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Creditor's Rights - Fraudulent Conveyances - Security Assignment of Contract Payments Void if Assignor Retains Control

John A. Beach S.Ed.
University of Michigan Law School

CREDITOR'S RIGHTS—FRAUDULENT CONVEYANCES—SECURITY ASSIGNMENT OF CONTRACT PAYMENTS VOID IF ASSIGNOR RETAINS CONTROL—An insolvent debtor, who owed some $3,500 on plaintiff's partially-collected judgment, executed an instrument assigning to another creditor, a bank, all moneys due and to become due to the debtor under an existing contract,[1] expressly as security for payment of the debtor's present and future indebtedness to the bank. The contract obligor was notified of the assignment, and thereafter the bank collected the amounts periodically accruing under the contract. The bank applied part of these collected amounts to the balance that the debtor owed the bank. The rest was either handed over to the debtor or credited to his general account, upon which he was allowed to draw at will. In execution of his judgment, plaintiff garnished some $3,000 in the contract obligor's possession which had accrued on the contract but had not yet been paid over to the bank pursuant to the assignment. When the obligor resisted garnishment by pleading the prior assignment, plaintiff sought to set aside the assignment as fraudulent, and the bank intervened. The trial court upheld the assignment and gave the bank priority to the extent of the amount the debtor owed it at the time of trial, allocating any surplus to the payment of plaintiff's judgment. On appeal, *held,* reversed. Since the debtor never lost control of the money purportedly assigned to the bank, the assignment was fraudulent in law as to the plaintiff, and the entire fund held by the obligor is payable to him. *Dupree v. Quinn,* (Tex. Civ. App. 1956) 290 S.W. (2d) 329.

Although the reported facts might have supported a finding of actual intent to hinder, delay, and defraud creditors,[2] the trial court made a contrary finding, so that the appellate court's invalidation of the assignment was as a matter of law. The primary ground of decision was the doctrine which invalidates an assignment for security when the purported assignor retains control over the property to an extent inconsistent with or repugnant to a valid assignment. This rule was applied in *Benedict v.*

1 Courts differ as to the validity of a security transfer of rights arising in the future, but by analogy to the common law rule allowing transfers of things having "potential existence," a right to payment under an existing contract is assignable. United States Fidelity & Guaranty Co. v. R. S. Armstrong & Bro., 225 Ala. 276, 142 S. 576 (1932). Cf. Rockmore v. Lehman, (2d Cir. 1942) 128 F. (2d) 564.

2 Tex. Civ. Stat. Ann. (Vernon, 1945) art. 3996. Among the badges of fraud were the following: insolvency of the debtor, known by the bank; plaintiff's outstanding judgment, known by the bank; other security for the debtor's loans, held by the bank. The latter circumstance prompted the court to suggest, as an alternate ground for decision, that there was no consideration for the assignment, and therefore it was presumptively fraudulent under Texas law. This is not overly convincing. Surely the assignment was not intended as a gift, and an assignment of present or future payments under a contract securing a continuing line of credit, with disclosed or undisclosed reservation of any surplus for the use of the debtor, has been held not fraudulent in law. Didier v. Patterson, 93 Va. 534, 25 S.E. 661 (1896); Leitch v. Hollister, 4 N.Y. 211 (1850); Merillat v. Hensey, 221 U.S. 333 (1911). Nor is exaction of excessive security necessarily fraudulent. Peoples-Pittsburgh Trust Co. v. Holy Family Polish National Catholic Church, 341 Pa. 390, 19 A. (2d) 360 (1941).

Ratner,[3] where Justice Brandeis denied that the evil to be avoided was coextensive with the evil of ostensible ownership,[4] but rather that the very fact that the assignor retained unfettered dominion and control was a conclusive touchstone of fraud.[5] Dominion retained over assigned accounts receivable was held fatal, even though no ostensible ownership was involved since the assignment was of intangibles. That decision, purporting to discover and apply New York law in a bankruptcy proceeding, has found widespread application in the field of non-notification accounts-receivable financing.[6] It has been rejected by some states,[7] and it is not absolutely clear whether the New York courts would apply it outside of bankruptcy situations.[8] The federal courts have applied the rule with varying degrees of strictness,[9] so that what constitutes sufficient dominion retained by the assignor to invalidate the assignment is not altogether clear. For example, a non-notification hypothecation of receivables has been held to survive the rule if the assignor segregates the accounts as agent for the assignee,[10] but fails if the assignor is allowed to use the collections for his own purposes.[11] The written assignment agreement is not controlling, as the courts will infer the terms of an actual agreement from the actions of the parties.[12]

[3] 268 U.S. 353 (1925).

[4] "It rests not upon seeming ownership because of possession retained, but upon a lack of ownership because of dominion reserved." Id. at 363.

[5] See Brown v. Leo, (2d Cir. 1926) 12 F. (2d) 350; Lee v. State Bank & Trust Co., (2d Cir. 1930) 38 F. (2d) 45; 85 A.L.R. 216 at 222 (1933).

[6] But see In re M. J. Hoey & Co., (2d Cir. 1927) 19 F. (2d) 764, applying the rule to an assignment of stock exchange seat. See generally, comment, "Accounts Receivable as Collateral Security," 44 YALE L.J. 639 (1935). A substantial, but not exhaustive, investigation has disclosed no use of the doctrine to invalidate an assignment with contemporary notice to the obligor.

[7] In re United Fuel and Supply Co., 250 Mich. 325, 230 N.W. 164 (1930). *Contra*, Stulz-Sickles Co. v. Fredburn Constr. Corp., 114 N.J. Eq. 475, 169 A. 27 (1933). In general, states like Michigan, which allowed freehanded chattel mortgages prior to Benedict v. Ratner, note 3 supra, tend not to follow that decision, while states like New York, which invalidated such mortgages [2 GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES, rev. ed., §583a (1940)], tend to adopt it. REPORT OF NEW YORK LAW REVISION COMMISSION FOR 1946, p. 491 (Communication and Study relating to Assignments of Accounts Receivable, Legis. Doc. No. 65K at 140, 141). See Mich. Comp. Laws (1948) §691.906, expressly allowing collection of assigned accounts and use of proceeds by assignor, despite absence of recording and/or notice to obligor. See note 13 infra.

[8] REPORT OF NEW YORK LAW REVISION COMMISSION, note 7 supra, at 489.

[9] See remarks of Chief Judge Hutcheson in Second Nat. Bank of Houston v. Phillips, (5th Cir. 1951) 189 F. (2d) 115.

[10] Chapman v. Emerson, (4th Cir. 1925) 8 F. (2d) 353 (1925), goes far in upholding the transaction even though the assignor used some collections for his own purposes. But see In re Almond-Jones Co., (D.C. Md. 1926) 13 F. (2d) 152, affd. sub nom. Union Trust Co. v. Peck, (4th Cir. 1927) 16 F. (2d) 986.

[11] In re Fergusson Drug Co., (E.D. Pa. 1937) 19 F. Supp. 206, affd. sub nom. Markovitz v. Taylor, (3d Cir. 1938) 94 F. (2d) 782. Validity of the entire transaction may depend upon assignor's substituting accounts for ones collected and used for his own purposes. Compare Coppard v. Martin, (5th Cir. 1926) 15 F. (2d) 743, with City Nat. Bank of Beaumont v. Zorn, (5th Cir. 1934) 68 F. (2d) 566.

[12] Lee v. State Bank & Trust Co., note 5 supra. For elaboration of the wavering lines drawn between close cases and general disapproval of the doctrine of Benedict v. Ratner, note 3 supra, see Cohen and Gerber, "Mortgages of Accounts Receivable," 29 GEO. L.J. 555 (1941).

Despite the highly conceptual nature of this test of "dominion" which is "repugnant" to a valid transfer, there may be real, or at least potential, evils justifying it. Since recording requirements for mortgages of goods and chattels are not applicable to intangibles, creditors typically have no way of discovering a debtor's hypothecation of his accounts.[13] Furthermore, opportunity for a debtor to execute an antedated assignment in collusion with a friendly creditor is real when nothing other than the instrument is required for a valid assignment. Finally, any rule which increases the estate available to all creditors, albeit by defeating the special creditor's advantage, arguably has some merit. Yet it may be questioned whether the rule of conclusive invalidity should be extended to a case like the present where the obligor of the assigned contract was notified, and where all collections were made by the assignee. These circumstances would seem to negate "dominion," since the actual funds were completely out of the debtor's hands[14] and there was no secrecy. The arrangement in the principal case is explainable on legitimate grounds far short of fraud. If, without any assignment, the debtor had received cash payments from his contract obligor, preferential payment of this cash to the bank would have been permissible even if payments exceeded the debt owed the bank.[15] Instead, the payments were due from the obligor at specific future times, and in the absence of ability to pay them over presently, the debtor assigned them to the bank.[16] Assignment of the entire amount of the then unliquidated

[13] A number of states have passed statutes validating assignments of accounts either with or without recording requirements. E.g., Mich. Comp. Laws (1948) §§691.901 to 691.911. Texas Civ. Stat. Ann. (Vernon, 1947) art. 260-1, provides permissive validation by filing notice of intention to assign accounts, which leaves open the question whether the assignment can be validated in any other way such as by notification to the obligor. See Koessler, "New Legislation Affecting Non-Notification Financing of Accounts Receivable," 44 MICH. L. REV. 563 at 603 (1946). This statute has not been construed by the Texas courts and was not mentioned in the present case, but two federal decisions indicate that filing pursuant to the statute in the present case would have immunized the assignment from attack. Second Nat. Bank of Houston v. Phillips, note 9 supra; In re Cumings, (S.D. Tex. 1951) 99 F. Supp. 690. See generally Hanna, "The Extension of Public Recordation," 31 COL. L. REV. 617 at 623 to 630 (1931).

[14] In re Monumental Shoe Mfg. Co., (D.C. Md. 1926) 14 F. (2d) 549, held Benedict v. Ratner, note 3 supra, inapplicable where the assignor collected all accounts, but paid them to the assignee bank, which then drew a check and deposited it in the assignor's account, retaining the right to apply such payments to the assignor's debt.

[15] Collections deposited to debtor's account would be subject to the bank's right of set-off to the extent of outstanding loans, nowithstanding the debtor's insolvency. Citizens' Bank & Trust Co. v. Yantis, (Tex. Civ. App. 1926) 287 S.W. 505. Any surplus would remain available to other creditors. See Didier v. Patterson, note 2 supra. Such a set-off might well be a voidable preference in bankruptcy, on the ground the deposits were made with the purpose of creating a preference. Union Trust v. Peck, note 10 supra; Blue v. Herkimer Nat. Bank, (2d Cir. 1929) 30 F. (2d) 256. Outside of bankruptcy, payment and receipt of a preference are not necessarily fraudulent. Shelley v. Boothe, 73 Mo. 74 (1880).

[16] Upholding this assignment would, of course, allow the bank, with the debtor's cooperation, to obtain a lien on his property prior to the time the judgment could garnish, since only sums presently due may be garnished, Medley v. American Radiator Co., (Tex. Civ. App. 1901) 66 S.W. 86, while future payments under an existing contract are assignable. Note 1 supra. If this is unfortunate at all, it is so quite independently from, and beyond cure by, the doctrine applied in the present case.

future payments was convenient, since the excess could be credited to the debtor's checking account, and was in fact necessary to avoid splitting the obligor's debt between two payees. Moreover, it is important to note that application of *Benedict v. Ratner* in its typical bankruptcy setting destroys the assignee's lien and thereby increases the bankrupt debtor's estate to be shared by all creditors, whereas invalidation of the transfer on suit of a judgment creditor, as in the principal case, merely shifts a preference from one individual creditor to another. It seems questionable to apply the conceptual rule of "dominion retained" to the present case where dominion over collections was not really retained by the assignor, where the rule serves a single creditor rather than all creditors, and where the possibility of an antedated assignment is negated by contemporary notice to the obligor. In any case, numerous statutes validating, or setting forth means of perfecting, assignments of accounts[17] provide assignors an escape from the entire doctrine.

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[17] See note 13 supra.