10-1-1936

Treatment of Secured Claims Against Insolvent Estates

Richard E. Kohler
TREATMENT OF SECURED CLAIMS AGAINST INSOLVENT ESTATES

In the *United Security Trust Company* case¹ the Supreme Court of Pennsylvania has taken a firm position on the much mooted question whether the Equity or Bankruptcy Rule should be applied to the settlement of insolvent estates. The court ruled that a secured creditor of an insolvent estate, *whether the insolvent be living or dead, individual or corporate*, who elects to prove his claim, may do so only for the excess of the amount of the claim over the sum realized on the collateral, or its unrealized value. Thus the court has adopted what is known as the Bankruptcy Rule, and has disapproved the Equity Rule under which the creditor is entitled to dividends on the full amount of the debt, notwithstanding he has collateral security on which he has or may thereafter receive a partial payment of his debt.²

The rules are applicable in three situations: 1. Where there has been an assignment for the benefit of creditors. 2. The distribution of an insolvent decedent’s property in the orphans’ court. 3. Receiverships in equity. Into one of these three general classifications usually fall the cases to which the rules could be applied.

The Bankruptcy Rule has existed in England since the days of James I³ and is incorporated in the bankruptcy laws of today, both here⁴ and abroad.⁵ Our Federal Bankruptcy Act provides that claims of secured creditors shall be allowed only for the difference between the amount of the debt and the value of the security. After this value is ascertained, by methods prescribed in the Act,⁶ the amount is credited to the claim and dividends paid upon the balance only. The Bankruptcy Rule has been enacted into state insolvency legislation, including that of Pennsylvania.⁷ It has also been adopted by the courts of a few states.⁸

The Equity Rule was first advanced by Lord Cottenham almost a century ago,⁹ but its application was limited to liquidations conducted in a court of equity. Its life in England was ended by the Judicature Acts of 1873 which provided that the Bankruptcy Rule should be applied to all liquidations. In this

¹321 Pa. 276, 184 A. 106. (1926).
²For general discussion see Glenn, Liquidation (1935), chapter 36, page 749; Annotations; 94 A.L.R. 466; L.R.A. (1918B) 1024; Merrill v. National Bank of Jacksonville, 173 U.S. 131 (1898).
³Stat. 21 James I, chapter 19.
⁵Bankrupt Act, 1914 (4 and 5 George V, chapter 59).
⁶Converting into money, foreclosure sale, agreement, arbitration, compromise, or litigation, as the court may direct.
⁸Georgia, Iowa, Massachusetts, Mississippi, New Jersey, North Carolina, Rhode Island, Tennessee, Washington, and now Pennsylvania.
country the Equity Rule is favored in the majority of jurisdictions. The Federal courts have adopted the Equity Rule in the liquidation of national banks, and in equitable receiverships of corporations.

In Pennsylvania, before the Insolvency Act, the courts consistently applied the Equity Rule in cases where there had been assignments for the benefit of creditors. As stated in Jamison's Estate, "It is settled that a creditor of an assigned estate is entitled to a dividend on the full amount of his debt at the date of assignment, notwithstanding he has collateral security of any kind on which he has, or may hereafter receive a partial payment of his debt." For this rule, the Bankruptcy Rule was substituted by section 28 of the Insolvency Act of 1901. However, after the passage of this act, there were no cases recognizing the change in the rule until the recent United Security Trust Company case which has provoked this note.

The leading authority for the application of the Equity Rule in Pennsylvania was Fulton's Estate. This case involved a claim for interest by a secured creditor against the estate of an insolvent decedent. The two rules were not discussed in the opinion, but the court applied the Equity Rule. In the United Security Trust Company case the court expressly disapproves the decision in Fulton's Estate.

Our appellate courts had never considered the question in regard to receiverships in equity. In two lower court cases, dealing with exceptions to accounts of the Secretary of Banking in possession of insolvent banks, the courts followed Fulton's Estate.

---

10Merrill v. National Bank of Jacksonville, supra note 2, in which the Equity Rule was adopted by a divided court, four members dissenting and favoring the Bankruptcy Rule.
12Supra, note 7.
13Morris v. Olwine, 22 Pa. 441 (1854); Patten's Appeal, 45 Pa. 151 (1863); Brough's Estate, 71 Pa. 460 (1872); Graeff's Appeal, 79 Pa. 146 (1875); Miller's Estate, 82 Pa. 113 (1876).
14163 Pa. 143, 29 A. 1001 (1894).
15P.L. 404, 39 P.S. section 90. "All claims shall be made as of the date of the distribution of the fund, interest being allowed or discount being made to that time. A creditor having a claim for which the insolvent is primarily liable, and others secondarily, may prove for his whole claim; but, if the insolvent is only secondarily liable, the value of the liability of the primary debtor shall be adjusted between the creditor and the assignee; or, if the valuation cannot be agreed on, the same shall be submitted to the appropriate tribunal, and a dividend shall only be awarded to the creditor on the difference between such value, so determined, and the amount of his claim. In like manner, any collateral security held by any creditor for his debt shall be valued by said tribunal, and if the security be retained by the creditor his dividend shall be on the difference between his claim and the value of his security, so ascertained: Provided, That the creditor shall have the right to surrender his security, and take a dividend on his whole debt. If such creditor refuses to have his security valued or surrender the same, he shall be excluded from participation in the fund."
17In re Miners and Merchants Bank of Nanty-Glo, 18 D. & C. 537 (1933); In re Coatesville Trust Co., 20 D. & C. 557 (1934).
18Supra, note 16.
The United Security Trust Company case\(^1\) concerned the rights of assignees of secured depositors in an insolvent trust company to share in the dividends. Concerning this feature we reach one of the most interesting points of the case. The policy behind the Insolvency Act, dealing with assignments for the benefit of creditors, was to treat each creditor on an equal basis, and in furtherance of this purpose the act incorporated the Bankruptcy Rule. Although the facts in this case did not bring it within the specific terms of the Insolvency Act, the court reasons that the same policy is applicable and the Bankruptcy Rule should therefore be applied in this, a cognate situation. The court thereby declares this situation within the scope of the change effected by the statute. It quotes *Gooch v. Oregon Short Line Railroad Co.*\(^2\) "For although courts sometimes have been slow to extend the effect of statutes modifying the common law beyond the direct operation of the words, it is obvious that a statute may indicate a change in the policy of the law, although it expresses that change only in the specific cases most likely to occur to the mind." The court reached the conclusion that equality of distribution among creditors can only be obtained by the application of the Bankruptcy Rule.

A second reason for the decision may be found in the concluding sentence of the opinion, "We think, therefore, that desirable uniformity of administration will be attained by applying the Bankruptcy Rule in all cases of the distribution of the assets of insolvents whether living or dead, individual or corporate, and that as this court, since the Act of 1901, is not committed to the application of any other rule, the Bankruptcy Rule should hereafter be considered of general application."

Much has been written concerning the relative merits of the two rules. The argument for the Equity Rule is that the unsecured creditors have no equitable right of "marshalling" against the secured creditors. The latter are said to have a legal right to prove their debt of which a liquidating court may not deprive them.

The Bankruptcy Rule is hailed as the "common sense rule" by its advocates. A Massachusetts judge has said that if it were not for this rule the secured creditor "would in fact have had a greater security than the pledge was intended to give him; for originally it would have been security only for a proportion of the debt equal to its value; when by proving the whole debt, and holding the pledge for the balance, it becomes security for as much more than its value as is the dividend which may be received on the whole debt."\(^2\) England has abolished the Equity Rule entirely.\(^2\) Although both rules still exist in the United States, preference for the Bankruptcy Rule is frequently shown by stipulations in agreements.

---

\(^1\)Supra, note 1.

\(^2\)258 U. S. 22, 24 (1921).

\(^3\)Parker, C. J. in Amory v. Francis, 16 Mass. 309 (1820).

\(^2\)Supra.
Such stipulations will be enforced even though the Equity Rule prevails in that jurisdiction. The application of the Equity Rule does produce undesirable results in certain situations. One authority has said, "It is to be regretted that the bankruptcy rule, which undoubtedly makes more for justice, has not secured as sweeping a victory with us as it has finally attained in England." It has finally attained such a sweeping victory in Pennsylvania.

The United Security Trust Company case is of two-fold importance. 1. It illustrates judicial interpretation of legislative policy into situations, not specifically covered by statute, but which are of analogous nature; and 2. It has made the Bankruptcy Rule of uniform application to all liquidations under the laws of Pennsylvania.

Richard E. Kohler

---

25 Glenn, Creditor's Rights and Remedies (1915), page 434.