Interest on Claims in Receivership Proceedings

Ralph E. Clark

INTEREST ON CLAIMS IN RECEIVERSHIP PROCEEDINGS*

INTEREST ON UNSECURED CLAIMS

OUTSIDE the cases of receivership, the Supreme Court of the United States has said:

> "We reach the conclusion that whatever may have been the English and early American rule, the tendency in Virginia as elsewhere in this country, is to allow interest on contracts to pay money from the date that the debt becomes due."[1]

Interest is allowed as a matter of law in cases of contract or the unlawful detention of money.[2] In the absence of statute the general rule is that in actions for tort the allowance of interest is not an absolute right[3]—it rests in the discretion of the court or jury.[4]

The rule generally announced governing the payment of interest on claims in receivership proceedings may be briefly stated as follows:—[5]

> "As a general rule, after property of an insolvent passes into the hands of a receiver, interest is not allowed on claims against the funds. * * * The delay in distribution is the act of the law; it is a necessary incident to the settlement of the estate."

This rule was laid down early in the history of receiverships, has been generally followed by courts of equity, and the substance of this rule has been incorporated in the bankruptcy statutes of Eng-

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* By Ralph E. Clark, of the Cincinnati Bar, author of CLARK ON RECEIVERS.

[1] Am. Iron Co. v. Seaboard Air Line (1913), 233 U. S. 261 at 265.

[2] Lincoln v. Claflin (1868), 7 Wall. 132 at 139.

[3] Drumm-Flato Commission Co. v. Edmisson (1907), 208 U. S. 534 at 539.

[4] The Scotland (1885), 118 U. S. 507 at 518; Lincoln v. Claflin (1868), 7 Wall. 132 at 139; Bates v. Dresser, March 1, 1920, U. S. Supreme Court.

[5] Thomas v. Western Car Co. (1893), 149 U. S. 95 at 116; New York Trust Co. v. Detroit T. & I. Ry. (1918), 151 Fed. 514 at 519.

land and the United States. Various reasons have been given for the above rule. The Connecticut Supreme Court of Errors has said:[6]

> "No debt can arise against an insolvent estate in the hands of a receiver. From this principal comes the general rule that only claims as then existing can be recognized as obligations of the estate. For this reason interest cannot be allowed on claims after insolvency has been judicially declared."

Judge William H. Taft, then of the Circuit Court of Appeals, Sixth District, in the case of *Chemical National Bank* v. *Armstrong,* 16 U. S., App. 465, at page 535, says:

> "It will not do to say that the date fixed for stopping interest on all claims is a mere matter of convenience in calculating which works no injury to anyone because all are treated alike. The creditor with a debt bearing 8% interest is very injuriously affected in comparison with the creditor whose debt bears but 4%."

Lindley, L. J., in the case of *In re Browne & Wingrove* [1891], L. R. 2 Q. B. D., 574 at 581, says:

> "The rule which prevents proof for future interest is not a positive enactment—it is rather a rule of convenience. In ordinary cases it produces no injustice."

Mr. Justice Lamar in *American Iron Co.* v. *Seaboard Air Line* (1913) 233 U. S. 261 at 266 said:

> "And it is true as held in *Tredegar Co.* v. *Seaboard Railway,* 183 Fed. Rep. 289, 290. That as a general rule, after property of an insolvent is in *custodia legis,* interest thereafter accruing is not allowed on debts payable out of the funds realized by sale of the property. But that is not because the claims had lost their interest bearing qualities during that period, but is a necessary and enforced rule of distribution, due to the fact that in case of receiverships the assets are generally insufficient to pay all debts in full. If all claims were of equal dignity and all bore the same rate of interest

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[6] Lippitt v. Thomas L. & T. Co. (1914), 88 Conn. 185 at 206, 90 Atl. 369.

> from the date of the receivership to the date of final distribution, it would be immaterial whether the dividend was calculated on the basis of the principal alone, or of interest and principal combined. But some of the debts might carry a high rate and some a low rate, and hence, inequality would result in the payment of interest which accrued during the delay incident to collecting and distributing the funds. As this delay was the act of the law, no one should thereby gain an advantage or suffer a loss. For that and like reasons, in case funds are not sufficient to pay claims of equal dignity, the distribution is made only on the basis of the principal debt. But that rule did not prevent the running of interest during receivership; and if, as a result of good fortune or good management, the estate proved sufficient to discharge the claims in full, interest as well as principal should be paid."

It is difficult, if not impossible, to reconcile all these different statements made by courts of high authority. We agree with the statements made by Lindley, L. J., and Mr. Justice Lamar, just quoted. When a receiver is appointed of the property of an insolvent, be he an individual or corporation—liens, charges and equities which existed before receivership are not changed, altered or annulled by reason of the receivership. Furthermore, if a claimant has a substantive right or claim against the individual or corporation before insolvency, this substantive right is not cancelled or annulled or divested by the receivership. A court of equity cannot change the contracts and substantive rights of a claimant which existed before receivership. If this is true, then it is difficult to conceive how a claimant's substantive right to interest against the insolvent individual or corporation can be annulled or arrested at the time of appointment of receiver. When the Connecticut Supreme Court of Error says: "That no debt can arise against an insolvent estate in the hands of a receiver," we believe this court nas not stated tne law correctly, if this court means that no obligation to pay interest which existed before receivership continues after appointment of receiver. It is true that after appointment of a receiver, no obligation can be initiated or created anew by the party whose property is in the hands of a receiver so as to bind such property. But it certainly cannot be true that an obligation to pay interest ceases to be an obligation by the appointment of a receiver. The New York court in the case of *Fera* v. *Wickham* (1892)[7] says: "By an assignment in trust for the assignor's creditors, what natural equities previously existed become suspended by an intervention by the rights of other creditors." Such a statement we believe, is in violation of the fundamental principles of equity, and is not in accord with the most recent rulings of the Circuit Court of Appeals for the southern district of New York,[8] nor with the most recent rulings of the Supreme Court of the United States.[9] We believe the rule stopping interest at time of appointment of receiver is a rule of convenience, and in most cases does work for an equitable distribution to creditors, but not in all cases.

When a court of equity appoints a receiver of the property of an insolvent person or corporation for the purpose of distributing this property to creditors, the court appointing the receiver has deprived claimants of their ordinary legal and equitable remedies against this property. No levy, execution or attachment can be brought against the assets of the insolvent when they are in the hands of a receiver. The court of equity having deprived claimants of their ordinary remedies invites such claimants to submit such claims to a receiver or to a master for allowance and liquidation, or rejection, making proper provisions for the receiver's or master's findings to be reported to the court for confirmation. It is the court's duty to distribute the assets equitably and ratably to claimants whose claims are properly presented and proved. The appointment of a receiver cannot deprive a debt of its interest-bearing quality; neither can it annul the contract of the insolvent to pay interest. If there is enough property to go around, justice and the contractual rights of the claimants demand that interest should be carried down to the actual payment of the money.[10] Therefore, to divide the property up equit-

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[7] 135 N. Y. 223. See also People v. Am. Loan & T. Co. (1902), 172 N. Y 371 at 378, when Vann, J., says: "By law the creditor becomes the equitable owner of the assets and the administration of affairs is for their benefit as such."

[8] Penn. Steel Co. v. N. Y. City Ry. Co. (1912), 198 N. Y. 721 at 742.

[9] Wm. Filene's Sons Co. v. Weed (1917), 245 U. S. 597.

[10] Lord Mansfield in Robinson v. Bland (1760), 2 Burr. 1087; Blair v. Clayton Ent. Co. (1910), 9 Del. Ch. 98; Williams, Adm. v. Am. Bank (1842), 4 Metc. 317 at 317.

ably and ratably if sufficient to go around, interest must be figured up to the time of distribution.[11] If there is not sufficient property to go around, which is of course the case when insolvency takes place, then the only equitable and ratable distribution of the assets appears to us to be to figure interest according to contracts on claims up to the time of distribution, then declare such a dividend as is possible on the amount of the claims, including interest.[12] However, if all claims bear the same rate of interest, we can of course stop interest at time of appointment of receiver or any other subsequent time, and the division would be equitable and ratable; but if one creditor has a debt bearing 8% interest, the stopping of interest at time of appointment of receiver may very injuriously affect him in comparison to the creditor whose debt bears but 4%.

Although authorities without number may be found for stopping interest at time of appointment of receiver, nevertheless if it is necessary to calculate interest on all claims up to the time of distribution in order to make a truly equitable and ratable distribution, then we believe this ought and can be done without violating any positive usage and rule of equity.

INTEREST ON SECURED CLAIMS

A debtor when incurring his obligation to pay and giving security for such obligation, generally but not always by contract, secures the payment of interest as well as the principal of the debt. If he does so secure the payment of interest, the creditor who has a right to hold or appropriate the security or collateral can hold or appropriate it when default occurs of either interest or principal. If interest is so secured, then the creditor can not be compelled to relinquish his right to hold or appropriate the security until he has been paid both principal and all interest due up to the time he relinquished the security. If the security is realized and he is not paid his debt in full. then

[11] Cases of solvency. People v. Merchant's Trust Co. (1907), 187 N. Y. 293, 79 N. E. 1004; First Nat. Bank v. J. I. Campbell Co. (1908), 52 Tex. Civ. App. 445, 114 S. W. 887. See Annotation L. R. A. 1917 D., p. 1166.

[12] Blair v. Clayton Ent. Co. (1910), 9 Del. Ch. 95 at 98; Re Murray, Assignee of Commercial Ins. Co. (1836), 6 Paige 204; Amer. Iron Co. v. Seaboard Air Line (1913), 233 U. S. 261 at 266.

his actual claim against the debtor insolvent is the original claim and *all interest up to date of presenting his claim,* less the actual amount realized by his security. In other words, out of the security or securities if they are more than enough to pay the secured creditor, he must be paid his full claim with interest to date of payment before any balance can be turned over to the receiver for distribution to other creditors.[13] If interest on the creditor's claim is not subject to lien, then the question arises, shall interest be calculated on the creditor's secured claim when the collateral or security is realized and proceeds applied toward payment of the secured creditors claim? If the creditor has no such lien covering his interest, then he can not receive from the realization of his collaterals a sum greater than his original debt, less interest. However, after he has realized his securities, he still has a claim against the insolvent for the balance of his original debt and for interest on it, whether this be calculated to date of insolvency or to date of presentation of claim.

Now we come to the question on what basis shall the claim of the secured creditor against the general assets be allowed? The so-called Bankruptcy Rule forces the secured creditor to realize his securities first and prove for the balance. On this balance he is to receive his dividends. The so-called Chancery Rule allows the secured creditor to receive dividends upon the original claim unreduced provided that he shall not in the aggregate receive more than the total amount of his debt or claim.

We believe the Chancery Rule in insolvency and Receivership cases can not be upheld on equitable principles, although high authority can be cited for upholding it.[14] Under the Chancery Rule and under the rule refusing to calculate interest subsequent to appointment of receiver a secured claimant would present his claim against the general assets for the original amount with interest up to the time of insolvency and appointment of receiver. Under the

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[13] Spring Coal Co. v. Keech (1902), 239 Fed. 48, 1917 L. R. A. 1152 and notes; Huff v. Bidwell (1914), 218 Fed. 6 at 9; First Nat. Bank v. Ewing, 103 Fed. 168.

[14] U. S. cases supporting Chancery Rule are Chemical Nat. Bk. v. Armstrong, 16 U. S. App. 465, 59 Fed. 372, 8 C. C. A. 155, 28 L. R. A. 231, 65 Fed. 573, 13 C. C. A. 47; Merrill v. Nat. Bank of Jacksonville (1898), 173 U. S. 131. See however Westinghouse Elec. & Mfg. Co. v. Idaho Ry. L. & P. Co. (1915), 228 Fed. 972.

Bankruptcy Rule he would present his claim for the balance due after realization of his collateral with interest up to the time of appointment of receiver.

Our idea of a true equitable and ratable distribution along what may be called scientific lines, would we believe, be to calculate the original claim with interest agreed upon up to the time of making distribution, subtract from this the amount realized from securities or collateral realized, and pay dividends upon the balance.

INTEREST ON PRIORITY CLAIMS

When it has been determined that interest shall be allowed on ordinary claims secured by mortgage, pledge, etc., the next question which naturally presents itself is, shall interest be allowed on claims which by statute or otherwise have precedence or priority over such secured claims? An ordinary lien is created by a contract between the parties. If that lien contract covers interest on the obligations secured, then interest must be added to the claim; if that contract does not include interest, then any claim for interest must be met out of general assets. Suppose however, the law either statutory or otherwise, says that public policy demands and law or equity recognizes that certain claims when insolvency takes place shall be given priority even over ordinary secured claims. Take for instance claims for supplies secured by a lien which by statute takes priority over mortgages. Does such a statute giving priority to certain claims, cover interest on such claims? Of course, it is impossible to lay down a rule covering all statutes when each separate statute may be worded differently from every other statute. In the first place, the appointment of a receiver has not created any claims, neither has it added to nor taken away from any claims. If a claim before receivership drew interest, its interest bearing quality has not been taken away from it by appointment of a receiver. On the other hand, if a claim did not bear interest, the appointment of a receiver will not of itself make it interest-bearing.

As to interest on claims secured by a lien which is given priority and which undoubtedly come within the case of *American Iron Co.* v. *Seaboard Air Line,* there seems to be little doubt. As to cases wherein there is no lien but only a priority declared by statute or by the six months priority rule or by other usages and rules of equity, these cases present more difficulties.

We have two very important Federal Appellate Court cases[15] wherein interest was allowed on claims for supplies which were preferred by the so-called six months' rule. In each of these cases there were enough funds to pay such supply claimants in full with interest, without encroaching on the mortgage security.

A case presents much greater difficulties wherein the holders of priority claims ask interest on the same, subsequent to time of appointment of a receiver, and if such interest is paid it must be taken out of the corpus of the estate and so reduce the amount payable to the mortgage creditors. This situation is fully discussed in the case of *New York T. Co.* v. *Detroit T. & I. Ry. Co.* (1918) 251 Fed. 514. The court in that case concedes that in his circuit the rule prevails that six months' claims are payable out of the earnings of the receivership, or even in a proper case, from the corpus of the company's property in preference to the mortgages foreclosed. The court concedes that the case before him (mainly supplies of railroad ties) comes under the six months' rule, and in refusing interest cites as authority the case of *Thomas* v. *Western Car Co.*, 149 U. S. 116. The court, however, overlooks we believe, the fact that Mr. Justice Shiras in the *Thomas* case specifically makes the statement that the claim for car rentals did not come under supplies furnished from day to day and necessary for the maintenance of the road. Furthermore, the claim for interest in the *Thomas* case was attempted to be inflicted on the mortgagors as a penalty for resisting claims. This was refused. Since in the *Thomas* case the court refused to allow the car claims as six months priority claims at all, it is very difficult to apply what the court said concerning interest on those claims to a case like the *N. Y. Trust Co.* case where the court actually concedes that the claims themselves come under the six months rule.

Says Mr. Justice Lamar in *Am. Iron Co.* v. *Seaboard Air Line* when commenting on the *Thomas* case:

> "For manifestly, the law does not contemplate that either the debtor or the trustees can, by securing the appointment

[15] Penn. Steel Co. v. N. Y. City Ry. Co. (1914), 216 Fed. 458 at 471; Texas Co. v. International & G. N. Ry. Co. (1918), 250 Fed. 742 at 745.

of Receiver, stop the running of interest on claims of the highest dignity."

This is true whether the mortgage claims are not paid at all or are paid in part or in full. The only justification of stopping payment of interest on claims at time of appointment, is because in cases of a deficiency of assets the cutting off of interest at time of appointment amounts to the same thing as adding it to claims of equal dignity and then in the distribution scaling these claims down below the original claims plus this interest added. In other words, as between claims of equal dignity and equal interest bearing quality it does not help to add a certain per cent and then have to take it off again for lack of funds. But this rule of interest does not apply as between claims of different dignities, because it does not work an equitable and ratable distribution. For instance, if $1,000 and interest is due on first mortgage claims, and $1,000 and interest is due on second mortgage claims, all other things being equal and we cut off the interest on the first mortgage claims, we are actually depriving the first mortgage holders of what they are entitled to by contract of mortgage. If the contract of mortgage says so, this interest is covered by the pledge, and the court can not cut it out in favor of the second mortgagee. Does it make any difference if the priority claimant bases his claim on a statute or usage and rule of equity rather than on a contract lien? Judge Sater in the *N. Y. Trust Co.* case, concedes that the six months claims have priority over the mortgage claims, but refuses to allow interest on the six months claims beyond the time of appointment of receiver. If Judge Sater's proposition is sound, which gives the six months claims priority over mortgages, then we are unable to see why interest on these claims should not be given priority over the mortgages. If the supply claimants have their money used and tied up to keep up the mortgage security, they it would seem should be entitled to interest on the same, as well as the mortgage security holders themselves are entitled to interest. If the policy of the law says that supply claimants are and have added their property to the mortgagee's security, and the security covers interest on the mortgage debt, then the supply creditor has added his property and lost the earning power of that property in order that the mortgage creditor may recover his debt and also interest on same. We can not from the facts of the case of *N. Y.* v. *Detroit,* distinguish it on principle from *Am. Iron Co.* v. *Seaboard Air Line; Penn. Steel Co.* v. *N. Y. City Ry. Co.* and *Texas Co.* v. *International G. N. Ry. Co.,* unless there were laches or something of the kind which was not brought out in the report of the case.

We are aware of a number of decisions holding as does Judge Sater, but we believe these decisions must give way to the principles as stated above and laid down in *Am. Iron Co.* v. *Seaboard Air Line.* A discretion as to allowing interest is allowed on matters of tort, *Eddy* v. *Lafayette,* 163 U. S. 456 at 467; *De La Rama* v. *De La Rama* (1915) 241 U. S. 154, at 159. However, in cases of contract or the unlawful detention of money interest is allowed as a matter of law. *Lincoln* v. *Claflin* (1868) 7 Wall., 132 at 139. If courts will, as a matter of law, allow interest on contract claims and on the unlawful detention of money, does not a claim for payment of supplies come under one or the other? If as a matter of law interest is recoverable on such a claim, it becomes part of the claim, and if this is so how can we separate the two and when the time of payment comes allow the original claim to be preferred and not allow interest on the same to be preferred.

INTEREST ON JUDGMENTS RENDERED SUBSEQUENT TO RECEIVERSHIP

Outside of the law of receivers, a judgment will ordinarily include the principal sum due plus any interest up to the time judgment is rendered. If at the time a receiver is appointed a claim has not been reduced to judgment, the appointment of a receiver does not of itself stop the running of interest on that claim subsequent to the appointment of receiver. Neither does the appointment of a receiver of itself prevent a judgment being rendered against the defendant whose property has been placed in the hands of a receiver.[16] If judgment is rendered against the defendant subsequent to the time of appointment of receiver, this judgment, like any other judgment, should be for the full amount of the claim plus interest up to the time of rendering judgment. This judgment does not become a lien on property in the hands of the receiver, neither can a levy or

[16] CLARK ON RECEIVERS, Vol. I, sec. 767.

execution be issued against such property.[17] A judgment in such a case is a liquidation of the claim and represents what the appointing court or another court has determined to be the amount of the claim. A judgment against a defendant whose property is in the hands of a receiver is a measure of the plaintiff's claim at the time the judgment is rendered, and as far as the amount of the judgment is concerned it makes no difference whether the defendant is solvent or insolvent.

When the owner of the judgment however, comes to present his judgment to the appointing court and demands payment out of the assets in the receiver's hands, then the appointing court before ordering distribution must determine whether or not the defendant is solvent and whether or not all proper claims can be paid in full. If insolvency is found, then some or all claims must be scaled down. If the court can distribute equitably by refusing to consider interest after appointment of receiver, then a judgment rendered subsequent to appointment must be adjusted to its value at time of appointment of receiver. Payments are to be made on adjudicated claims; not on the amount due upon the claims when adjudicated.[18] When the appointing court comes to allow this adjudicated claim it will therefore determine the value of this claim as of the time when insolvency occurred or at the time when distribution is made according to the rule of interest which the distributing court adopts.

INTEREST WHEN SOLVENCY IS SHOWN

We have discussed at length the payment of interest in cases of insolvency and shown that insolvency and appointment of receiver does not take away the interest bearing quality of a debt, although it may be stopped at time of appointment in certain cases where the stopping of it at this time will not militate against an equitable and ratable distribution of the assets. If the appointment of a receiver in some way did stop the running of interest on claims, as some courts hold, then it would be difficult in theory to restore this interest bearing quality when solvency was determined. However, if the debt has never lost its interest bearing quality, then the showing of

[17] CLARK ON RECEIVERS, Vol. I, sec. 766.

[18] White v. Knox (1883), 111 U. S. 784.

solvency not only recognizes the interest bearing quality of the debt, but in addition means that there are funds on hand sufficient to pay interest up to the time of payment. Although there are many contradictory decisions on the subject of interest when there is insolvency shown, nevertheless, the decisions are generally uniform in holding that when solvency is shown, debts shall draw interest as if no receiver had been appointed.[19]

Cincinnati, Ohio. RALPH E. CLARK.

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[19] See Note 11, *supra.*