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# Bankruptcy -- Compositions -- A Suggestion for Federal Legislation

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power over the bank which is undesirable.[18] It is believed that the courts are increasingly accepting these reasons as outweighing the rather vague notion of "superior public rights" under which such pledges to the public have been sustained, and that there is even less reason for sustaining the pledges to secure private depositors. Expressions of doubt, and often of open disapproval, are coming from the courts, as well as from commentators, as to the validity of allowing assets to be pledged whether to secure a public depositor or a private depositor.[19]

The banks themselves are becoming increasingly interested. At the recent meeting of the executive council of the American Bankers' Association the following was placed in the program for banking reform: "Deposits of public funds in banks should have the same status as private deposits, and should not be accorded special and additional security."[20] It is submitted that such a plan is desirable from the standpoint of sound banking, and would benefit the banks, the depositors, and the public.

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**Bankruptcy—Compositions—A Suggestion for Federal Legislation.**

In these days of economic stress it has become highly desirable to find some method, less disastrous to the debtor than bankruptcy, of relieving the insolvent debtor of his excessive debts. On first appearance it would seem that the common law composition with creditors might go a long way toward meeting this demand.

A common law composition with creditors is an agreement between an insolvent debtor and two or more of his creditors,[1] whereby

[18] Commercial Bk. & Tr. Co. v. Citizens Tr. and G. Co., *supra* note 6. The courts seldom mention this reason. However, it is believed to be a material one, since a large depositor, heavily secured, would be in a position largely to dictate to the bank. On the other hand, large corporations doing business in numerous localities may refuse to patronize the smaller local banks unless given security. The best remedy for this situation, under present banking laws, seems to be to permit surety bonds without a pledge, which only decrease the amount of the bank's profits instead of actually taking away general assets upon which all depositors have a right to rely equally. See Coöp. Ass'n v. First State Bank, 168 Minn. 28, 209 N. W. 631 (1926).

[19] See Balt. & O. Ry. v. Smith, *supra* note 14, at 867; Schumacker v. Eastern Bk. & Tr. Co., *supra* note 3 at 927. Note (1931) 79 U. OF PA. L. REV. 608; (1929) 77 U. OF PA. L. REV. 916; (1932) 41 YALE L. J. 1076; (1932) 10 NEB. L. BULL. 327; (1928) 2 DAK. L. REV. 68.

[20] THE TARHEEL BANKER, May, 1933, at 30; TIME, April 24, 1933, at 47.

[1] Schroeder v. Pissis, 128 Cal. 209, 60 Pac. 758 (1900) ("It is not necessary that all the creditors of a debtor should sign a composition agreement in order

the creditors agree to discharge the whole of their respective claims upon payment of a dividend less than the full amount of the claim.[2] The consideration for the promise to accept a lesser sum in discharge of the larger sum lies in the reciprocal promises of the other assenting creditors.[3] The original claim is not discharged until the agreement to pay the lesser sum is satisfied, although the right of action thereon is temporarily suspended. If notes given as a part of the dividend are not paid on maturity, the accepting creditor is remitted to his original claim.[4] The utmost good faith is required of the debtor and if he is guilty of any fraud the composition falls and the assenting creditors are remitted to their original claims.[5]

The fraud which appears most often is that of giving a secret preference to one or more of the assenting creditors. Of course, if the non-preferred creditors know of the preference when they enter the agreement, the preference is valid and the non-preferred creditors cannot avoid the agreement.[6] Likewise, if a non-preferred creditor accepts a payment under the agreement, after he has learned of the preference, he is held to have waived his right to rescind.[7]

Where the preference was secret it is the almost universal rule[8]

to make it valid and binding. It is sufficient if two or more creditors sign."); Crawford v. Krueger, 201 Pa. 348; 50 Atl. 931 (1902).

[2] For other definitions of a composition with creditors, see *In re* Nachman Co., 6 F. (2d) 427, 439 (C. C. A. 2d, 1925); Seaweard v. DeArmond, 101 Ore. 30, 34, 198 Pac. 916 (1921).

[3] First Nat. Bank v. Ware, 95 Me. 388, 50 Atl. 24 (1901); Cohen v. P. E. Harding Const. Co. 41 R. I. 242, 103 Atl. 703 (1918).

[4] Clarke v. White, 12 Pet. 178, 9 L. ed. 1046 (U. S. 1838); Farmers' Bank of Dardanelle v. Sellers, 167 Ark. 152, 267 S. W. 591 (1925). A few cases have refused to permit the creditor to reassert his original claim even though the note given him as a part of his dividend has not been paid on maturity. This ruling, in each case, was based on the ground that the note had been taken as payment, thereby intimating that had the note been accepted merely as a promise to pay an installment under the composition agreement, the general rule would have been followed. Bartlett v. Woodworth-Mason Co., 69 N. H. 316, 41 Atl. 264 (1898); Swartz v. Brown, 135 App. Div. 913, 119 N. Y. Supp. 1024 (1909).

[5] Storms v. Horton, 77 Conn. 334, 59 Atl. 421 (1905); Ball v. McGeoch, 81 Wis. 160, 51 N. W. 443 (1892).

[6] Dillon v. Ennis, 205 S. W. 191 (Mo. 1918); Continental Nat. Bank of Chicago v. McGeoch, 92 Wis. 286 (1896).

[7] Farmers' Bank of Dardanelle v. Sellers, *supra* note 4.

[8] A careful search disclosed three cases holding that the non-preferred creditors remain bound by the composition even though there was a secret preference, but at least two of these have been overruled. Bartlett v. Blaine, 83 Ill. 25, 25 Am. Rep. 346 (1876); Page v. Carter, 16 N. H. 524, 41 Am. Dec. 726 (1844); Babcock v. Dill 43 Barb. 577 (N. Y. 1865); in addition, a dictum in a leading case states that so long as the preference agreement remains executory the non-preferred creditors remain bound. Hanover Nat. Bank Of City of N. Y. v. Blake, 142 N. Y. 404, 37 N. E. 519, 27 L. R. A. 33, 40 Am. St. Rep. 607 (1894).

that the non-preferred creditors are remitted to their original claims[9] and may credit any amount received under the composition as a part payment and sue for the balance.[10] This rule is open to the objection that it permits the first non-preferred creditor to learn of the fraud to come in and deplete the assets in the hands of the debtor to the detriment of his fellow non-preferred creditors. This objection appears sound in those cases in which all of the creditors are bound by the agreement, but in those cases in which there are creditors who never entered the agreement, the objection loses force in that it does not appear that the non-preferred creditors will suffer any more acutely from the fact that this fellow non-preferred creditor gets his full claim than from the fact that the non-assenting creditors get their full claims. The last argument in turn loses force when it is noted that creditors of an insolvent debtor will very rarely enter into a composition unless all, or at least a specified group representing substantially all of the creditors become parties. In any case it would seem a good rule, as held in a few cases,[11] that in any action by a non-preferred creditor to rescind the composition agreement, all the non-preferred creditors must be joined.

As to the preference itself, it is void; if executory it cannot be enforced,[12] and if executed it can be recovered by the debtor.[13] Thus the debtor, who was a party to the fraud practiced on the non-preferred creditors, along with the preferred creditor, is allowed to profit by his own wrongful act in that, in most cases, if the preference were not promised, the preferred creditor would not have joined the composition and the debtor would have been liable for his full claim. Indeed, as between the debtor and preferred creditor, the equities seem to be with the creditor who was entitled to his full

[9] Kullman v. Greenbaum, 92 Cal. 403, 28 Pac. 674 (1891); Powers Dry Goods Co. v. Harlin, 68 Minn. 193, 71 N. W. 16 (1897).

[10] *In re* Chaplin, 115 Fed. 162 (E. D. Mass. 1902); Burgess v. Simpson Grocery Co., 128 Ga. 423, 57 S. E. 717 (1907).

[11] Cheveront v. Textor, 53 Md. 296 (1879); Evans, Fite, Porter and Co. v. Bell, 83 Tenn. 569 (1885).

[12] Batchelder & Lincoln Co. v. Whitmore, 122 Fed. 335 (C. C. A. 1st, 1903); Brown v. Nealley, 161 Mass. 1, 36 N. E. 464 (1894).

[13] Brown v. Everett-Ridley-Ragan Co., 111 Ga. 404, 36 S. E. 813 (1900). An exception to this rule is found in New York. The New York cases unanimously hold the preference void and refuse to enforce it when executory. Klaw v. Famous Players-Lasky Corp., 239 N. Y. 592, 147 N. E. 209 (1924); Burk v. Wright, 226 App. Div. 274, 235 N. Y. Supp. 105 (1929), but where the preference has been executed, the debtor is not allowed to recover the sum paid as a preference on the ground that the parties being *in pari delicto* the courts will leave them as it finds them. Solinger v. Earle, 82 N. Y. 393 (1880); Mehr v. Starr, 138 N. Y. Supp. 317 (1912).

claim and gave it up for the promised dividend and preference, which in most cases added together is somewhat less than the full claim. The only favorable side of the rule reached seems to be that the non-preferred creditors can attack these assets if in the hands of the debtor, and this is in turn subject to the criticism above set forth.

In respect to the dividend due to the preferred creditor under the composition agreement, the overwhelming majority of courts holds that, while the non-preferred creditors can assert their original claims after the fraud is discovered, the preferred creditor is bound by the agreement, and his recovery is limited to the dividend therein provided, which he is permitted to retain.[14]

The fact that on discovery of the preference the non-preferred creditors may race for the assets lends instability to the composition and impairs its usefulness as an insolvency device. It would seem a sound rule, and a deterrent to secret preferences, to hold the debtor bound to pay both the preference and the preferred creditor's dividend, the payment, however, to be made, not to the preferred creditor, but to the non-preferred creditors as a bonus above the specified dividends. Of course, if this rule were applied, it follows that the non-preferred creditors should be deprived of their right to rescind the composition agreement. This would make it impossible for the first non-preferred creditor to learn of the fraud to get an advantage in the race for the debtor's remaining assets, and would seem to reach a generally desirable result.

Assuming such results to be established, there remains but one obstacle preventing the composition from becoming an effective device for relieving harassed debtors, namely, inability to bind the non-assenting parties by compulsion. This obstacle might easily be removed by a statutory measure analogous to that provided for in bankruptcy compositions.[15]

A composition, if its legal handicaps are removed as above suggested, has at least three distinct advantages over bankruptcy proceedings:

(1) The composition permits the debtor to retain control of his assets, while in the bankruptcy proceedings the assets are turned over to a referee to administer.

[14] Bank of Commerce v. Hoeber, 88 Mo. 37, 57 Am. Rep. 359 (1885); Gross, Kelly & Co. v. Bibo, 19 N. M. 495, 145 Pac. 480 (1914). One case was found which permitted the preferred creditor, on being deprived of the preference, to sue on his original claim. Stewart v. Blum, 28 Pa. 225 (1857).

[15] 30 STAT. 549 (1898); 36 STAT. 839 (1925), 11 U. S. C. A. §30 (1926).

(2) After a discharge through a composition the debtor usually is able to continue right on in his old established business, whereas bankruptcy proceedings commonly destroy his business and force him to start all over.

(3) A composition of this nature can be effected within a few days with little or no cost of administration, while the administration of a bankrupt's estate generally takes a relatively long period and often is so expensive that in the case of small estates there is nothing at all left for distribution to the creditors.[16]

The National Bankruptcy Act as it stood before the Amendment of March 3, 1933, provided that the bankrupt might offer either before or after adjudication, terms of composition to his creditors after, but not before, he has been examined in open court, or at a meeting of his creditors, and has filed in court the schedule of his property and list of his creditors required to be filed by bankrupts.[17] The inability to bind the non-assenting creditors by compulsion found in the common law composition is eliminated under the bankruptcy composition by a provision that the composition may be confirmed, thus binding all the creditors, whenever it has been accepted in writing by the majority of the creditors representing a majority in amount of such claims.[18]

As regards the method of dealing with the problem of hidden assets and secret preferences, it is doubtful if that provided for in the bankruptcy composition is any more satisfactory than the present method of the common law composition. The Bankruptcy Act provides merely that the judge may set aside the composition upon the application of the parties in interest filed at any time within six months after the composition has been confirmed if it shall appear that fraud was practiced in procuring the composition.[19] The estate is then automatically administered in bankruptcy, a result which maintains equality but is no better than can be reached under a common law composition by anyone of the non-preferred creditors starting bankruptcy proceedings after learning of the fraud. It further appears that this provision under the bankruptcy composi-

[16] The high cost of administering small estates in bankruptcy, as well as the length of time necessary, is clearly shown in the charts prepared and used by Mr. Billig in his article, *Extra Judicial Administration of Insolvent Estates: A Study of Recent Cases* (1930) 78 U. OF PA. L. REV. 293.

[17] *Supra* note 15.

[18] *Supra* note 15.

[19] 30 STAT. 550 (1898), 11 U. S. C. A. §31 (1926).

tion is weak in that it limits the right to attack the composition to six months.

The composition in bankruptcy undoubtedly overcomes some of the weaknesses manifested in the common law composition as it now stands, but is far from a desirable method of meeting the present day need. It is too formal, it has attached to it the stigma of bankruptcy, and it does not satisfactorily deal with the problems of hidden assets and secret preferences, for which reasons compositions in bankruptcy have been relatively seldom resorted to.[20]

Section 73 of the Bankruptcy Act enacted by Amendment March 3, 1933,[21] provides for compositions by debtors. This amendment was enacted for the express purpose of aiding debtors to avoid bankruptcy. It follows generally the terms of the earlier provision for compositions in bankruptcy, is open to the same criticism, and seems to offer no advantage not avaliable under the earlier provision.[22]

Due to the prevalent dissatisfaction with bankruptcy proceedings, some years ago the National Credit Men's Association set up a system of liquidating insolvent estates known as "friendly adjustment," which seems to be working with some success.[23] As a legal device it amounts to a common law composition with the creditors accepting their *pro rata* share of the assets in full discharge of their claims. Of course, if any creditor or the debtor does not assent, the estate will have to go through bankruptcy, but the Association, so far, seems to have had marked success in getting all the parties to assent.

The method of liquidation is analogous to that of bankruptcy in that the assets are turned over to a third party to administer, in this case a liquidating agent of the Association. The outstanding advantages claimed for the "friendly adjustment" are that it car-

[20] See, Report By the Attorney General (Prepared By The Solicitor General) To The President On The Bankruptcy Act And Its Administration In the Courts Of The United States, Dated December 5, 1931, at page 10. ("Unfortunately the composition machinery is so cumbersome and so easily abused by minority creditors that it is quite unattractive to honest debtors, as evidenced by the fact that scarcely one per cent of the cases in bankruptcy terminate in compositions.")

[21] 11 U. S. C. A. Supp. §202 (1933).

[22] *Supra* note 15.

[23] For a more thorough study of "friendly adjustments," see Billig, *What Price Bankruptcy: A Plea For "Friendly Adjustment"* (1929) 14 CORN. L. Q. 413, and Billig, *supra* note 16. For an adverse criticism of "friendly adjustments," see Gamer, *On Comparing "Friendly Adjustment" and Bankruptcy* (1931) 16 CORN. L. Q. 35.

ries out the liquidation much more rapidly than is usual in bankruptcy, and that it pays larger dividend to the creditors. The rapidity of administration is accounted for by the fact that the Association maintains permanent liquidating forces which keep in close contact with prospective purchasers of an insolvent's stock, while the higher dividend is due to the lower cost of administration which in every case is a flat ten per cent.

It has been objected that there is too great a chance for fraud in this type of liquidation, but it would seem that the local agency of the Association is in at least as good position as the court to ascertain the true state of the debtor's affairs. The real objections to "friendly adjustments," in respect to our present need, seem to be that under this plan ten per cent of the assets, which might well be saved to the debtors, is paid to some outside party, and that, as is true of a bankruptcy proceeding, the debtor is commonly put out of business.

From the purely practical standpoint, it seems that in many cases the parties themselves could effectuate a composition which, by saving the costs of a bankruptcy proceeding or of a friendly adjustment, would reserve to the debtor sufficient assets to enable him to continue on in his business and at the same time pay to the creditors larger dividends than would either a bankruptcy or a "friendly adjustment."

It would seem that a Federal statute reaching such a desirable result and still containing sufficient checks against fraud might well be worked out along the following lines:

(1) An insolvent debtor may at any time send to each of his creditors a schedule of his assets and a list of his creditors, together with notice of a creditor's meeting to be held not less than ten days, and not more than twenty days, hence, for the purpose of working out, if possible, the terms of a composition.

(2) If, at the meeting of the creditors, terms of composition are arranged which are satisfactory to the debtor and to a majority of the creditors representing a majority in amount of the claims, who signify their assent by signing an agreement embodying the terms arranged, all of the creditors shall be automatically bound. There shall be reserved to any non-assenting creditor the right to apply within ten days to a court of equity of the United States sitting in chambers to set aside the agreement for good cause shown.

(3) If no non-assenting creditor applies to have the agreement

set aside within the ten day period, or, if on such application a decision favoring the validity of the agreement is handed down, the agreement shall be binding as of the date assented to as required, and the rights of the parties shall thereafter be limited to the terms of the agreement and the terms of this act.

(4) If the parties cannot reach an agreement as to the terms of the composition, or if on application of a non-assenting creditor, the agreement is set aside, the estate shall on the petition of any interested party, be automatically declared bankrupt.

(5) A copy of the composition agreement, containing the signatures of the assenting creditors and of the debtor, together with a verified list of all the debtor's creditors and a verified schedule of his assets shall be filed by the debtor with the U. S. district court, for purposes of record.

(6) If the debtor fails to make any payment as provided for in the agreement, any creditor may cause the estate to be administered in bankruptcy, but the claims to be filed by the creditors who were bound by the composition agreement shall be those provided for in the composition and not the original claims. If, however, there is a surplus remaining after all claims, both those provided for in the composition and those subsequently acquired against the debtor, have been paid in full, the surplus shall be paid *pro rata* to the creditors bound by the composition until their original claims are paid in full.

(7) If at any time within five years after the composition became binding, assets which were fraudulently hidden at the time of the composition, including any fraudulent conveyance made within three years prior thereto, are discovered, on the application of any interested party such assets shall be recovered and paid *pro rata* to the creditors bound by the composition as a bonus above the dividend agreed upon in the composition, even though the effect of such payment is to pay such creditors more than their original claims with interest. Further, the debtor shall be subject to a criminal action.

(8) If, at any time within five years after the composition became binding, a secret preference to one of the creditors is diserence and the dividend to the preferred creditor shall be recovered and paid *pro rata* to the other creditors bound under the composition, as a bonus above the dividend agreed upon in the composition even though the effect of such payment is to pay such creditors more than their original claims with interest. Further, both the debtor and the preferred creditor shall be subject to criminal actions.

It is submitted that an act based on the above suggestions would go a long way toward meeting the present need for relieving hard pressed debtors without destroying their businesses and without working undue hardships on their creditors; and that such an act might well be enacted by Congress as a system of relief alternate to bankruptcy.

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**Bills and Notes—Interpretation of "All Prior Endorsements Guaranteed."**

A draft was endorsed without authority by an attorney of the payee and deposited for collection in a bank which forwarded it with "all prior endorsements guaranteed" to the drawee who on the back of the draft had reserved the right to determine the authority of an attorney endorsing it. *Held:* Under these particular facts, the collecting bank by its endorsement guaranteed to the drawee only the genuineness of the prior endorsement and not the authority of the endorser.[1]

Incited by the decision in two cases in which the drawee bank could not recover back the money paid on a forgery, where the collecting bank had used a restrictive endorsement, the New York Clearing House in 1896 adopted a rule requiring its members to send no paper through the exchange which was restrictively endorsed, unless all prior endorsements were guaranteed.[2] Their lead has since been followed by practically every clearing house in the country.

Adequate protection is afforded to an endorsee who is a holder in due course both in the case of forgeries and unauthorized prior

[1] Holloway v. Barbee *et al.*, 203 N. C. 713, 166 S. E. 895 (1932). Inquiry has revealed that this case is regarded by some as holding that "all prior endorsements guaranteed," guarantees to the drawee only the genuineness of prior endorsements and not the authority of the endorser. This is an erroneous view since the court decides no more than that such endorsement guarantees only the genuineness of prior endorsements where the drawee has assumed the risk of the authority.

The bank is designated as a drawee in this comment, since under §87 of the N. I. L., "Where an instrument is made payable at a bank, it is equivalent to an order to the bank to pay the same for the account of the principal debtor thereon."

[2] First National Bank of Belmont v. First National Bank of Barnesville, 58 Ohio St. 207, 50 N. E. 723 (1898). Many of the clearing houses no longer use the form "all prior endorsements guaranteed," but the members contract to assume such responsibility. Some of the forms in use are: "endorsements guaranteed," "previous endorsements guaranteed," "absence of endorsements guaranteed," "absent endorsement hereby supplied and guaranteed."