Michigan Law Review

Volume 40 | Issue 1

1941

PRINCIPAL AND SURETY - RIGHT OF SURETY TO SUBROGATION TO CLAIM OF CREDITOR AGAINST INSOLVENT NATIONAL BANK

William C. Whitehead
University of Michigan Law School

Follow this and additional works at: https://repository.law.umich.edu/mlr

Part of the Bankruptcy Law Commons

Recommended Citation
William C. Whitehead, *PRINCIPAL AND SURETY - RIGHT OF SURETY TO SUBROGATION TO CLAIM OF CREDITOR AGAINST INSOLVENT NATIONAL BANK*, 40 MICH. L. REV. 141 (1941).
Available at: https://repository.law.umich.edu/mlr/vol40/iss1/25

This Regular Feature is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

PRINCIPAL AND SURETY — RIGHT OF SURETY TO SUBROGATION TO CLAIM OF CREDITOR AGAINST INSOLVENT NATIONAL BANK — At the closing of defendant bank the commonwealth of Pennsylvania had on deposit $135,000, which was secured by the bond of defendant with plaintiff as surety, and a pledge of bonds of $12,000 par value. The commonwealth received the first dividend, amounting to forty per cent, and plaintiff paid the balance, subtracting $12,441.44 obtained on the intermediate sale of the bonds. Plaintiff contends that it is entitled to subrogation on the basis of the full amount of the original claim of the commonwealth against defendant; and that dividends subsequent to the first should be paid on that claim, although not in excess of the amount actually paid by plaintiff. *Held*, that conceding the right of plaintiff to subrogation, plaintiff should be compensated with the unsecured depositors only to the extent of an equal proportion of its actual loss. In accordance therewith plaintiff is entitled to subrogation to the claim by the commonwealth only to the amount which plaintiff actually paid out ($68,588.66), and should receive the second, third and fourth dividends on that sum. *American Surety Co. of New York v. Bethlehem National Bank of Bethlehem, Pa.*, (C. C. A. 3d, 1940) 116 F. (2d) 75.

The opposing equities of the case are adequately expressed by the district court, which held for plaintiff.[1] The stand of defendant is that plaintiff seeks to participate on a claim larger than its total outlay, whereas the depositors can prove only for their actual advancements.[2] In opposition, it is clear that the limitation of plaintiff's demand contended for by defendant would give the depositors a windfall, for in lieu of payment by plaintiff the commonwealth would be participating to the full extent of its claim against defendant.[3] The alternative to a right of subrogation is a paying surety's direct claim against its principal debtor for indemnification.[4] It is submitted that by so proceeding, plaintiff in the principal case could have protected itself to the extent sought,

[1] American Surety Co. of New York v. Bethlehem Nat. Bank of Bethlehem, Pa., (D. C. Pa. 1940) 33 F. Supp. 722 at 724, noted in 54 HARV. L. REV. 349 (1940).

[2] The fallacy in this position hinges upon the failure to take into consideration the forty per cent dividend which the depositors have already received and to which plaintiff is concededly not entitled. See note 5, infra.

[3] Before payment was made by plaintiff to the commonwealth, the latter had sold the bonds held as collateral and applied the proceeds to the obligation owing by defendant. Hence, the commonwealth's claim against defendant should be reduced by that amount, and the top limit on that claim, to which plaintiff seeks subrogation, would be $123,558.56. This limitation to the rule of Merrill v. National Bank of Jacksonville, 173 U. S. 131, 19 S. Ct. 360 (1899), was adopted in Ward v. First Nat. Bank of Caruthersville, (C. C. A. 8th, 1935) 76 F. (2d) 256. However the district court held that by the rule in the Merrill case, the commonwealth's claim became fixed at the date of insolvency of defendant and plaintiff could be subrogated to the full claim for $135,000. American Surety Co. of New York v. Bethlehem Nat. Bank of Bethlehem, Pa., 33 F. Supp. 722 at 724 (1940).

[4] Mellette Farmers' Elevator Co. v. H. Poehler Co., (C. C. A. 4th, 1927) 18 F. (2d) 430. By payment of the principal debt the surety becomes a simple contract creditor and can maintain assumpsit for money paid, laid out and expended. 21 R. C. L. 1097 (1918).

but not allowed, of subrogation to the full amount of the commonwealth's claim.[5] Of course the remedy of the surety is dependent upon the circumstances of the particular situation.[6] Nevertheless the resultant right should be harmonious with a general principle which looks to the equities of that situation.[7] If plaintiff had paid the commonwealth the full amount of the bond and the latter had satisfied the obligation in full by application of the proceeds from the sale of the collateral, plaintiff could have taken the first dividend on the full amount of the bond,[8] and continued to take additional dividends on that sum, which is substantially its position in the principal case.[9] It is difficult to make out an equity in the depositors in the principal case predicated solely on the failure of plaintiff to pay the commonwealth before the latter had partially pursued its claim against defendant. The situation is one which is not easily brought within the general principle applied by the lower court, but the incongruity is only appar-

[5] 13 Stat. L. 114, § 50 (1864), 12 U. S. C. (1934), § 194. The federal banking law declares that distribution shall be ratable and is to be determined by the federal court in each instance. "A ratable distribution is one which is made at proportionate rates. . . ." State ex rel. Carroll v. Corning State Savings Bank, 127 Iowa 198 at 203, 103 N. W. 97 (1905). The federal bankruptcy law, 30 Stat. L. 564 (1898), 11 U.S.C. (1934), § 105c, provides that claimants filing after the first dividend has been paid cannot recover their portion thereof from the participating claimants, but the former shall be entitled to payment to the amount of the first dividend from the remaining assets before the payment of further dividends. It would appear that this is the sort of ratable distribution contemplated by the federal banking law.

It is conceivable that the defendant would argue that plaintiff had in effect already received a first dividend, since payment to the commonwealth of the forty per cent dividend reduced the amount which plaintiff was obligated to pay the commonwealth. However, such reasoning ignores the decrease by forty per cent of the basic figure upon which the commonwealth was claiming when plaintiff submitted his claim for indemnity.

The similarity, in effect, of the two proceedings, subrogation and indemnification, would be perfect if the defendant were solvent, for under the former the claim is for sixty per cent of the $123,588.66, which amounts to exactly the sum which plaintiff paid the commonwealth.

[6] Although between the debtor and the creditor the debt is extinguished, equity keeps it alive in favor of the surety to the extent which will best achieve justice by avoiding a conflict with the legal or equitable rights of other creditors of the common debtor. SHELDON, SUBROGATION, 2d ed., 5, 15 (1893).

[7] "When a statutory system is administered the only question for the courts is what the statutes prescribe. But when the courts without statute take possession of all the assets of a corporation . . . and so make it impossible to collect debts except from the court's hands, they have no warrant for excluding creditors, or for introducing supposed equities other than those determined by the contracts that the debtor was content to make and the creditors to accept." William Filene's Sons Co. v. Weed, 245 U. S. 597 at 600-601, 38 S. Ct. 211 (1918).

[8] Claim for indemnity per note 4, supra.

[9] Under the hypothetical case plaintiff would have taken the first dividend rather than the commonwealth. It would then have lost sixty per cent of the $123,588.66, and would occupy the present position of plaintiff in the principal case, and in either instance should be entitled thereafter to claim dividends on $123,588.66 to the extent of sixty per cent thereof.

ent. In the event that plaintiff paid the commonwealth the full amount of its bond, with a portion of the obligation from defendant to the commonwealth still owing—disregarding the capital—plaintiff would not be entitled to either subrogation or indemnification against the insolvent estate.[10] These remedies are withheld, however, not because of any superior equity in the depositors, but because the proof of such a claim would impair the commonwealth's superior right to satisfaction of its entire claim. In this respect it would seem proper to allow proof by the creditor of its original claim against the principal debtor in full and permit it to hold the excess payments for the surety.[11] To return to the principal case, the equities favor the contention of plaintiff surety both in principle and upon the peculiar circumstances of the particular situation.[12] If plaintiff is allowed to participate only to the extent of the amount actually paid, and that amount is to be charged, in effect, with an initial dividend which plaintiff did not receive, the unsecured depositors are obtaining an unjustifiable preference, for the amount upon which the commonwealth would have been entitled to receive dividends has been reduced forty per cent.

William C. Whitehead

[10] Subrogation is an equitable device and will not be allowed to prejudice the creditor's claim against the principal debtor. A condition to the surety's right of subrogation is complete satisfaction of the creditor's claim against the principal debtor. Knaffl v. Knoxville Banking & Trust Co., 133 Tenn. 655, 182 S. W. 232 (1915). The allowance of a claim for indemnification under these circumstances would defeat the purpose for which subrogation is denied. The surety has no right to deplete the estate of an insolvent principal debtor until the suretyship creditor has been completely satisfied. Jenkins v. National Surety Co., 277 U. S. 258, 48 S. Ct. 445 (1928). It should be remarked that the right of the surety here is held in abeyance for the protection of his creditor and not because of any equities in the general creditors of the principal debtor.

[11] To restrict the claim of the commonwealth in this hypothetical case to the amount actually owing would mean that the creditor would never be fully compensated and the surety would be precluded forever from claiming against the insolvent principal debtor's estate. The full claim should be allowed as a necessary corollary of Knaffl v. Knoxville Banking & Trust Co., 133 Tenn. 655, 182 S. W. 232 (1915), in order that the general creditors will not get an unjust enrichment at the expense of the surety.

[12] William Filene's Sons Co. v. Weed, 245 U. S. 597 at 601, 38 S. Ct. 211 (1918); SHELDON, SUBROGATION, 2d ed., 5, 15 (1893).