



Fall 9-1-1964

Preferences To Directors Of Insolvent Corporations

Follow this and additional works at: <https://scholarlycommons.law.wlu.edu/wlulr>



Part of the [Business Organizations Law Commons](#)

Recommended Citation

Preferences To Directors Of Insolvent Corporations, 21 Wash. & Lee L. Rev. 353 (1964).

Available at: <https://scholarlycommons.law.wlu.edu/wlulr/vol21/iss2/20>

This Comment is brought to you for free and open access by the Washington and Lee Law Review at Washington and Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Washington and Lee Law Review by an authorized editor of Washington and Lee University School of Law Scholarly Commons. For more information, please contact christensena@wlu.edu.

separate and he could have objected to the agreement at that time. Furthermore, the accused did not request to be present at the conference, and there was no objection to his absence at the time of the trial or on appeal. The Supreme Court of Virginia, when considering the right of an accused to be present at a conference in the judge's chambers, laid down the following rule:

"The prisoner's right of personal presence in a felony case throughout the trial from arraignment to sentence, when anything is done that can affect his interest, is an inalienable one. It is to be rigidly and jealously guarded. Yet, in its protection and enforcement, it must not be so enlarged as to exceed its true scope and thereby made to include all inquiry into the consideration of purely legal matters by the trial judge which are in fact and reality merely careful and prudent preparation for the resumption and conduct of the trial."⁴²

In conclusion, the *Near* situation is closely analogous to other conference situations which have held the presence of the accused not to be essential, and there are, in addition, other factors which strongly support such a holding in the *Near* case. It is submitted that *Near's* absence did not constitute a violation of Virginia law, and that this Virginia law insures due process to the accused.

ROBERT T. MITCHELL, JR.

PREFERENCES TO DIRECTORS OF INSOLVENT CORPORATIONS

At common law it was settled that an insolvent debtor could prefer certain creditors over others.¹ This general rule still applies, with some limitations.² Until the commencement of bankruptcy or other liquidation proceedings,³ a debtor has the right to dispose of his property, to use it to secure and pay his debts, and the right to prefer one of his creditors over others.⁴

¹188 Va. at 592-93, 50 S.E.2d at 411-12.

²*Coder v. Arts*, 213 U.S. 223, 242 (1909); *Huntley v. Kingman*, 152 U.S. 527, 532 (1894); *Bradley v. Farwell*, 3 Fed. Cas. 1146 (No. 1779) (C.C.D. Mass. 1874); *Catlin v. Eagle Bank*, 6 Conn. 233 (1826). See Va. Code Ann. § 55-80 (Repl. Vol. 1959); 15A *Fletcher, Corporations* § 7423 (Repl. Vol. 1938).

³See generally, 15A *Fletcher, Corporations* §§ 7421-23 (Repl. Vol. 1938); 2 *Glenn, Fraudulent Conveyances & Preferences* § 384 (rev. ed. 1940).

⁴For example, the receivership created upon the debtor's death.

⁵*Merillat v. Hensey*, 221 U.S. 333 (1911); *Irving Trust Co. v. Kamisky*, 19 F. Supp. 816 (S.D.N.Y. 1937). See also, *Stewart v. Dunham*, 115 U.S. 61 (1885); *Hannan*

Problems arise, however, where the preferred creditor is an officer and director of the corporation which is indebted to him. Under those circumstances the weight of authority is against preferences, although the underlying reason is often obscured. Such a situation was presented by the recent Virginia case of *Darden v. George G. Lee Co.*⁵ Darden was a director and secretary-treasurer of the Ricks Company and had personally advanced \$22,500 during a creditors' arrangement in 1958. In 1960, the corporation became insolvent and Darden decided to liquidate. There were only two creditors, Darden and the Lee Company. When it became apparent that the assets of the Ricks Company would be insufficient to cover both debts, Darden took an assignment of all the company's accounts receivable, the sole remaining asset of the insolvent corporation, thus leaving nothing from which the Lee Company could satisfy the debt due to it.

The assignment was set aside as a fraudulent conveyance by the Circuit Court of Princess Anne County. The Supreme Court of Appeals of Virginia agreed with the lower court that:

"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."⁶

The basic law on fraudulent conveyances is the 1570 English statute of 13 Elizabeth, which proscribed conveyances made with intent to hinder, delay, or defraud other creditors. The Virginia statute,⁷ like those of many other jurisdictions, closely parallels 13 Elizabeth in treating all conveyances made with such intent as fraudulent and void, if the transferee had knowledge of the debtor's intent.⁸ As the court in *Darden* pointed out:

v. Hardee, 69 F.2d 394 (D.C. Cir. 1934); *Salem Trust Co. v. Federal Nat'l Bank*, 11 F. Supp. 105 (D. Mass. 1934). A preference, as such, is not necessarily a fraudulent conveyance. *Lyons Bank & Trust Co. v. Tuxedo State Bank*, 89 Ind. App. 269, 166 N.E. 254 (1929); 1 Glenn, *Fraudulent Conveyances & Preferences* § 289 (rev. ed. 1940), where the author points out that to allow another creditor, acting in his own interest, to set aside a preferential transfer would amount to substituting him as the preferred party.

⁵204 Va. 108, 129 S.E.2d 897 (1963).

⁶204 Va. at 112, 129 S.E.2d at 900.

⁷Va. Code Ann. § 55-80 (Repl. Vol. 1959).

⁸It is not enough that the purpose of the grantor be fraudulent. Knowledge of such purpose must be brought home to the grantee. *Hutcheson v. Savings Bank* 129 Va. 281, 105 S.E. 677 (1921). It is not necessary, however, to prove the grantee had positive knowledge of the grantor's fraudulent intent—it is sufficient to show he had knowledge of facts which should have put him on notice. *Ibid.* See also, *Crowder v. Crowder*, 125 Va. 80, 99 S.E. 746 (1919).

"Merely because the preference hinders creditors is not sufficient reason under the Virginia statute to set aside an assignment as it applies to a purchaser for a valuable consideration. However, it is sufficient if the assignee . . . had notice of the fact that the assignment was made with 'intent to hinder.'"⁹

In order to set aside a preference as a fraudulent conveyance, it is necessary to show: (1) the debtor did not act in good faith, but rather his sole purpose was to hinder and delay his other creditors,¹⁰ and, (2) the preferred creditor had notice of the debtor's intent.¹¹ It might be noted that every preferential transfer necessarily hinders and delays other creditors in the collection of their claims, and it seems not unlikely that many preferred creditors are aware of this hindering effect. But, a preferential transfer will not be set aside merely because the transferee realizes that he has been preferred,¹² or knows that the debtor is insolvent¹³ or that the transfer has completely exhausted the debtor's assets.¹⁴ If the debtor's purpose is to pay or secure one of his bona fide creditors, the transaction amounts to a valid preference and the hindering effect on other creditors has been held merely incidental thereto.¹⁵ But, the question arises, how do the courts decide what the debtor's intent is? The court, in *Darden*, did not attempt to answer this question but held, as a matter of law, that because of his position, Darden was chargeable with the intent to hinder and delay the other creditor.¹⁶

⁹204 Va. at 112, 129 S.E.2d at 899-900.

¹⁰As a general rule, an insolvent debtor may make a valid conveyance to pay or secure a bona fide debt, if that is his sole purpose, even though such conveyance may and is intended by the grantor to give a preference over other creditors. *Surratt v. Eskridge*, 131 Va. 325, 108 S.E. 677 (1921). But, if the debtor's sole purpose is to hinder, delay or defraud other creditors, the conveyance is voidable, even though made upon a valuable consideration. *Coder v. Arts*, 213 U.S. 223 (1909). See also, *Stewart v. Dunham*, 115 U.S. 61 (1885).

¹¹See note 8 supra. The good faith grantee who has given value will be protected. See, for example, the Virginia statute which says: "This section shall not affect the title of a purchaser for valuable consideration, unless it appear that he had notice of the fraudulent intent of his immediate grantor or of the fraud rendering void the title of such grantor." Va. Code Ann. § 55-80 (Repl. Vol. 1959).

¹²*Surratt v. Eskridge*, 131 Va. 325, 108 S.E. 677 (1921).

¹³Even if a vendor was insolvent in the vendee's knowledge, the vendee acting in good faith could purchase personal property without a duty to see that the purchase price went to the vendee's creditors. *Gaspee Cab, Inc. v. McGovern*, 51 R.I. 247, 153 Atl. 870 (1931).

¹⁴An individual may turn out part or the whole of his property in payment of his debts, and in so doing may prefer creditors." *Reichwald v. Commercial Hotel Co.*, 106 Ill. 439, 451 (1883).

¹⁵See, note 17 infra.

¹⁶204 Va. 108 at 112, 129 S.E.2d 897 at 900 (1963). In *Reed v. McIntyre*, 98 U.S. 507 (1878), the court pointed out that such an intent was often conclusively pre-

Debtor-creditor law developed so as to reward the diligent creditor who reached his debtor's assets ahead of the other creditors. The principle of equal distribution of assets among creditors by law does not arise until bankruptcy or other liquidation proceedings are commenced. Until the commencement of such proceedings, a creditor's only assurance of satisfaction is to win the race for priority. The more diligent creditors are rewarded with preferential payments. The preference has been protected as being a necessary incident of the creditor's right to seek his own remedy outside of judicial proceedings. It would be anomalous to say that a creditor must lose merely because he has been voluntarily paid.¹⁷

The scramble for position may not be the most satisfactory way for creditors to protect their interests, but, at least in theory, each creditor has an equal opportunity to reach his debtor's assets. However, when one of the creditors has an advantage, not shared by other creditors, so that his priority is virtually assured, the equilibrium among creditors is upset. Under such circumstances, the competition in the diligence race becomes manifestly unfair.

By the overwhelming weight of authority, directors of an insolvent corporation who are also creditors of the corporation may not use their positions of special knowledge and power to grant themselves preferences or advantages over other creditors.¹⁸ Some jurisdictions have enacted statutes specifically prohibiting all preferences, no matter to whom they are made.¹⁹ Some jurisdictions, without

sumed, "if the assignment contained provisions inconsistent with good faith, or so unreasonable and unusual in their character as to justify the conclusion that it was . . . a mere 'trick or contrivance to defeat creditors'."

¹⁷"If, as must be conceded, he has the right to *pay* one creditor in preference to another, even where he is aware of his inability to pay all in full—in other words, where he is insolvent—there is no just reason why, in making provision for all by way of assignment, he may not make special provision for some." *Huntley v. Kingman*, 152 U.S. 527, 532 (1894). See also *Reed v. McIntyre*, note 16 *supra*.

¹⁸*Jackman v. Newbold*, 28 F.2d 107 (8th Cir. 1928); *Stuart v. Larson*, 298 Fed. 223 (8th Cir. 1924) (which contains a good review of the principal authorities on this subject); *Lippincott v. Shaw Carriage Co.*, 25 Fed. 577 (C.C.D. Ind. 1885). See also, *City Nat'l Bank v. Goshen Woolen Mills Co.*, 35 Ind. App. 562, 69 N.E. 206 (1903), for an opinion which cites an extraordinary number of cases in support of this general rule. See generally, *Annot.*, 19 A.L.R. 320 (1922).

¹⁹Arkansas: Ark. Stat. § 64-801 (1957); Kentucky Rev. Stat. § 379.060 (1963); Maryland: Md. Ann. Code art. 47, § 14 (1957); Massachusetts: Mass. Ann. Laws ch. 109A, § 4 (1954); New Jersey: N.J. Stat. Ann. § 14:14-2 (1937); New Mexico: N.M. Stat. Ann. § 27-1-1 (1953). These statutes all contain provisions excepting certain debts—typically laborer's wages.

such a statute, adhere to the "trust fund doctrine,"²⁰ which holds that on insolvency the corporation assets become a trust fund which the directors, as trustees, must distribute *pro rata* among all the creditors.²¹ Other courts, while not holding that the directors are technical trustees, say that they hold their powers in trust for the benefit of creditors.²² Some courts have denied preferences to directors on the ground that they are fiduciaries and, as such, cannot use their position to secure an advantage for themselves.²³ In *Howe, Brown & Co. v. Sanford Fork & Tool Co.*,²⁴ the court denied a preference to a director because of "sound public policy and a sense of common fairness. . . . They ought not to be competitors in a contest of which they must be the judges."²⁵ In the leading case of *Jackman v. Newbold*,²⁶

²⁰The "trust fund doctrine" was enunciated by Justice Story in *Wood v. Dummer*, 30 Fed. Cas. 435 (No. 17944) (C.C.D. Me. 1824). For a full discussion of the trust fund doctrine, see 15A Fletcher, Corporations §§ 7369-70 (Repl. Vol. 1938).

²¹"It is well settled that the officers and directors of an insolvent corporation hold its assets as a trust fund for the benefit of its creditors, and that they will not be allowed to take advantage of their position, and the superior opportunity of information which it affords, to secure an advantage for themselves over other creditors." *Wigginton v. Auburn Wagon Co.*, 33 F.2d 496, 500 (4th Cir. 1929). See also, *Richardson v. Green*, 133 U.S. 30 (1890); *Standard Chemical Oil Co. v. Faircloth*, 200 Ala. 657, 77 So. 31 (1917); *Rouse v. Merchants' Nat'l Bank*, 46 Ohio St. 493, 22 N.E. 293 (1889).

²²"These powers are held by them in trust for all the creditors, and cannot be used by them for their own benefit." *Bonney v. Tilley*, 109 Cal. 346, 42 Pac. 439, 440 (1895).

²³In *Sutton Mfg. Co. v. Hutchinson*, 63 Fed. 496 (C.C.D. Ind. 1894), it was said, "Although such directors and officers are not technical trustees, they hold, in respect of the property under their control, a fiduciary relation to creditors. . . . This rule is imperatively demanded by the principle that one who has the possession and control of property for the benefit of others—and surely an insolvent corporation, which has ceased to do business holds its property for the benefit of creditors—may not dispose of it for his own special advantage. . . ." *Id.* at 501-02. See also, *Hammond v. Lyon Realty Co.*, 163 Md. 442, 163 Atl. 480 (1932); *Taylor v. Mitchell*, 80 Minn. 492, 83 N.W. 418 (1900), in which the court draws a distinction between the situation where the officers and directors take security contemporaneously with the giving of a loan. The general rule is that a corporation may secure a director for a contemporaneous loan. See generally, Annot., 5 A.L.R. 561 (1920).

²⁴44 Fed. 231 (C.C.D. Ind. 1890).

²⁵*Id.* at 233. The court further pointed out: "Whether or not such preferences are fairly given is an impractical inquiry, because there can be in ordinary cases no means of discovering the truth; and consequently the presumption to the contrary should in every case be conclusive." But this case was later revised, the Supreme Court ruling that it was "going too far to hold that a corporation may not give a mortgage to its directors who have lent their credit to it, to induce a continuance of the loan of that credit. . . . at a time when the corporation. . . is a going concern, and is intending and expecting to continue in business." *Sanford Fork & Tool Co. v. Howe*, 157 U.S. 312, 320 (1895).

²⁶28 F.2d 107 (8th Cir. 1928).

the court observed: "The law applicable to this situation is not difficult. It is merely common sense and common honesty, applied in the interest of fair dealing."²⁷ The court, in the principal case, refers to the rule against preference to directors as, "simple justice."²⁸

But the courts are not unanimous in denying directors the right to prefer themselves. In *Wyman v. Bowman*²⁹ it was stated:

"Contracts and transactions between individuals and corporations of which they are directors or officers, which are fair, which are made in good faith, which do not secure to the individuals any undue or unjust benefit or advantage, and in which the interest of the individuals and the duty of the officials work in unison for the welfare of the corporation, are valid and enforceable both at law and in equity."³⁰

Other courts have said that, although such transactions will be closely scrutinized, a director may prefer himself if he acts in "good faith."³¹

In those jurisdictions which have not completely prohibited all preferences, the courts have nevertheless denied them to directors on various grounds. It appears that preferences to directors are not allowed where the circumstances of the case indicate that other creditors have thereby been denied an equal opportunity to reach the corporate assets. The courts seem to solve the difficult problem of the director's intent by deciding whether the overall fairness of the diligence race was impaired, and if so, then they find that the directors intended to hinder and delay the other creditors.

In *Darden*, as has already been pointed out, the court found that, because of his position, Darden was "chargeable with that intent." But the court did not hold the preference void merely because Darden was a director. In addition, Darden was in complete control of the financial affairs of the Ricks Company. Darden relied chiefly on the early case of *Planters Bank v. Whittle*,³² in which the Virginia Supreme Court of Appeals upheld the right of a director to grant him-

²⁷Id. at 111.

²⁸*Darden v. George G. Lee Co.*, 204 Va. 108, 112, 129 S.E.2d 897, 900 (1963).

²⁹127 Fed. 257 (8th Cir. 1904).

³⁰Id. at 273.

³¹*Corey v. Wadsworth*, 118 Ala. 488, 25 So. 503 (1899) (actual fraud); *Buell v. Buckingham*, 16 Iowa 284 (1864); *Beck v. Semones' Adm'r*, 145 Va. 429, 134 S.E. 677 (1926); *Planters Bank v. Whittle*, 78 Va. 737 (1884); *Alexandria Savings Inst. v. Thomas*, 70 Va. (29 Gratt.) 483 (1877). See also, *Stuart v. Larson*, 298 Fed. 223 (8th Cir. 1924).

³²78 Va. 737 (1884).

self a preference.³³ But the court held that the facts in the principal case were more in keeping with those in *Certain-Teed Products Corp. v. Wallinger*,³⁴ in which it had been said that *Planters Bank* and the several other Virginia cases allowing such preferential transfers, "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."³⁵ That this was the point upon which the *Darden* case turned seems clear from the language of the opinion.

"The 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 him under the rule laid down in the *Certain-Teed Products* case rather than our holding in the *Planters Bank* case."³⁶

Thus, the court put its finger on the precise factor which upset the equilibrium between the two creditors, and held that because of Darden's complete control of the affairs of the Ricks Company, he must have intended to hinder and delay the Lee Company. But the court did not go so far as to hold, as a matter of law, that he could not have acted in good faith by virtue of his position as a director who secured himself in preference to another creditor. This, it is submitted, would be the better rule.

It seems safe to say that the assets of many small, family corporations are augmented from time to time by loans from their officers and directors. It is important that outside creditors should feel that they are in as good a position with respect to the corporate assets as the directors who may be aware of impending disaster. Actual bad faith or intent to hinder is difficult to prove. Such difficulties could be eliminated in Virginia, as they are in other jurisdictions,³⁷ by a rule that, as a matter of law, a director is deemed to act in bad faith when he accepts a preference from an insolvent corporation, because of the inherent probability of unfairness in the diligence race.

RONALD J. KAYE

³³The court went on to say, "Of course in such cases... [directors] must act with the utmost good faith, and the transactions to be upheld must be free from the taint of fraud or suspicion." *Id.* at 740.

³⁴89 F.2d 427 (4th Cir. 1937).

³⁵*Id.* at 435.

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

³⁷For example, Georgia has a statute which says: "Directors primarily represent the corporation and its stockholders, but when the corporation becomes insolvent they are bound to manage the remaining assets for the benefit of its creditors, and cannot in any manner use their powers for the purpose of obtaining a preference or advantage to themselves." Ga. Code Ann. § 22-709 (1936).

