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BANKS AND BANKING--COLLECTIONS OF OUT-OF-TOWN ITEMS--PRIORITIES ON INSOLVENCY OF CORRESPONDENT BANK

BANKS AND BANKING — COLLECTIONS OF OUT-OF-TOWN ITEMS — PRIORITIES ON INSOLVENCY OF CORRESPONDENT BANK — In settlement of an adverse balance on the day's clearings, *D* bank gave to plaintiff a draft on its metropolitan correspondent. *D* bank then became insolvent, and on presentment the drawee refused to pay, though *D* bank had sufficient funds on deposit to cover the draft. The receiver allowed plaintiff's claim as a general one. There was no indication that *D* knew it was insolvent at the time it issued the draft. Plaintiff then brought suit against the receiver to establish a preferred claim.

Held, that the issuance of the draft created a trust fund, and plaintiff bank was entitled to a preferred claim in the closed bank's assets. *First Nat. Bank of Milaca v. Benson*, (Minn. 1934) 255 N. W. 482.

Where items are sent for collection by an out-of-town bank directly to the drawee bank, which remits by sending its draft on a correspondent but becomes insolvent before the draft is paid, the cases are not agreed as to whether a preference [1] will be allowed in favor of the collecting bank. One line of cases allows a preferred claim on the theory that the drawee is agent to collect from itself and that the draft represents trust funds in the hands of the drawee.[2] Another line of cases does not allow a preference, on the ground that the items are not sent for collection but for payment, and hence the draft creates only a debtor and creditor relationship.[3] The facts in the instant case differ from these cases in that the collecting bank is another local bank. Some courts hold that this fact makes a difference and refuse to allow a preference.[4] Other courts say this fact makes no difference, allowing the claim as preferred [5] or not [6] as they would conclude in the former situation. In both cases there are logical difficulties in allowing a preference on the theory of a trust. First, it is difficult to see how a drawee bank can be agent to collect from itself when items are presented to it for pay-

[1] Regarding the use of the word "preference" in this connection, see 33 MICH. L. REV. 628, n. 1 (1935).

[2] Edwards v. Lewis, 98 Fla. 956, 124 So. 746 (1929), criticized in 14 MINN. L. REV. 407 (1930); People ex rel. v. People's Bank & Trust Co., 353 Ill. 479, 187 N. E. 522, 89 A. L. R. 1328 (1933); Kesl v. Hanover State Bank, 109 Kan. 776, 204 Pac. 994 (1921). Some courts have allowed a priority on the theory that the draft operates as a *pro tanto* assignment: Bank of Republic v. Republic State Bank, 328 Mo. 848, 42 S. W. (2d) 27 (1931); Federal Reserve Bank of Richmond v. Peters, 139 Va. 45, 123 S. E. 379, 42 A. L. R. 742 (1924). *Contra*: Pecos County State Bank v. Lynch, (C. C. A. 5th, 1934) 69 F. (2d) 226; Leach v. Battle Creek Sav. Bank, 203 Iowa 507, 211 N. W. 520, 212 N. W. 760 (1926). Such a holding is also contra to the Uniform Negotiable Instruments Law, secs. 127, 189.

[3] Leach v. Citizens' State Bank of Arthur, 203 Iowa 782, 211 N. W. 522 (1926); People v. Merchants' & Mechanics' Bank of Troy, 78 N. Y. 269, 34 Am. Rep. 532 (1879); Hecker-Jones-Jewell Milling Co. v. Cosmopolitan Trust Co., 242 Mass. 181, 136 N. E. 333 (1922). See also 14 MINN. L. REV. 407 (1930). Where a person purchases a draft from a bank which becomes insolvent before the draft is cashed, no preference is allowed. Spiroplos v. Scandinavian-American Bank of Tacoma, 116 Wash. 491, 199 Pac. 997, 16 A. L. R. 181 (1921); 3 MICHIE, BANKS AND BANKING 316 (1931). See, however, the curious case of Fulton v. B. R. Baker-Toledo Co., 125 Ohio St. 518, 182 N. E. 513 (1932), noted in 31 MICH. L. REV. 843 (1933), reversed in 128 Ohio St. 226, 190 N. E. 459 (1934), noted 32 MICH. L. REV. 1161 (1934).

[4] First Nat. Bank of Larned v. Farmers' State Bank of Larned, 120 Kan. 706, 244 Pac. 1039, 44 A. L. R. 1531 (1926), distinguishing a prior holding in Kesl v. Hanover State Bank, 109 Kan. 776, 204 Pac. 994 (1921), where a preference was allowed on the ground that the transaction in the latter case took place through the mails.

[5] Farmers' Bank of Bowling Green v. Cantley, (Mo. App. 1929) 16 S. W. (2d) 642, holding agency in both situations.

[6] Leach v. Citizens' State Bank of Arthur, 203 Iowa 782, 211 N. W. 522 (1926), holding agency in neither case.

ment.[7] The drawee is merely complying with its duty to depositors to pay items drawn on their accounts when presented.[8] Second, nothing has in fact been added to the bank's assets, so there has been no augmentation, nor is there a *res* [9] upon which to base a trust.[10] When the drawee charged the drawers' accounts and issued its draft to the remittor, it was merely substituting the remittor for the depositors as its creditor, the transaction being the making of a few book entries.[11] In at least twenty states the question has been settled by the Bank Collection Code [12] or other statute.[13] Since the allowance of a preferred claim presupposes a fiduciary relationship,[14] an augmentation of assets,[15] and the tracing of the funds into the hands of the receiver,[16] it is submitted that the result in the instant case would be better accomplished by legislation.

B. H. D.

[7] Leach v. Citizens' State Bank of Arthur, 203 Iowa 782, 211 N. W. 522 (1926); 14 MINN. L. REV. 407 (1930). This would seem to be especially true where the transaction takes place over the counter, as in the principal case, in which situation there is no reason why the remittor cannot demand cash. First Nat. Bank of Larned v. Farmers' State Bank of Larned, 120 Kan. 706, 244 Pac. 1039, 44 A. L. R. 1531 (1926).

[8] 2 MORSE, BANKS AND BANKING, 6th ed., sec. 453 (1928).

[9] The phrase "augmentation of assets" is used synonymously with the word "res." Townsend, "Constructive Trusts and Bank Collections," 39 YALE L. J. 980 at 1003 (1930).

[10] Nyssa-Arcadia Drainage Dist. v. First Nat. Bank, (D. C. Ore. 1925) 3 F. (2d) 648; Larabee Flour Mills v. First Nat. Bank of Henryetta, (C. C. A. 8th, 1926) 13 F. (2d) 330; Hecker-Jones-Jewell Milling Co. v. Cosmopolitan Trust Co., 242 Mass. 181, 136 N. E. 333 (1922); People v. Merchants' & Mechanics' Bank of Troy, 78 N. Y. 269, 34 Am. Rep. 532 (1879); State ex rel. Sorensen v. Nebraska State Savings Bank, (Neb. 1935) 259 N. W. 46. For a contrary view, see Farmers' Bank of Bowling Green v. Cantley, (Mo. App. 1929) 16 S. W. (2d) 642. The doctrine of augmentation of assets is criticized in 75 UNIV. PA. L. REV. 69 (1926).

[11] 75 UNIV. PA. L. REV. 69 (1926).

[12] Sec. 13 (2).

[13] See, for example, Iowa Code (1931), sec. 9239-c1; N. C. Code (1931), sec. 218 (c), subsec. (14).

[14] People ex rel. v. People's Bank & Trust Co., 353 Ill. 479, 187 N. E. 522, 89 A. L. R. 1328 (1933); 37 YALE L. J. 1150 (1928).

[15] See citations in note 14, supra.

[16] See citations in note 14, supra; also 3 MICHIE, BANKS AND BANKING 307 (1931). For discussions on the subject of tracing trust funds in insolvent banks, see Townsend, "Tracing Technique in Bank Preference Cases," 7 CINN. L. REV. 201 (1933); Townsend, "Constructive Trusts and Bank Collections," 39 YALE L. J. 980 (1930).