law should reward the diligent creditor who obtained a lien on his debtor's assets ahead of other creditors.[40] In fact, creditors' remedies are still structured in such a way that a creditor who

had long been held that equity acted only when legal remedies were inadequate, it was incumbent on the creditor seeking a creditor's bill to plead the inadequacy of the legal remedies. For a summary of the early common law developments, see Clark, *Receivers at the Instance of Judgment Creditors and Priorities Incident Thereto,* 17 VA. L. REV. 45 (1930); Riesenfeld, *Collection of Money Judgments in American Law—A Historical Inventory and a Prospectus,* 42 IOWA L. REV. 155 (1960). As to the general nature and scope of creditor's bills in Virginia, see LILE *supra* note 32, at §§ 417-444.

[36] This analysis assumes that there are no prior liens on the property. Special note should be taken of the Virginia rule that a judgment lien attaches to realty fraudulently conveyed. Matney v. Combs, 171 Va. 244, 198 S.E. 469 (1938). Thus, if a creditor dockets a judgment on real estate subject to the fraudulent conveyance, priority will date from the time of docketing. If a second creditor subsequently upsets the fraudulent conveyance, the creditor with the earlier date of docketing would have priority. *See* 1 GLENN, *supra* note 9, at § 121.

[37] *E.g.,* Young v. Willis, 82 Va. 291 (1886). In *Young,* the court stated that "[T]he right to prefer one creditor or another results from the ownership of the property and the unrestricted power of alienation. The debtor, if no lien has attached, can sell it or transfer it to any creditor or purchaser, and apply the proceeds to any creditor he may desire. . . ." *Id.* at 298.

[38] *See generally* 1 GLENN, *supra* note 9, at §§ 9-11; Marsh v. Kay, 168 N.Y. 196, 61 N.E. 177 (1901).

[39] *See* BUMP, *supra* note 27, at 180.

[40] *See, e.g.,* Planters Bank of Farmville v. Whittle, 78 Va. 737 (1884); Johnson v. Lucas, 103 Va. 36, 48 S.E. 497 (1904). For a comment arguing that the race of diligence theory is the basis for the Virginia position on preferences, see Note, 21 WASH. & LEE L. REV. 353 (1964) [hereinafter cited as WASH. & LEE Note].

fears that his debtor will have inadequate resources to pay his claim is required by law to engage in a race of diligence, since the creditor who wins the race obtains a preference.[41] Thus, the sanction of this race for preferences through statutory procedures implies an endorsement of the consensual preference.[42]

In arriving at this conclusion courts have recognized that the effect of every preference is to hinder incidentally and delay creditors.[43] Whenever an insolvent debtor prefers one of his creditors, he necessarily puts his cash or other assets beyond the reach of execution.[44] Does mere knowledge by the debtor of this inherent effect show that he intended to defraud his creditors? The universal answer to this question is no.[45] Without any other design injurious to creditors beyond that implied in favoring one creditor over others, the intent to prefer does not show fraud under statutes similar to section 55-80.[46] This proposition necessarily inheres in the general rule that preferences are not fraudulent conveyances.

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[41] For example, the first creditor to docket a judgment lien against his debtor's real property obtains priority over other creditors. VA. CODE §§ 8.01-458 to 459 (Repl. Vol. 1977). Similarly, the first creditor to have the sheriff levy his writ of execution on the debtor's personal property is ahead of other creditors. *Id.* at § 8.01-478. *See also id.* at § 8.01-488. The priority rule of first in time is first in right also applies to garnishment, *id.* at § 8.01-501, attachment, *id.* at §§ 8.01-548 & 8.01-268, and fraudulent conveyances. *See* note 34 *supra.* In his hornbook on bankruptcy, Professor MacLachlan aptly describes the common law system of collection by execution as "grab law." MACLACHLAN, *supra* note 29, at § 5.

[42] Section 67(a) of the Bankruptcy Act discourages the race of diligence to a certain extent, providing in part:

> Every lien against the property of [the bankrupt] obtained by attachment, judgment, levy, or other legal or equitable process or proceeding within four months before the filing of a petition initiating a proceeding under this title by or against [the bankrupt] shall be deemed null and void (a) if at the time when such lien was obtained [the bankrupt] was insolvent or (b) such lien was sought and permitted in fraud of the provisions of this title . . . .

11 U.S.C. § 107(a) (1976). No section of the new Bankruptcy Act specifically focuses on judicial liens. It appears that such liens will be attacked as preferences. *See* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 547, 92 Stat. 2549 (1978) (to be codified in 11 U.S.C. § 547). As Collier points out, a judicial lien is simply one form of preference. 4 COLLIER, *supra* note 7, at § 67.

[43] *See generally* 1 GLENN, *supra* note 9, at § 289a.

[44] The Virginia Supreme Court has recognized that, "[e]very preferential payment must to some extent hinder and delay creditors, but is not necessarily a fraudulent conveyance." Surratt v. Eskridge, 131 Va. 325, 107 S.E. 677 (1921).

[45] Bump clearly indicates that this is the common law rule. BUMP, *supra* note 27, at 187-88. In Shelley v. Boothe, 73 Mo. 74 (1880), the court forcefully stated the point:

> The right of a debtor to prefer one creditor over another necessarily implies the right of such creditor to accept such preference. While the effect of such preference must, to the extent that it is made, necessarily be to defer or to hinder or delay other creditors, the mere knowledge of the preferred creditor that such will be its effect, and the debtor intended it should have that effect, will not be sufficient to avoid the transaction as to a creditor preferred.

Id. at 77. *See also* 4 COLLIER, *supra* note 7, at § 67.42.

[46] The Second Circuit stated this proposition as follows:

> It is difficult to imagine a preferential transfer which does not incidentally hinder and delay creditors, for, whenever an insolvent debtor pays one of his creditors in

III.

There are two elements which a creditor must prove to challenge successfully a transaction under section 55-80. First, he must show that the grantor possessed fraudulent intent.[47] Second, if the grantee proves he paid valuable consideration for the transfer, the creditor must show that the grantee was a party to the fraud.[48] Stated a little differently, a bona fide purchaser may retain the transferred property despite the guilty intent of his grantor.[49] The reason for permitting this defense is obvious. As noted above, a debtor does not hold his property in trust for his creditors. Until a creditor obtains a lien on a particular asset, he has no interest in it. All that he can require under the fraudulent conveyance laws is that the debtor not unfairly diminish his estate. Therefore, as long as the debtor exchanges property for assets of equal value and the grantee is not privy to a wrongful purpose of his grantor, the creditors cannot complain.[50]

The manner in which these two elements of proof come into play under section 55-80 is well illustrated by the many Virginia decisions involving preferential payments by one family member to another. The case of *Irby v. Gardner*[51] is a good example. In *Irby*, a mother gave a preference to her son.[52] Just prior to the transfer, she allegedly declared that she would give away her property rather than permit her creditors to reach it. After the conveyance the son allowed his mother to live rent free on the property. In reversing the lower court's decree in favor of the creditor, the supreme court noted that while such exchanges are viewed with suspicion, the law does not preclude close relatives from dealing with one another.[53] Any

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> full he thereby puts the cash or property so used beyond the reach of execution by the others. Pro tanto every preference hinders and delays them. If the debtor is aware that it will necessarily have that result, the transfer would seem to be made with an intent to hinder, delay, and defraud the other creditors; yet the securing or paying of an actual debt, in good faith, without any design injurious to creditors beyond that implied in giving the preference, was not deemed a fraudulent conveyance under the principles of the common law and the statute of Elizabeth.

Irving Trust Co. v. Chase Nat'l Bank, 65 F.2d 409, 410 (2d Cir. 1933).

[47] *See, e.g.*, In re Decker, 295 F. Supp. 501 (W.D. Va. 1969); Hutchenson v. Savings Bank, 129 Va. 281, 105 S.E. 677 (1921); Flook v. Armentrout, 100 Va. 638, 42 S.E. 686 (1902); *cf.* Catron v. Bostic, 123 Va. 355, 96 S.E. 845 (1918)(debtor made transfer which was disadvantageous to himself and creditors but which did not show fraudulent intent).

[48] Once the grantee has shown the payment of a valuable consideration, then a plaintiff has the burden of showing that the grantee was a party to or had notice of the fraud. In this context, notice must be "so strong and clear as to fix upon the grantee the imputation of *mala fides.*" Bruce v. Dean, 149 Va. 39, 51, 140 S.E. 277, 282 (1927). *See also* Hutchenson v. Savings Bank, 129 Va. 281, 105 S.E. 677 (1921); Flook v. Armentrout, 100 Va. 638, 42 S.E. 686 (1902); Garland v. Rives, 25 Va. (4 Rand.) 282 (1826).

[49] *See* VA. CODE § 55-80 (Repl. Vol. 1974); Bryan v. Jackson, 178 Va. 123, 16 S.E.2d 366 (1941); Morriss v. Bronson, 170 Va. 516, 197 S.E. 479 (1938).

[50] *See generally* 1 GLENN, *supra* note 9, at § 275; text accompanying notes 28-30 & 43-46 *supra.*

[51] 157 Va. 132, 160 S.E. 81 (1931).

[52] *Id.* at 135-36, 160 S.E.at 82-83.

[53] *Id.* at 143, 160 S.E. at 85. The general rule is that a family relationship alone does not constitute sufficient evidence of fraud to take a case to the jury, Bank of Pochantas v. Fermer,

suspicions raised by the relationship of the parties was overcome when the son produced extensive documentation demonstrating the existence of the debt satisfied by the transfer.[54] The most troublesome issue, however, was raised by the mother's statement of her purpose in transferring the property. The court gave a twofold answer to the creditor on this point. First, it relied on language in a previous case in which the court stated that since "a debtor has the right to pay one creditor in preference to another, so he may, without the imputation of fraud, secure one creditor to prevent another from gaining an advantage."[55] Through this statement the court affirmed the general rule that the intent to prefer, notwithstanding the inherent effect on other creditors, should not be equated with hindering or delaying creditors within the meaning of section 55-80. Second, even though it was "conceded" that the mother had the required intent, the creditor must also prove that the "grantee, if the sale [was] made for a valuable consideration, had notice of the fraudulent intent of the grantor."[56] Since the son had clearly proven the existence of the debt and was not shown to have had knowledge of his mother's statement, there was insufficient evidence of fraud on his part. In confronting the argument that permission by the son allowing his mother to live rent free on the property evidenced a secret trust, the court responded that the testimony, when viewed as a whole, indicated that the son accepted the transfer to protect his position as his mother's creditor, and that allowing the mother to live thereafter rent free on the land was a normal reaction of a son for an aged mother.[57] In sum, the creditor had not shown the grantee's participation

161 Va. 37, 170 S.E. 591 (1933), although plaintiff's case may be strengthened by showing this family relationship. Johnson v. Lucas, 103 Va. 36, 48 S.E. 497 (1904). An exception to this rule exists, however, concerning transfers by an indebted husband to his wife. In the contest between the husband's creditors and the wife, the burden of proof rests with the wife to demonstrate by clear and convincing evidence that the transaction was bona fide. Morrisette v. Cook and Bernheimer Co., 122 Va. 588, 95 S.E. 449 (1918); Richardson v. Pierce, 105 Va. 628, 54 S.E. 480 (1906). In Bryan v. Jackson, 178 Va. 123, 16 S.E.2d 366 (1941), a wife was able to convince the court that a transfer to her from her husband was not a fraudulent conveyance. She ultimately lost the case, however, as the court found the transfer to be preferential under section 60 of the Bankruptcy Act. *Id.* at 129-30.

[54] *Compare Irby with* Temple v. Jones, Son & Co., 179 Va. 286, 19 S.E.2d 57 (1942). In *Temple,* a father paid off a debt he claimed to owe to his son while insolvent with several suits pending against him. After the creditors presented their claims, neither the father nor the son could prove the existence of the debt between them. *Id.* at 294-96. Since the defendants failed to follow normal business practices with regard to the alleged transaction, there was sufficient evidence to sustain an inference of fraud. In contrast, the son in *Irby* kept complete records of the loan transaction between his mother and himself by retaining the checks which showed the exact amount of the debt. For a similar case in which a relative of the debtor failed to prove the existence of the debt due to a lack of proper records, see Fowlkes v. Tucker, 164 Va. 507, 180 S.E. 302 (1935).

[55] Williams v. Lord & Robinson, 75 Va. 390, 402 (1881).

[56] 157 Va. at 138-39; *see* Sanderson v. Bell, 154 Va. 415, 153 S.E. 651 (1930); Johnson v. Lucas, 103 Va. 36, 48 S.E. 497 (1904); Neff v. Edwards, 148 Va. 616, 139 S.E. 291 (1927); Lucas Sergeant & Co. v. Clafflin & Co., 76 Va. 269 (1882).

[57] *Cf.* Neff v. Edwards, 148 Va. 616, 139 S.E. 291 (1927). In *Neff* the grantee permitted his brother to remain in possession after the property was conveyed to satisfy an antecedent debt. This fact did not show bad faith on the part of the grantee since he might have allowed

in the fraud by clear and convincing evidence.[58]

The court's holding in *Irby* raises one issue crucial to this study: what is the basis for conceding that the mother possessed fraudulent intent? Presumably, she had the dual purpose of paying off a debt to her son, as well as frustrating the efforts of her other creditors. This duality of purpose seems to be present in most preferential transactions.[59] As noted earlier, the necessary consequence of giving a preference is to make it more difficult for creditors to collect their claims. One would assume that when the court says that the intent to prefer is permissible, the grantor's other motive is an insufficient basis to characterize the transaction as fraudulent as a matter of law. Does the analysis change if the mother's sole purpose was to defraud her creditors by preferring her son?[60] To begin with, only in an extremely rare case could the creditor prove by "clear and convincing" evidence[61] that this was the grantor's sole motive.[62] Given the existence of the bona fide debt and the mother's denial that she ever made the statement, *Irby v. Gardner* does not seem to raise this specific situation.[63] Yet, assuming such a case could arise, the issue becomes whether a wrongful purpose can convert an otherwise legal act into an illegal one. To extend this reasoning further, assume that the son knew that his mother's sole purpose was to frustrate her other creditors by the preference. The transaction ought to be sustained, nonetheless, since the law permits debtors to "hinder" creditors through preferences.[64] If creditors were allowed to challenge preferential transfers on the ground that the debtor's sole purpose was to defraud them, the bright line rule permitting such transactions would be dimmed since any questionable remark by the debtor would serve as a ground for attack.[65] Given the inherent consequences of all preferences,

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the debtor to stay in possession out of gratitude for giving him the preference. *Id.* at 626, 139 S.E. at 294.

[58] A reading of the family fraudulent conveyance cases demonstrates, as the court said in Temple v. James & Son, 179 Va. 286, 19 S.E.2d 57 (1942), that precedent is of little value. *Id.* at 298, 19 S.E.2d at 62. The exact facts and the "flavor" of the case are far more important than precedent in determining whether fraud is present.

[59] *See* notes 44 & 46 *supra.*

[60] For example, suppose the mother said that her sole purpose was to see to it that her other creditors were not paid and that she decided to pay her son only for this reason. Does such a statement serve as a sufficient basis for finding fraud? Most courts would say no. *See* note 44 *supra.*

[61] To establish fraud, a plaintiff must prove his case by clear and convincing evidence. Colonial Inv. Co. v. Chevydate Cement Block Co., 194 Va. 454, 73 S.E.2d 419 (1952); McClintock v. Royall, 173 Va. 408, 4 S.E.2d 369 (1939).

[62] For an example of a case in which the debtor admitted such an intent, see Elliot v. Elliot, 365 F. Supp. 450, 454 (S.D.N.Y. 1973).

[63] *Irby* was limited to the issue of whether the son adequately proved the existence of the obligations owed to him by his mother. The court's concession that the mother possessed the required fraudulent intent was considered dictum, given that the lower could had found no intent to defraud on her part as a matter of law. *See* 157 Va. at 143, 160 S.E. at 85; text accompanying notes 56-57 *supra.*

[64] *See* text accompanying notes 41-42 *supra.*

[65] For example, section 4 of the UFCA was passed to provide a bright line rule and relieve the court of having to look to the common law badges of fraud to determine the factual issue of intent. *See* Commission's Prefatory Note to the UFCA.

ease of administration requires that a mere preference be sustained.[66] Of course, the creditor could always show that the preference was in fact something else, such as an attempt to camouflage a secret trust for the debtor.[67]

IV.

Under the majority rule of *Surratt*, an insolvent corporation, like an individual, may grant preferences.[68] Corporate assets are not held in trust for creditors,[69] nor will the law imply an equitable lien in their favor.[70] In the absence of a statute, a preferred corporate creditor may retain the payment despite a suit brought by a representative of the other creditors.[71] When a corporate debtor makes a preferential transfer to or for the benefit of a controlling director, however, most courts recognize that the usual rule validating preferences does not apply.[72] They hold that in a suit brought by a representative of the debtor's creditors, the director should reimburse the corporation for benefits received, since the controlling director serves as a fiduciary to the other creditors of the corporation.[73] From this

[66] In a similar view, a debtor, though insolvent, may use cash or other nonexempt property to purchase land or personalty which can be claimed as exempt. *See* 1 GLENN, *supra* note 9, at § 1973; REISENFELD, *supra* note 23, at 566. There are exceptions to this general rule, however, and facts may be presented from which a court may infer the required fraudulent intent in this situation. Thus, where an insolvent debtor buys goods on credit, sells them and devotes the proceeds, not to the payment of the purchase price, but to the acquisition of a homestead, the transaction may be attacked as a fraudulent conveyance. The underlying idea is that his purpose was to defraud the creditor from the beginning through his plan. *See, e.g.*, Stoner v. Walsh, 24 Cal. App. 3d 938, 101 Cal. Rptr. 485 (1972).

[67] Buffum v. Peter Barceloux Co., 289 U.S. 227 (1933); Surratt v. Eskridge, 131 Va. 325, 108 S.E. 677 (1921) (dicta). *See also* 3 COLLIER, *supra* note 7, at § 60.03; 1 GLENN, *supra* note 9, at § 289a. A classic example of camouflage involves a preferential transfer for the purpose of frustrating the policy of the Bankruptcy Act. *See* Dean v. Davis, 242 U.S. 438 (1917).

[68] 15A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 7421 (rev. perm. ed. 1973) [hereinafter cited as FLETCHER].

[69] The common "trust fund theory" is to the contrary. "According to the 'trust fund' doctrine, the capital stock of a corporation, or the assets of an insolvent corporation representing its capital stock, is a trust fund for the benefit of creditors of the corporation." 15A FLETCHER, *supra* note 68, at § 7369. *See generally id.* at §§ 7369-7389. The doctrine has been repudiated in recent times. H. HENN, CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 171 (2d ed. 1970). For the treatment of the doctrine in Virginia, see cases cited in notes 70-71 *infra*.

[70] Beck v. Semones' Adm'r, 145 Va. 429, 134 S.E. 677 (1926); Planters Bank v. Whittle, 78 Va. 737 (1884).

[71] Two exceptions to this general rule have been recognized by the Virginia Supreme Court. *See* Ashworth v. Hagen Estate, Inc., 165 Va. 151, 181 S.E. 381 (1935); Reid v. Perrow, 136 Va. 449, 118 S.E. 120 (1923).

[72] *See* cases collected at 15A FLETCHER, *supra* note 68, at §§ 7470, 7476; Regal Ware, Inc. v. Fidelity Corp., 550 F.2d 934 (4th Cir.), *cert. denied*, 434 U.S. 824 (1977).

[73] All of the cases granting creditors a remedy against this type of wrongful conduct involve suits in which creditors acted collectively. Another theory supporting the majority view, as stated by Professor Glenn, ". . . is that while the director's obligation is to the corporation only, yet one of his duties is to do nothing to impair corporate credit, which a preference tends to do, and that the creditors work out their right through that of the corporation." 2 GLENN, *supra* note 9, at § 386. *See also* Note, 38 HARV. L. REV. 541 (1925).

perspective the director has abused his fiduciary position by manipulating the debtor's funds for his personal gain at the expense of third parties. Fletcher summarizes this position in the following words:

> The denial of the right of directors of an insolvent corporation to obtain a preference by way of security or payment of debts due them by the corporation is not as a rule founded upon the trust fund doctrine, but upon the theory that it is inequitable that a director, whose position as to knowledge of conditions and power to act for the corporation gives him an advantage, should be permitted to protect his own claim to the detriment of others at a time when it is apparent that all the unsecured debts of the corporation are equally in peril and that all of them cannot be paid.[74]

While a preference made to a controlling director may be void for this reason, this rule is not a part of the law of fraudulent conveyances. Many decisions such as *Sutton Manufacturing Co. v. Hutchinson*[75] make this clear. In *Sutton,* a director-creditor asserted that he was entitled to retain a preference he obtained from the corporate debtor. To support his position, the director argued that the transfer should not be set aside since it did not violate the Indiana fraudulent conveyance act. The court responded that although preferences made without actual fraudulent intent were valid under the fraudulent conveyance laws, these statutes did not provide the only remedy to creditors in this situation. The long standing rule that directors are not permitted to violate their fiduciary obligation to creditors was a sufficient basis for the court's judgment requiring the director to surrender the payment.[76]

The *Sutton* court's distinction seems proper. Nothing in the policy underlying statutes similar to section 55-80 prohibits this kind of conduct. The corporate debtor is neither attempting to totally defeat its creditors' claims nor gain a secret benefit for itself. Although creditors are hindered by the preference, the hinderance is identical to that which occurs when any debtor prefers any creditor. One might argue, in a manner similar to that asserted by the creditor in *Irby*, that the corporation's sole purpose was to defeat creditors' claims. This seems unrealistic, however.[77] After all, a corporation can only act through its officers and even if one imputes the director's intent to the debtor, presumably his primary intent is to be paid. A purpose to hinder creditors would be secondary, if it existed at all.

The rule prohibiting directors of an insolvent corporation from granting

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[74] 15A FLETCHER, *supra* note 68, § 7469 at 234.

[75] 63 F. 496 (7th Cir. 1894).

[76] *Id.* at 501. The *Sutton* court also relied on the trust fund theory to hold the creditor liable. The court stated that an equitable lien attached to the corporation's assets for the benefit of all creditors which took priority over the right of the director-creditor. *Id.* at 502. While this was an alternative basis for upsetting the transaction, the fact that the trust fund theory is no longer favored does not lessen the authority of this case as precedent for the principle set forth in the text. For a decision by the Fourth Circuit illustrating exactly the same point, see Davis v. Woolf, 147 F.2d 629 (4th Cir. 1945).

[77] *See* text accompanying notes 63-67 *supra.*

themselves preferences applies to at least two common fact patterns.[78] The first, or *Darden*[79] type, occurs when the corporation pays a debt to its controlling director ahead of its other creditors. In the second, or *Bank of Commerce*[80] type, the debtor prefers a creditor whose obligation is guaranteed by a director. Suppose that the obligation in which the director has a direct interest is $5,000. In the former situation if the corporation does not prefer the director, he loses $5,000, while in the latter type case if the corporation does not favor the creditor whose debt the director guaranteed, the director will lose $5,000. From the director's viewpoint the cases are identical, although the loss suffered may be more immediate in the former than the latter.

V.

The law in Virginia with regard to cases in which a corporate debtor makes a preferential transfer to or for the benefit of its controlling director is unsettled. The three Virginia cases dealing with this issue are in conflict. This failure stems from the supreme court's inability to define clearly the vice of the challenged conduct, namely, the manipulation of the corporate debtor by the controlling director to gain an advantage for himself over other creditors. Ironically, however, each decision, when viewed in isolation, is arguably correct.

In the first of three decisions, *Planters Bank v. Whittle,*[81] the court viewed the case as involving no more than a simple preference. In *Planters Bank,* some of the directors of the debtor were secondarily liable on several of the corporation's notes held by the Planters Bank. The corporation had agreed to indemnify the directors if they were called upon to pay the notes.[82] While the two suits were pending against the corporation by other creditors, the debtor paid off Planters Bank.[83] Thereafter, those creditors brought suit against Planters Bank charging that the payments it had accepted were fraudulent and therefore void. The directors were not joined as defendants. The plaintiff creditors conceded that there was no actual fraud. Instead, they argued that an insolvent corporation's assets are a trust fund to be used to pay its debts. Moreover, the directors of the corporation should be regarded by the law as trustees for creditors. From the plaintiffs' perspective, the directors' duty requires application of the debtor's assets ratably in paying off its assets to general creditors. This

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78 *See* 15A FLETCHER, *supra* note 68, at §§ 7470, 7476.

79 204 Va. 108, 129 S.E.2d 897 (1963).

80 218 Va. 781, 39 S.E.2d 909 (1978).

81 78 Va. 737 (1884).

82 *Id.* at 738. Under the arrangement, "[t]he Bank discounted for the company four negotiable notes, upon all of which one or more of the directors of the company were accomodation endorsers — the company agreeing when the endorsements were made to indemnify the endorsers." *Id.*

83 Transfers by a debtor of his principal asset while a suit is pending against him are often regarded as "badges of fraud." *See, e.g.,* Philco Fin. Corp. v. Pearson, 335 F. Supp. 33, 40-41 (N.D. Miss. 1971). The plaintiff in *Planters Bank,* however, did not assert that the transfer was a fraudulent conveyance.

duty also precludes the directors from using corporate assets for their own advantage by preferring themselves as creditors or favoring other creditors for whose claims they stand as sureties. Therefore, when a director violates this fiduciary duty to the corporation's creditors, the transaction must be voided.[84] The Virginia Supreme Court emphatically rejected plaintiff's argument by stating that:

> It is not only well settled that the directors may make preferences between creditors, but such preferences may be made in their own favor when they themselves are creditors of the corporation. Of course in such cases they must act with the utmost good faith, and the transactions to be upheld must be free from the taint of fraud or suspicion.[85]

In support of its decision, the court cited a number of cases from other jurisdictions[86] permitting a creditor-director to obtain a preference over other creditors of the corporation. Reliance on these precedents indicates how positive the court in *Planters Bank* was that self-dealing by directors giving them an advantage over outsiders was perfectly proper.[87] Particularly revealing is the following argument from one of the cases noted approvingly by the Virginia court.[88] A corporate director has a right to enter contracts with the corporation, and, if necessary, to use the superior knowledge gained through his position to gain an advantage in the race for the debtor's assets. Since all creditors know that directors possess this advantage, it is not unfair. Outside creditors assume such a risk. While such practices have brought corporations into disrepute, the present law does not prevent such activities.[89]

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[84] In *Planters Bank*, the court stated:

> There is no proof of actual fraud in the transactions involved, but the appellees [creditors] insist that the assets of an insolvent corporation are a trust fund for the payment of his debts; that the directors or trustees for the creditors, whose duty it is to apply the assets ratably for the benefit of the general creditors, and that therefore they can make no lawful preferences in favor of themselves, or in favor of those creditors for whose claims they are individually responsible.

78 Va. at 739.

[85] *Id.* at 740.

[86] Ashurst Appeal, 60 Pa. 290 (1869); Buell v. Buckingham & Co., 16 Iowa 284 (1864); Whitwell v. Warner, 20 Vt. 425 (1848).

[87] Stated a little differently, the court did not distinguish the situation in which the creditor-director received a preference from the situation in which the director stood as surety for the debt actually paid.

[88] Buell v. Buckingham, 16 Iowa 284 (1864).

[89] More specifically, the *Buell* court held that:

> Being an officer in the corporation did not deprive (the purchaser) of the right to enter into competition with other creditors and run a race of vigilance with them, availing himself in the contest, of his superior knowledge and of the advantages of his position, to obtain security for, or payment of, his debt. He has an advantage, it is true, but it is one which results from his position, and which is known to every person who deals with and extends credit to a corporation. This is one of the causes which has operated to bring corporate companies into discredit, and may constitute a good legislative reason for giving priority to outside creditors. But the legislature

While today most courts would reject this position and decide the case differently,[90] the court's holding in *Planters Bank* seems quite acceptable in view of the plaintiffs' approach. Plaintiffs' reliance on the trust fund doctrine seems misplaced, for the majority of jurisdictions had rejected it at the time *Planters Bank* was decided.[91] Although the breach of the director's fiduciary duty to the creditors was argued,[92] the court may not have recognized this theory since the plaintiff creditors appeared to have fused it with the trust fund argument. The court merely rejected the rule offered by the plaintiffs as too broad.[93] Moreover, the directors were not joined as defendants. The rule condemning a director's breach of fiduciary duty to creditors requires the director to surrender the amount of the preference. It is never used against the preferred creditor.[94] Therefore, if the plaintiff intended to rely on the director's breach of fiduciary duty to him, he failed to sue the proper party.

In the next decision involving this issue, the court departed radically from the earlier holding in *Planters Bank*. In *Darden v. George G. Lee Co.*[95] the controlling director of the debtor corporation,[96] was one of its two creditors. When it became evident that the company did not have sufficient assets to pay both creditors, Darden assigned all of the company's assets to himself. The other creditor, George G. Lee Co.,[97] asserted that this

must furnish the remedy. . . .
Id. at 291-92.

[90] *See, e.g.,* Darden v. George G. Lee Co., 204 Va. 108, 129 S.E.2d 879 (1964); cases cited in 15A FLETCHER, *supra* note 68, at § 7469. Interestingly, Fletcher cites *Darden* for the proposition that preferences to director-creditors are forbidden on the premise that "directors are fiduciaries and cannot reap any advantage from their position as such." *Id.* at § 230. As will be indicated this is not an unreasonable reading of *Darden*. *See* text accompanying note 100 *infra.*

[91] *See* 2 GLENN, *supra* note 9, at §§ 596-598, 602-604; Note, *The Present Status of the Trust Fund Doctrine,* 8 COLUM. L. REV. 303 (1908).

[92] *See* note 84 *supra.*

[93] *See* text accompanying note 85 *supra.* In fact, the court went out of its way to indicate that there are certain situations in which a corporation's assets are a trust fund for general creditors. "Much stress is laid by the [creditors] on the case of *Sawyer v. Hoag,* 84 U.S. (17 Wall.) 610 (1873). In that case, the well established principle was asserted that the capital stock of a corporation, especially its unpaid subscriptions, is a trust fund for the benefit of the general creditors, which cannot be withdrawn from their reach by any act or device on the part of the director. But no such doctrine as is here contended for was there laid down. On the contrary, the court recognized a distinction between the capital stock of a corporation and its ordinary assets with which, it was said, the directors may deal as they choose." Planters Bank v. Whittle, 78 Va. 737, 740 (1884).

[94] *See* text accompanying note 101 *infra.*

[95] 204 Va. 108, 129 S.E.2d 897 (1964).

[96] Several years prior to the suit the debtor had gone through a creditor's arrangement at which Darden had acted as its attorney. In this proceeding, Darden advanced the debtor $25,000 for the purpose of paying off its creditors. In exchange for the advance, Darden took the debtor's note, received fifty per cent of its common stock, and was elected a director and secretary-treasurer of the company. *Id.* at 109, 129 S.E.2d at 898. When it became evident that the company was so far insolvent that it could not continue, "Darden closed the doors of the corportion and took the key." *Id.*

[97] The Lee Company was a large creditor of the debtor's in a prior proceeding under the Bankruptcy Act. It received forty per cent of its claim in the federal proceeding. After Darden

transfer constituted a fraudulent conveyance under section 55-80 and demanded that the transferred assets be restored to the corporation and divided ratably between the debtor's two creditors. As one would have anticipated, Darden claimed that *Planters Bank* was the controlling precedent for the case. The Virginia Supreme Court disagreed. The court stated that the facts were "more in keeping with those in *Certain-Teed Products Corporation v. Wallinger,*"[98] a Fourth Circuit case, than *Planters Bank.* In both *Certain-Teed* and in *Darden* the director controlled the debtor's affairs, while in *Planters Bank* the crucial element of control was not present.[99] Thus, the court declared that it would adopt the rule of *Certain-Teed* and restated it as follows:

The weight of authority seems to be that the directors of an insol-

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took control of the debtor, it continued to purchase plumbing supplies and materials from the Lee Comapny.

[98] 89 F.2d 427 (4th Cir. 1937). The *Darden* court did not set forth the facts of *Certain-Teed.* Had this been done, the factual differences in the cases would have been evident. The defendant, Certain-Teed, owned a subsidiary, Beaver, over which operations were closely controlled. *Id.* at 430. Over a lengthy period Certain-Teed loaned substantial sums without security to Beaver. Nonetheless, Beaver became hopelessly insolvent. Thereafter, the stockholders, including the defendant, agreed that the subsidiary be discontinued and its assets liquidated and distributed to creditors. Shortly thereafter, a state court receiver was appointed and bankruptcy ensued. *Id.* at 431. From the time of the stockholder's meeting to a point shortly before Beaver's adjudication as bankrupt, Certain-Teed accepted a number of payments on the debt owed to it by Beaver. When Beaver's trustee in bankruptcy attempted to regain these assets, Certain-Teed defended on the ground that mere ownership of the majority of Beaver's stock and the existence of common officers and directors did not make Certain-Teed responsible for Beaver's obligations or create a principal-agent relationship. *Id.* at 434. The Fourth Circuit accepted this as a correct statement of the law, but held it inapplicable to the facts. The court pointed out that Certain-Teed had no right to accept payments from Beaver after a receiver was appointed, since the law requires that such assets be distributed among creditors equally. *Id.* Nor could the defendant accept payments after Beaver's stockholders directed the cessation of business to ratably pay creditors from the assets obtained through liquidation. This purpose was frustrated by Certain-Teed's acceptance of preferential payments which hindered creditors. Given the close connection of the defendant to the bankrupt, the Fourth Circuit held that it was proper to infer that Certain-Teed had ordered such payments be made to it with the knowledge that they were contrary to the shareholders' resolution to discontinue the business. Thus, the trustee recovered for wrongful diversion of assets. In effect, the court held that Certain-Teed was a knowing convertor.

Clearly, the operative facts of *Certain-Teed* were not present in *Darden.* The Fourth Circut condemned Certain-Teed because it accepted preferential transfers after Beaver's stockholders had voted to liquidate the business and a receiver for Beaver had been appointed. These two crucial facts were not present in *Darden.* To a large degree, *Certain-Teed* rests on the theory that the parent ordered funds to be diverted to it at a time when it knew such an act was unauthorized and wrongful. The rule adopted by the Virginia court rests on a different base. *See* text accompanying notes 103-04 *infra.*

[99] This is a questionable reading of *Planters Bank.* From the apparent facts, the probable inference is that the directors who acted as guarantors controlled the corporation. *See* text accompanying notes 81-84 *supra; cf.* Beck v. Semones' Adm'r, 145 Va. 429, 134 S.E. 677 (1926) (director-creditors asked for permission to receive a preference from the debtor's other directors). In fact, the point was not raised in *Planters Bank* because the court did not think it was significant.

> vent corporation, who are also creditors of the corporation, have no right to grant themselves a preference or an advantage over other creditors in the payment of their claims. This rule is based on simple justice.[100]

Applying this rule, the court ultimately concluded that the assignment must be set aside, and divided the assets ratably between Darden and George G. Lee Company.[101]

Undoubtedly the result reached in *Darden* is correct, but the manner in which the court employed its new rule seems peculiar. The court noted that the effect of granting the preference to Darden was to hinder George G. Lee Company. While every preference hinders creditors, this alone is insufficient under section 55-80 to upset an assignment to one who pays a valuable consideration.[102] If, however, the assignee has notice that the transfer was made with "intent to hinder," a cause of action is stated under section 55-80. In the crucial paragraph of the opinion, the court quoted the trial judge's application of the intent requirement with approval:

> The obvious and inevitable effect of this transaction was to delay and hinder the creditor, Lee Company, from satisfying its claim. Because of his position, the defendant Darden is chargeable with that intent. Under Sec. 55-80 of the Code, a conveyance or assignment may be made with intent to hinder or delay, without any intent absolutely to defraud. Either intent is sufficient. Under such circumstances there is legal or constructive fraud which renders the transaction void as to creditors.[103]

The court then concluded that there was clear evidence proving that Darden was in control of the debtor when the assignment was made, that he knew what effect the assignment would have, and that such evidence brought the case within the *Certain-Teed* rule.[104]

There are probably few instances in which a court has so obviously strained to fit a square peg into a round hole. To begin with, the *Certain-Teed* rule is not a part of the law of fradulent conveyances: the court's restatement of it shows that there is no "unfairness" to creditors.[105] In-

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[100] 204 Va. at 112, 129 S.E.2d at 897.

[101] *Id.* at 113-14; 129 S.E.2d at 898.

[102] *See* text accompanying notes 43-46 *supra.*

[103] 204 Va. 112, 129 S.E.2d at 897.

[104] The court agreed with the lower court's finding that:

> It appears clear from the evidence that at the time the defendant Darden arranged for the assignment to himself of the accounts receivable of the Ricks Corporation that the corporation was insolvent [and] that he knew there were no other assets out of which the corporation's creditor, Lee Company, could satisfy his claim. . . .

Id. at 113; 129 S.E.2d at 900.

The conclusions of the lower court on questions of fact in cases where the evidence has been heard *ore tenus* are entitled to peculiar weights and considerations, and we should accept them just as we accept the jury's verdict sustained by evidence which it might have believed. *Id.*

[105] The question in *Certain-Teed* was whether the parent should be liable to its subsidi-

stead, the rule concerns the fiduciary duty of a controlling director to the corporation's creditors. It is difficult to believe that the court did not realize this. *Certain-Teed* was not a fraudulent conveyance case.[106] Nor are any of the five cases the court cited in support of its adopted rule.[107] In fact one of the cases cited was *Sutton Manufacturing Co. v. Hutchinson*,[108] which, as indicated earlier,[109] stated that the director who gave himself a preference violated the rules regarding fiduciary duties of directors, although such activity was permissible under fraudulent conveyance law.

Why did the court ignore this point? Why didn't it simply condemn Darden's conduct as a breach of a director's fiduciary duty, correctly citing *Certain-Teed* as authority? Apparently the court did not think that the defendant had raised this issue. Darden defended solely on the basis of *Planters Bank*, contending that the decision and rationale stated there precluded liability being imposed on him.[110] Thus, the court's attention

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ary's trustee in bankruptcy for diverting assets received from the subsidiary. 89 F.2d at 431-35; *see* note 98 *supra*. In *Certain-Teed*, the Fourth Circuit addressed the argument of whether this transfer could be regarded as a simple preference, and found that: "[I]t is no answer to say that in Virginia, a preferential transfer by an insolvent corporation to a stockholder has been held permissible in such cases as . . . Planters Bank v. Whittle, 78 Va. 737 [1884] . . . Beck v. Semones' Adm'r, 145 Va. 429, 134 S.E. 677 [1926] for these cases do not go so far as to authorize a preference which has been obtained by a creditor *in complete control of the affairs of a corporate debtor*. The rule generally prevailing under such circumstances is to the contrary." 89 F.2d at 435 (emphasis added). One might assume that the *Darden* court's subsequent misinterpretation of *Planters Bank* was based on the Fourth Circuit's misreading of that case. *See* note 99 *supra*.

[106] Four cases are cited by the Fourth Circuit in *Certain-Teed* as authority for the proposition that Certain-Teed had violated its duty to creditors of its subsidiary: Richardson v. Green, 133 U.S. 30 (1890); Wiggington v. Auburn Wagon Co., 33 F.2d 496 (4th Cir. 1929); Jackman v. Newbold, 28 F.2d 107 (8th Cir. 1928); Sutton Mfg. Co. v. Hutchinson, 63 F. 496 (7th Cir. 1894). All four are clearly based on the theory that a director of an insolvent corporation owes a fiduciary duty to general creditors and will not be permitted to gain an advantage over them in his dealings with the corporation.

[107] The *Darden* court relied on the four cases cited by Darden. In addition, the court cited Stuart v. Larson, 298 F. 223 (8th Cir. 1924), in which the Eighth Circuit expressly followed Sutton Mfg. Co. v. Hutchinson, 63 F. 496 (7th Cir. 1894). On this basis, Fletcher describes *Darden* as being grounded on the rationale "that directors are fiduciaries and cannot reap any advantage from their position as such." 15A FLETCHER, *supra* note 68, § 7468 at 230; *see* note 76 *supra*.

[108] 63 F. 496 (7th Cir. 1894).

[109] *See* notes 74-76 *supra*.

[110] In *Darden*, the court indicated that two questions had to be resolved:

(1) Is an assignment of accounts receivable by an insolvent corporation to a creditor in partial satisfaction of an antecedent debt avoidable by another creditor as a fraudulent conveyance in the absence of actual fraud, simply because the assignee-creditor is a stockholder of the debtor corporation and has previously been an officer and director?

Darden argues in his brief that the question has been answered by our court where the issue was "squarely presented in 1884 in *Planters Bank v. Whittle*, 78 Va. 737."

204 Va. at 111.

(2) Assuming that the lower court has jurisdiction in liquidation of the corportion, are Lee's rights to estate dividends fixed as of the beginning of the liquidation or may Lee first receive liquidating dividends of 5% of its claim prior to any dividend

was never focused on the issue of whether this transaction ought to be characterized as a fraudulent transfer.[111] It is also possible that the justices were of the opinion that their own Rules of Court precluded them from raising this issue sua sponte.[112] Whatever the explanation, the court's decision to uphold plaintiff's claim under section 55-80 blurred the line between a fraudulent conveyance and a preference.

An attempt to explain *Darden* in terms of the law of fraudulent conveyances further demonstrates the confusion. In analyzing transactions under section 55-80, the two basic issues would seem to be whether the grantor possessed the requisite intent to defraud his creditors and whether the grantee qualified as a bona fide purchaser. In dealing with the first, the nature of the fraud involved necessarily must be defined. Only after a determination that the grantor was guilty of some kind of fraud does the issue of whether the grantee was privy to the fraud become relevant.[113] In the *Darden* opinion, the court ignored the first issue and focused solely upon the bona fides of the grantee. It never explained why the corporation's payments to Darden must be characterized as fraudulent.[114] By adopting this technique, however, the court could easily impute the assumed wrongful intent of the debtor to creditor Darden, the debtor's controlling director.

It is not apparent what was "unfair" in the fraudulent conveyance sense about the corporation's preference to Darden. The court's only reference to this question was the trial judge's statement that the payment hindered and delayed the other creditor in satisfying his claim and that the director knew this. Yet, the Virginia Supreme Court has emphasized often that while every preferential payment must hinder and delay creditors to some extent, this alone does not convert a preference into a fraudulent conveyance.[115] One wonders if the court appreciated the significance of this statement. This is equivalent to saying that the mere intent to prefer is not fraudulent. To convert a preference into a fraudulent conveyance the debtor's purpose must go beyond the simple desire to favor one creditor over another. Cases such as *Irby v. Gardner*[116] involving preferences between close relatives serve to accent this point. If read strictly, however, *Darden* points in a new direction, since it holds that the intent

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to Darden and then demand that Darden share ratably in dividends thereafter realized?

204 Va. at 113.

[111] Recall that *Planters Bank* was not a fraudulent conveyance case. The court may have been of the view that the precise theory employed was unimportant where the correct result was so evident.

[112] *See* Virginia Supreme Court Rules of Court 5:21. The court has required strict compliance with this rule. *See, e.g.*, Pearsall v. Richmond R & H Authority, 218 Va. 892, 242 S.E.2d 228 (1978); Lacks v. Bottled Gas, 215 Va. 94, 205 S.E.2d 671 (1974).

[113] Such an approach would seem to be inherent under VA. CODE § 55-80. The statute first declares void any transfer made with actual fraudulent intent. Thereafter, it provides that bona fide purchases from a fraudulent grantor are protected. *See* note 5 *supra*.

[114] *See* text accompanying notes 102-03 *supra*.

[115] Surratt v. Eskridge, 131 Va. 325, 345, 108 S.E. 677, 683 (1921).

[116] 157 Va. 132, 160 S.E. 81 (1931).

to prefer is fraudulent as a matter of law, and such a transaction may be set aside under section 55-80 if the preferred creditor knew of this intent.[117] The accuracy of this interpretation becomes evident in light of the facts the court used to demonstrate Darden's bad faith. Darden knew that the debtor was insolvent and that, if he accepted the assignment, the other creditor would receive nothing. This knowledge of the corporation's purpose to prefer him is the only evidence relied upon in charging Darden with "scienter".[118] Necessarily, this means that the corporation's intent to prefer was fraudulent under section 55-80. No other basis for finding fraud is stated in the case.[119]

Yet, this analysis of *Darden* fails to take into account the court's use of the *Certain-Teed* rule. Darden lost not because of his knowledge of the corporation's fraud, but because he was the debtor's controlling director. This becomes apparent once one inquires as to the outcome if the debtor had preferred a controlling director, such as Ames, who knew that the transfer would prevent George G. Lee Company from collecting any part of its debt. Since Ames possessed "scienter" in the same sense as Darden, presumably this transfer to him could be set aside if the scienter element is crucial. This is not the case, however, for the hypothetical tracks the facts of *Planters Bank,* the case that the *Darden* court carefully distinguished.[120] Thus, Darden's control of the debtor and his misuse of his fiduciary position, not his knowledge, made the preference wrongful.[121] Yet, as noted above, control over the debtor is irrelevant under the law of fraudulent conveyances.[122]

The rationale notwithstanding, *Darden* seemed to indicate a complete break from the point of view set forth in *Planters Bank.* After all, the

[117] 204 Va. at 112-13, 129 S.E.2d at 899-900.

[118] *Id.*, 129 S.E.2d at 899-900.

[119] A basis may be possible for a finding of actual fraud. Apparently, Lee & Company was a long time supplier and creditor of the debtor. *See* note 97 *supra.* Possibly, Darden continued to purchase goods from Lee for the purpose of building up sufficient assets to pay off the obligation owed to him. If this is true, such intent would be fraudulent. Compare this situation to the exception to the general rule permitting a debtor to convert nonexempt property into exempt property. *See* note 66 *supra.*

Alternatively the court might have based a theory on the reasoning of the Seventh Circuit in Bullard v. Aluminum Co. of America, 468 F.2d 11 (7th Cir. 1972). The creditor accepted a preferential payment of $23,000 from a known insolvent corporate debtor in discharge of a $46,000 debt and released the debtor's president as guarantor of the debt. Although the debt satisfied was a fair equivalent for the money paid, the court ruled that the transaction was not in "good faith" as required by 67d(1)(e)(1) of the Bankruptcy Act, 11 U.S.C. 107d(1)(e)(1) (1976). 468 F.2d at 13-14.

[120] The *Darden* court stated that:

> [t]he evidence in this case clearly shows that when Darden created the assignment of the accounts receivable to himself on July 28, 1960, he was in complete control of the affairs of the Ricks Company so as to bring himself within the rule laid down in the *Certain-Teed Products* case rather than our holding in the *Planters Bank* case.

204 Va. at 112-13, 129 S.E.2d at 900.

[121] *See* WASH. & LEE Note, *supra* note 40, at 353.

[122] *See* text accompanying note 75 *supra.*

practice prohibited in *Darden* was the "disreputable" practice the court felt powerless to prevent in the earlier decision.[123] While noncontrolling directors and shareholders might accept preferences, a controlling director could not be permitted to manipulate the debtor's affairs to his own benefit. Therefore, control over the corporation was the essence of *Darden,* or so it appeared until the court decided *Bank of Commerce.*

The facts in *Bank of Commerce*[124] were similar in several respects to those in *Planters Bank.* While the debtor corporation was insolvent, the controlling directors authorized payment of debts on which they were sureties to the Peoples Bank. Another creditor brought suit against the corporation and the controlling directors under section 55-80. The preferred creditor, Peoples Bank, was not joined as a defendant. The directors demurred, arguing that the payment to the Peoples Bank was not a fraudulent conveyance.[125] The trial court sustained the demurrer, and the plaintiff appealed to the Virginia Supreme Court. The plaintiff conceded that the preference could not be set aside, but asserted that the directors should be ordered to "restore" to the debtor the funds misappropriated for their benefit and that these funds thereafter be distributed ratably among the corporation's creditors.[126] Plaintiff relied on *Darden,* claiming that the effect of paying a note on which the controlling directors were secondarily liable was functionally identical to direct payment to the controlling directors and creditors. The defendants countered with *Planters Bank* as their primary authority. They did not seek, of course, to rely on its discarded rationale,[127] but suggested to the court that *Darden* and *Certain-Teed* could be reconciled with *Planters Bank:*

> The key is that the [preferred] creditor, the assignee, normally is without knowledge of the intent of the debtor, his assignee [sic]. In the case of the director-creditor, the assignor and the assignee are one in the same. Therefore the fraudulent intent of the director is attributable to the creditor, both being the same party and the

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[123] *See* text accompanying note 89 *supra.*

[124] 218 Va. 781, 239 S.E.2d 909 (1978).

[125] In *Bank of Commerce,* the defendants also demurred on the ground that the plaintiff had a "full, adequate, and complete remedy at law or money damages . . . ." *Id.* at 782, 239 S.E.2d at 911. While the trial court overruled this basis for a demurrer, the Virginia Supreme Court did not consider the point.

[126] In *Bank of Commerce,* the creditor did not attempt to set aside the transfer solely for its own benefit, substituting one preference for another, *see* text accompanying note 32 *supra,* but asked that a "receiver be appointed for the debtor, that the court determine the priorities of all creditors in the debtor's assets, and that the defendant directors be required to restore all funds to the debtor which were used for their benefit." *Id.* at 783, 239 S.E.2d at 911. Thus, the debtor requested a remedy which would have protected the rights of all the debtor's creditors similarly situated.

[127] *See* text accompanying notes 97-99 *supra.* The defendant's counsel recognized this difficulty. In his brief he said that "[a]t first glance it would appear that the language in *Planters Bank* and *Darden* are in irreconcilable conflict. In holding the preference invalid [in *Darden*], however, the court specifically did not overrule *Planters Bank* . . . which at the time it could very easily have done, rather it stated 'We find the factual situations in the instant case and the *Planters Bank* case to be different.'" Brief for Appellees at 5.

> preference may in such case be rightfully adjudged void. This was the case in both *Certain-Teed* and *Darden*. . . . In both *Planters Bank* and the instant case, the preference was to a creditor-assignee without actual notice, the director and creditor not being one and the same. *The fraudulent intent of the transfer is then not attributable to the assignee and it is as a consequence a valid preference, following perfectly the theory of fraudulent conveyances as it relates to preferential transfers.*[128]

The supreme court affirmed the trial judge on the basis of the defendants' argument.[129] Since the preferred creditor was without "scienter" of the fraudulent intent of the assignor and exercised no control over the debtor,[130] "one of the elements vital to plaintiff's cause of action under Code § 55-80 is lacking, *i.e.*, that the preferred creditor had notice of the debtor's fraudulent intent."[131] Therefore, the complaint failed to state facts sufficient "to set aside the transfer."[132]

The court's conclusion is rather strange, however, because the plaintiff did not seek relief in this form. Plaintiff asked that the directors be compelled to reimburse the debtor the amount paid to the preferred creditor; it did not request that the transfer be set aside. The court ducked the issue presented by the plaintiff's requested form of relief by focusing on the scienter of the preferred creditor.[133] The court explained its emphasis on the scienter issue by stating that this approach "is consistent with the reasoning employed in other jurisdictions" arriving at the same result on this issue.[134] Yet the authorities cited by the court do not adequately ac-

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[128] *Id.* at 6-8 (emphasis added).

[129] In reaching its conclusion, the court stated:

> So as we examine the assignee's knowledge of the intent of the debtor-assignor, it is important to note, as the defendants urge, that in the *Darden* situation the debtor-assignor and the creditor-assignee were, in effect, one person; the debtor was completely controlled by the creditor. Thus, because they were one and the same, the fraudulent intent of the debtor was ascribed to the creditor, and the preference was void. But here, as in the *Planters Bank* situation, the preference was made to a third-party creditor, the Peoples Bank of Virginia Beach, which exercised no control whatever over the insolvent corporation of which had no actual or constructive knowledge of the fraudulent intent of the assignor. Thus, one of the elements vital to the plaintiff's cause of action under Code § 55-80 is lacking, *i.e.*, that the preferred creditor had notice of the debtor's fraudulent intent.

218 Va. at 787-88, 239 S.E.2d at 914.

[130] *Id.* at 787, 239 S.E.2d at 914.

[131] *Id.* at 787-88, 239 S.E.2d at 914.

[132] *Id.* at 789, 239 S.E.2d at 915.

[133] The court used a similar ploy in *Planters Bank*, by focusing on the rights of nondefendants, the corporate directors of the debtor.

[134] 218 Va. at 788, 239 S.E.2d at 914. The only case the court cited for support on this point was Rockford Wholesale Grocery Co. v. Standard Grocery & Meat Co., 175 Ill. 89, 51 N.E. 642 (1898). The Virginia court, like the Illinois court in *Rockford*, protected the directors on the ground that the favored creditor ought to be able to retain the preference. "On no principle of law or reason can such creditor be deprived of its right to a preference merely because the directors guaranteed the debt." 51 N.E. at 643. Neither court notes, however, that the creditor could keep the preference even if the directors were held liable for the

count for the determination that the bona fides of the preferred creditor, who is not a defendant, protect the wrongdoing directors from liability.[135]

There is, however, a clear justification for the court's decision in this case. Section 55-80 provides that a transfer made with fraudulent intent may be avoided unless the grantee qualifies as a bona fide purchaser. The statute provides only one remedy for a violation: the avoidance of the transfer.[136] The statute does not provide for relief in the form of a money judgment against one not a party to the transfer.[137] If the court in *Bank of Commerce* had accepted plaintiff's position that *Darden* required the relief requested, the remedies available under section 55-80 would have been expanded.[138] Thus, the demurrer was sustained on the apparent ground that the plaintiff employed the wrong theory.

If this explanation of *Bank of Commerce* is accurate, the court's holding appears sound. The decision simply reflects the difficulties caused by the confusion of theories evident in *Darden*. The remedy problem presented in *Bank of Commerce*, however, did not exist in *Darden*. When the fraudulent transfer was set aside pursuant to section 55-80, Darden, as a defendant creditor, was ordered to reimburse the estate.[139] This possibility did not exist in *Bank of Commerce*. Yet, the court's result in no way precludes a plaintiff from ultimately prevailing in a case of this kind. To prevail, an injured creditor must challenge the transaction in its true form as a breach of a director's fiduciary duty to creditors and the suit must be brought in

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amount of that payment.

The Illinois court was also impressed by the fact that the loan was made and guaranteed by the directors while the corporation was solvent. Why this is significant is never made clear. The reasoning of *Rockford* is criticized in Campbell, *Preferences by Insolvent Corporations to Officers, Directors, or Stockholders*, 61 U. PA. L. REV. 163, 173 (1913).

[135] The court cited four treatises dealing with this question. Both 15A FLETCHER, *supra* note 68, at § 7476 and 1 GLENN, *supra* note 9, at § 386, strongly favor the rule requiring a corporate director to restore funds to the debtor when he breaches his fiduciary duty to creditors. The court implied that the contrary position is taken by 19 AM. JUR. 2d *Corporations* § 1577 (1965) and P. VARTANIAN, THE LAW OF CORPORATIONS IN VIRGINIA § 141(3) (1929). A reading of § 1577, however, reveals that AM. JUR'S editors do *not* take a position on this question. More significantly, in § 1574 it is pointed out that the majority of courts do not permit such a preference. VARTANIAN, certainly an obscure authority in comparison with either FLETCHER or GLENN, merely restates the Virginia rule as set forth in *Planters Bank*, the rationale of which the court rejected in *Darden*.

[136] *See* text accompanying notes 14-21 *supra*; *cf.* 1 GLENN, *supra* note 9, at § 2.

[137] The law universally has given a remedy for money damages against a fraudulent grantee for the value of the property that cannot be produced. 1 GLENN, *supra* note 9, at §§ 239-239a. Whether a person not a party to the transfer can be held liable on a tort theory for participating in a fraudulent conveyance appears highly doubtful. *See generally* 2 GLENN *supra* note 9, at § 74; Note, *Tort Liability for Fraudulent Conveyances*, 19 STAN. L. REV. 636 (1967).

[138] In effect, the *Bank of Commerce* court would have held that VA. CODE § 55-80 (Repl. Vol. 1974) gave rise to a remedy for money damages, presumably sounding in tort.

[139] Darden v. George G. Lee Co., 204 Va. 108, 129 S.E.2d 897 (1963) was an appeal involving the liquidation of a debtor corporation. The trial judge decided that Darden and Lee Company should share in the company's assets pro rata. *Id.* at 111, 129 S.E.2d at 899.

the interest of all creditors of the corporation.[140]

In fact, the court may have given such advice to plaintiff facing this situation. At one point in the opinion the court emphasized that the result in *Darden* turned on the "complete control"[141] of the debtor maintained by the director and cited the case of *Regal Ware, Inc. v. Fidelity Corporation,*[142] a 1977 Fourth Circuit decision. The facts of *Regal Ware* and *Bank of Commerce* were essentially similar. In *Regal Ware,* the defendant, Fidelity, used stock control over the insolvent debtor, Foresight, to give preferences to two New York banks whose debts Fidelity had guaranteed and to its wholly owned subsidiary, Fidelity Bankers Life Insurance Co.[143] The Fourth Circuit saw no reason to distinguish these two situations and held the defendant liable for the amounts paid to the three creditors.[144] The court relied on *Certain-Teed* and *Darden* in holding that a party may not use its stock control to give itself a preference over other creditors.[145] The Virginia court's citation of *Regal Ware* would seem to indicate that it will again follow the Fourth Circuit when a *Bank of Commerce* fact situation is properly presented so long as the complaining creditor sues the directors

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[140] Since plaintiff's theory of the case was clearly based on a breach of fiduciary duty, *see* text accompanying notes 126-27 *supra,* one might have expected the supreme court to overturn the demurrer and remand the case to the trial court for a full hearing. Such an action would necessitate an explanation by the court of the correct meaning of *Darden.* After all, the court misled the plaintiff to a degree in sustaining the action in *Darden* as a fraudulent conveyance. It had been anticipated that the *Bank of Commerce* plaintiffs would sue under the same statute in essentially a similar case, since in restating the *Certain-Teed* rule, the *Darden* court stated that it was improper for the directors "to grant themselves a preference or an advantage over other creditors." 204 Va. at 112, 129 S.E.2d at 897.

[141] 218 Va. at 787, 239 S.E.2d at 914.

[142] 550 F.2d 934 (4th Cir. 1977).

[143] *Id.* at 936-43.

[144] In holding the defendant liable, the Fourth Circuit stated that

> [H]ere, Fidelity directed the . . . assignent of the accounts receivable to a creditor (Fidelity Bankers Life Insurance Company) and itself for, at least, the purpose of preferring other creditors whose claims it guaranteed. Fidelity therefore depleted the assets of Foresight and [another subsidiary] in order to protect itself from liability on its guarantee to the two New York banks and in order to prefer the wholly owned subsidiary (Fidelity Bankers Life Insurance Company) to general unsecured creditors such as Regal Ware.

Id. at 945.

[145] The court rejected the defendant's argument that the case fell within the *Surratt* rule:

> Fidelity argues that, absent bankruptcy, it is not legally objectionable for an insolvent debtor to prefer some creditors over others, relying on *Surratt v. Eskridge,* 131 Va. 325, 108 S.E. 677 (1921) and *Hutcheson v. Savings Bank of Richmond,* 129 Va. 281, 105 S.E. 677 (1921). From that proposition it concludes that even if Foresight and [another subsidiary] be regarded as a single debtor, they could legitimately pay the debt to the New York banks even though, by doing so, the assets available to other creditors were lessened.
>
> Neither of these cases control here. They do not involve the situation which a parent corporation, which is also a creditor of an insolvent corporation, uses its stock control to give itself a preference as a creditor. That such cannot be done is clearly held in *Certain-Teed Products Corporation v. Wallinger,* . . . and *Darden v. Lee Company,* . . . .

Id. at 944.

under the proper theory. This seems evident, since it does not seem possible that the state's highest tribunal would treat differently essentially similar transactions when such a result could be avoided.[146] Presumably this accounts for the court's cryptic remark that the complaint does not set forth facts sufficient "to set aside the transfer."[147]

VI.

Undoubtedly, the law in Virginia would have been improved had the court openly followed *Regal Ware*, for such an approach would have both simplified and clarified the law in this area. The court could have stressed that the evil proscribed in *Darden* was the controlling director's breach of fiduciary duty to creditors, and that the rule adopted by *Darden* and reaffirmed in *Bank of Commerce* was limited to such circumstances. Overruling the defendant's demurrer on this ground would have been proper, even though the *Bank of Commerce* plaintiff labeled his action as one to upset a fraudulent conveyance. Since the plaintiff had made his underlying theory clear from the beginning, the defendant would not have been prejudiced by the court's reinterpretation of its earlier opinion.[148]

Concurrently, the court should have emphasized that the law of fraudulent conveyances was not applicable to these cases, thereby precluding the possibility that the validity of a simple preference could be questioned. Recall that *Darden* apparently held that the intent to prefer by the grantor is fraudulent. That some members of the bar have read *Darden* this way is evident from the argument made by the defendant's counsel in *Bank of Commerce.*[149] This error is reinforced by the court's statement of its scienter approach in *Bank of Commerce*, for it indicates that the debtor's intent in preferring Peoples Bank was fraudulent.[150] This misinterpretation of

[146] In *Bank of Commerce*, the Virginia Supreme Court assumed the debtor corporation possessed the required fraudulent intent and that the directors controlled the corporation. Therefore, following *Darden*, the court must have believed that the directors' conduct was wrongful. The only case the court cited in support of its position was Rockford Wholesale Grocery v. Standard Grocery & Meat Co., 175 Ill. 89, 51 N.E. 652 (1898) which held that such actions of the directors were acceptable.

[147] 218 Va. at 789, 239 S.E.2d at 915.

[148] *See* Brief for Appellant at 4-9. In addition to *Darden*, counsel relied on Ware v. Rankin, 97 Ga. App. 837, 104 S.E.2d 555 (1958) and Love Mfg. Co. v. Queen City Mfg. Co., 74 Miss. 290, 20 So. 146 (1896) which expressly relied on the directors' breach of fiduciary duty to creditors. *Ware* is especially clear since it was based on a Georgia statute which prohibited directors of an insolvent corporation from using remaining assets to gain any kind of advantage for themselves. 97 Ga. App. at 841, 104 S.E.2d at 559.

[149] Throughout his argument the director's counsel assumed that the intent to prefer was fraudulent and the validity of the preference turned on the assignee's knowledge. While it is true that counsel also asserted that *Darden* must be "limited to its facts," Brief for Appellee at 8, this argument was aimed at distinguishing a *Darden* type case from a *Bank of Commerce* type case. Counsel's entire position was predicated on the view that a preference is bad and may be set aside, unless the creditor qualifies as a bona fide purchaser. *Id.*

[150] After indicating the fact that preferences necessarily hinder and delay is not sufficient to set aside the transfer made to a purchaser for a valuable consideration, the *Bank of Commerce* court continued: "it is sufficient . . ., if the assignee . . . had notice of the fact

Virginia law should not have been permitted to continue.

An illustration reveals the potential difficulties. Assume that Smith, a private individual, is hopelessly insolvent. Smith has many creditors, but he uses all of his assets to pay off the debt of his friend Jones. A judgment creditor, Barr, wishes to upset the transfer under section 55-80. What must Barr plead to survive a demurrer? Suppose Barr asserts in his complaint that Smith, while insolvent, made a preferential transfer to creditor Jones, thus leaving Smith without assets to pay Barr's judgment. Such allegations are insufficient under Virginia authorities, but the reason for this insufficiency is stated differently in the cases. Under the traditional rule set forth in *Surratt v. Eskridge,*[151] Smith has the right to make the preferential transfer as an incident of ownership as long as preferring Jones is his only purpose.[152] As long as the property is unencumbered, Smith's creditors have no interest in any asset of the debtor. The transfer also is valid under *Darden*'s and *Bank of Commerce*'s scienter tests. While the allegations show a fraudulent transfer, the pleadings do not indicate that Jones possessed "scienter" *i.e.*, that Jones knew that Smith was insolvent and intended to make a preferential transfer. Suppose that Barr further alleges that Jones knew of Smith's insolvency before or at the time of the transfer. Under the older cases such as *Surratt,* the transfer is still valid. Since Smith, as an incident of ownership had the absolute right to make the transfer, Jones necessarily had the right to receive it. The fact that he knows other creditors of Smith cannot be paid is irrelevant.[153] The court in *Bank of Commerce* cites *Surratt* with approval, but says that "[e]mbodied within the concept of fraudulent conveyances is the fact that all preferential transfers necessarily 'hinder and delay' other creditors . . . ."[154] This in itself is not sufficient to upset the transfer where a bona fide purchaser (creditor) is involved. The court further states "it is sufficient, however, if the assignee . . . had notice of the fact that the assignment was made with intent to hinder."[155] Does Jones's knowledge of Smith's insolvency put him on notice of his debtor's intent to hinder? Under the scienter test the answer would seem to be yes. If the preferred creditor knows the debtor is insolvent, the law will presume he knows that the debtor can no longer pay off the claims of his other creditors. In *Darden,* the court pointed to the director's knowledge of the debtor's insolvency as the reason for charging him with the debtor's intent to hinder other creditors. *Bank of Commerce* is quite consistent with this interpreta-

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that the assignment was made with 'intent to hinder.' Darden v. George G. Lee Co. . . . So . . . we examine the assignee's knowledge of the intent of the debtor-assignor . . . ." 218 Va. at 787, 239 S.E.2d at 914. This goes well beyond those cases which indicate that the intent to prefer is a badge of fraud and is assumed to be inherent in the transaction. 2 GLENN, *supra* note 9, at § 378.

[151] 131 Va. 325, 108 S.E. 677 (1921).

[152] *See* text accompanying notes 37 & 45-46 *supra.*

[153] *See* note 45 *supra.*

[154] 218 Va. at 787, 239 S.E.2d at 914.

[155] *Id.* quoting Darden v. George G. Lee Co., 204 Va. 108, 112, 129 S.E.2d 897, 899-900 (1963).

tion, for the court sustained such a transfer on the ground that the preferred creditor had no notice of the grantor's wrongful intent. If the preferred creditor knew of the debtor's insolvency, he would be in possession of the same facts that director Darden held and presumably suffer the same fate. Therefore, Barr's additional allegation of insolvency would state a cause of action against Jones.[156]

The court should reject Barr's argument. One clear ground would be to limit *Darden*'s and *Bank of Commerce*'s scienter test to situations involving benefits granted to controlling directors by a debtor corporation as against its other creditors. The traditional rule would apply to all other preference cases. The court, however, fails to state clearly that such distinction exists.[157]

If the law of preferences has been modified as indicated, it is submitted that this is not a change for the better. There are two clear grounds for this conclusion. First, the "scienter" test that the court would be using seems to be quite similar to that found in section 60(b) of the current Bankruptcy Act which prohibits preferential transfers whenever the preferred creditor has "reasonable cause to believe the debtor insolvent."[158] Section 60(b) has been criticized on the ground that it is difficult to administer, encourages

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[156] Under the rules set down by the court in *Bank of Commerce*, a similar problem could arise in cases in which a corporation pays a debt on which a director is secondarily liable. For example, suppose that Frick Corp. prefers one of its creditors, Jones, on a debt on which its controlling director, Smith, is secondarily liable. Should Barr, a creditor of Frick Corp., allege any facts in addition to those just noted in his complaint to state a cause of action under section 55-80 of the Virginia Code? Clearly, if Barr alleges that Jones knew of Frick's insolvency, the cause of action would be stated for the reasons just noted. Jones would know that director Smith would be benefitted by the preference. Does this put Jones in possession of such information as would excite the suspicions of a man of ordinary prudence that this payment was a preference which hindered other creditors in collecting their claims? Since this issue was not raised in *Bank of Commerce*, one cannot be certain how the Virginia Supreme Court would answer it. Unquestionably, however, creditor Jones would possess precisely the same kind of information that condemned director Darden.

[157] The court says that its "focus on the scienter of the preferred creditor is consistent with the reasoning employed in other jurisdictions which have sustained the validity of a preference by an insolvent corporation when a director or officer is endorser, guarantor, or surety for the debt." 218 Va. at 788, 239 S.E.2d at 915. This might indicate that *Darden* and *Bank of Commerce* are viewed as special applications of the general rules regarding preferences. Yet in *Bank of Commerce* the court stated repeatedly that this focus on the bona fides of the preferred creditor constitutes the starting point of analysis. *Id; see* Irby v. Gardner, 157 Va. 132, 160 S.E. 81 (1931).

[158] Sections 60(a) and (b) of the Bankruptcy Act, 11 U.S.C. §§ 96(a), (b) (1976), state the conditions under which a preference is subject to avoidance of bankruptcy. The elements of 60(a) are: (1) a transfer as defined in section 1(30), (2) of the property of the debtor; (3) to or for the benefit of a creditor, (4) for or on account of an antecedent debt, (5) made or suffered by the debtor while insolvent, (6) within four months prior to the filing of a petition, and (7) having the effect and enabling the creditor to obtain a greater percentage of his debt than any other creditor of the same class. Section 60(b) provides:

> [a]ny such preference may be avoided by the trustee if the creditor receiving it or to be benefitted 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 . . . .

ignorance and poor creditor practices, and penalizes the diligent creditor.[159] For these reasons, the section 60(b) test was omitted from the new Bankruptcy Act.[160] Second, the scienter test would cause a remedial problem which has long prevented courts from characterizing preferences as fraudulent conveyances. In the hypothetical case set out above, the court would be substituting one preference for another by permitting Barr to set aside the preference to Jones. No doubt the court would avoid this absurd result when given the opportunity.

Finally, it should be stressed that the total adoption of the Fourth Circuit's approach set forth in *Certain-Teed* and *Regal Ware* effectively prevents the occurrence of the remedy problem which traditionally deterred equity from characterizing preferences such as the substitution of one preference over another as fraudulent conveyances. Under the Fourth Circuit's rule only a liquidator or a representative of all creditors may attack the director's breach of duty to creditors.[161] If successful, the remedy granted in such cases is to have the director restore to the corporation funds of the debtor used for the director's benefit. Thus, this creditor's suit requires equal distribution among parties similarly situated.

CONCLUSION

While the writer disagrees with the court's decision in *Bank of Commerce* on the merits, his principal complaint is that the court in both this decision and *Darden* failed to articulate clearly the basis for its decisions. In *Darden*, the court told us that a preferential transfer by a corporation to a controlling director-creditor was fraudulent as a matter of law, although the precise nature of the fraud was not revealed. In *Bank of*

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[159] The report of the House Judiciary Committee had this to say about 60(b):

> [T]he trustee must show that the creditor for whose benefit the preferential transfer was made had reasonable cause to believe the debtor was insolvent at the time of the transfer.
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> This provision was designed when the primary purpose of the preference section was to prevent the race of diligence. Whether or not a creditor knows or believes that his debtor is sliding into bankruptcy is important if the only purpose of the preference section is to deter the race. However, a creditor's state of mind has nothing whatsoever to do with the policy of equality of distribution, and whether or not he knows of the debtor's insolvency does little to comfort other creditors similarly situated who will receive that much less from the debtor's estate as a result of the prebankruptcy transfer to a preferred creditor. To argue that the creditor's should not be required to disgorge what they took in supposed innocence is to ignore the strong bankruptcy policy of equality among creditors. Finally, the requirement that the trustee prove the state of mind of his opponent is nearly insurmountable and defeats many preference actions. The amount of litigation it causes is too great when the requirement itself does not further any necessary bankruptcy policy. It also defeats the policy of the preference section by limiting the recoveries to only the most egregious cases. H.R. REP. No. 95-595, 95th Cong., 1st Sess. 178, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS No. 11c, 179, 335.

[160] *See* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 547, 92 Stat. 2549 (1978) (to be codified in 11 U.S.C. § 547).

[161] *See generally* 2 GLENN, *supra* note 9, at § 386.

Commerce, the court sustained a preference because of the bona fides of a third party, while ignoring the controlling director-defendant's conduct which was essentially similar to that summarily condemned in *Darden*. The court concluded by announcing that the plaintiff was not entitled to a remedy it did not seek.

As suggested earlier, the court ought to have recognized that situations involving preferences by corporate debtors to or for the benefit of controlling directors differ markedly from preferences generally. The same rules cannot be made to apply to both without causing confusion. Yet, it is submitted that this is now the state of the law in Virginia.