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The Distinction between the Equity Rule and the Bankruptcy against Insolvent Estates in Kentucky

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THE DISTINCTION BETWEEN THE EQUITY RULE AND THE BANKRUPTCY RULE IN PROVING SECURED CLAIMS AGAINST INSOLVENT ESTATES IN KENTUCKY*

In the case of *Banco-Kentucky's Receiver* v. *The National Bank of Kentucky's Receiver,*[1] the question was presented as to whether a secured creditor of an insolvent corporation could have the full benefit of his security, and at the same time could prove against the free assets of the insolvent the full amount of said creditor's claim or not. This question involved whether the equity rule or the bankruptcy rule was in force in Kentucky, or whether both of them were in force, depending on the state of case presented.

The Court, in its opinion, referred to the learned discussion of this question in the report of the Special Master in the court below,[2] the Honorable Lafon Allen, but due to considerations of space, did not incorporate that discussion in the opinion. That it may be available to the Bar, it is here reproduced:

"As between secured creditors and general creditors of an insolvent, their relative rights in distribution of assets, as established by statute or by court decisions in this state, are as follows:

"(1) Under a voluntary assignment by an insolvent for the benefit of all creditors, without discrimination, a secured creditor, prior to the Act of 1894, which for the first time fixed by statute the rights of creditors under a voluntary assignment[3] had the right to make double proof, that is to say, he could prove his whole claim against both funds (to-wit, his security and the assets assigned) and was entitled to share, upon that basis, in both funds, although, of course, he could not receive more than the whole amount of his demand.[4]

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* The introductory paragraphs were written by Richard Priest Dietzman, member of the Louisville, Kentucky Bar. The citations found in the Special Master's report have been edited.—Ed.

[1] 281 Ky. 784, 137 S.W. (2d) 357 (1939).

[2] See 281 Ky. 784, 818, 137 S.W. (2d) 357, 375 (1939).

[3] Weiser v. Muir, 103 Ky. 479, 45 S.W. 512 (1898).

[4] Logan v. Anderson, 18 B. Mon. 114 (1857); Hibler, Etc. v. Davis' Adm'r., 13 Bush 20 (1877); Citizens Bank of Paris v. Patterson, 78 Ky. 291 (1879).

"This rule was not applicable to voluntary assignments alone. It was not followed in all jurisdictions, there being a substantial diversity of views upon the subject. It was, however, followed by the courts of the United States (except where a different rule was fixed by statute, as in cases of bankruptcy) and in a substantial number of important states, including Kentucky. In those jurisdictions in which it obtained, it was applicable not only to voluntary assignments but to all distributions of insolvent estates, except where there was a different statutory rule. A full and interesting discussion of this subject is to be found in the opinion of the Supreme Court of the United States in *Merrill, Receiver of the First National Bank* v. *National Bank of Jacksonville.*[5] An elaborate review of the recent cases on this subject will be found in an annotation to *First Wisconsin National Bank of Milwaukee* v. *Kingston, State Commissioner of Banking.*[6] This annotation is supplementary to an earlier annotation to the case of *Citizens and Southern Bank* v. *Alexander, Receiver of the Irish American Bank.*[7] It will be noted that it both of these annotations Kentucky is put down as following the equity or chancery rule, allowing double proof, except as changed by statute.

"(2) Prior to the Act of 1892, explained below, in the distribution of the estate of an insolvent decedent, a secured creditor, whose contract security was insufficient to pay his demand in full, was excluded by statute from any share in free assets until after general creditors had received a sum equal, *pro rata,* with such lien creditors.[8]

"In such a case, the secured creditor, after general creditors had been made equal with him, was entitled to share upon the basis of his whole claim, without giving credit for what he had received from his special security. But, by the Act of 1892, this rule was changed and it was provided that, in such a case, the secured creditor, instead of being required to wait until general creditors had been made equal with him, was allowed to share with them from the beginning, but only upon the basis of the

[5] 173 U.S. 130, 43 L. ed. 640 (1899).
[6] 213 Wis. 681, 252 N.W. 153 (1934).
[7] L.R.A. 1918B, 1024.
[8] Gen. Stat., Ch. 39, Art. 2, secs. 33, 34; Spratt's Ex'x. v. First National Bank of Richmond, 84 Ky. 85 (1886).

unpaid balance of his claim, after giving credit for the proceeds or value of his special security.[9]

"(3) In cases where the security (or priority) of the secured creditor arose, not from a contract between him and his debtor, but 'out of a rule of equity, or statutory discrimination between creditors'[10] the secured creditor was subject to the equitable rule of equal reprisal, that is to say, if his security was insufficient to pay his demand in full, he was not allowed to share with general creditors until they had received from fee assets enough to indemnify them for the loss which they had suffered through the application of his securties exclusively to the discharge of his demand. This, it will be observed, was the former rule (prior to the Act of 1892), governing the distribution of an insolvent decedent's estate.[11]

"There were two situations in which this rule was applied:

(a) Where the second creditor was a bank which had a charter lien upon its shares owned by an insolvent debtor.[12]

(b) In partnership cases, where the partners make assignments of both individual and firm assets for the benefit of individual and firm creditors, and the latter claim the right to be subrogated to the right of each partner to have firm assets first applied to the discharge of firm debts.[13]

"(4) It will be noted that, in the above cases, the difference in the basis upon which secured creditors were allowed to share in the distribution of free assets (when not controlled by statute) depended upon a difference in the origin of their security. If it arose from a contract, then the secured creditor could make double proof but, if it arose out of a rule of equity or a statutory discrimination between creditors, he was subject to the rule of equal reprisal. We come now to a case in which a discrimination was made, not because of the origin of the security, but because of the origin of the right to share in a

[9] Kentucky Statutes (Carroll, 1936) sec. 3869.

[10] Supra, n. 2.

[11] Spratt's Ex'x. v. First National Bank of Richmond, *supra*, n. 6.

[12] German Security Bank v. Jefferson, etc., 73 Ky. (10 Bush) 326 (1874).

[13] Northern Bank of Kentucky v. Keizer, 63 Ky. (2 Duv.) 169 (1865); Fayette National Bank of Lexington v. Kenney's Assignee, 79 Ky. 133 (1880); Hill, et al. v. Cornwall and Bros., Assignee, 95 Ky. 512, 26 S.W. 540 (1894).

distribution of free assets. This is the case of *Bank of Louisville* v. *Lockridge*.[14] In that case, the notes held by the bank against the debtor were secured by pledges of collateral. The bank, becoming doubtful of the solvency of the debtor, secured the pledge of additional collateral, whereupon Lockridge, an unsecured creditor, sued for and obtained a judgment that the latter pledge operated as an involuntary assignment for the benefit of all creditors, since it was made in contemplation of insolvency and with design to prefer the bank. The bank claimed that it had the right to make double proof, just as if the assignment had been voluntary. The court held that he could not do this.

"This ruling was based upon a construction of certain provisions of the Act of 1856 which, as the court found, indicated "that the legislature regarded the act of insolvency" (that is, the preferential conveyance) as placing the estate of the insolvent debtor in the same condition and to be distributed in the same manner as the estate of a decedent. As we have seen, the rule of equal reprisal had, by statute, been made applicable to the distribution of the estate of an insolvent decedent, and, accordingly, the court applied that rule in the *Lockridge* case. This rule, as applied to insolvent decedents' estates, was changed by an Act of 1892 and, in the same year, the Act of 1856 (preferential conveyance statute) was changed in the same manner, so that the present law, applicable to both of those classes of cases, is that the secured creditor may prove against free assets only the balance of his demand after crediting his security.

"(5) By an act of 1894[15] the same rule was made applicable to the voluntary assignments for the benefit of creditors.[16]

"(6) As to banks in liquidation, an act of 1912 provided that a secured creditor could prove against free assets only the unsatisfied balance of his demand. It is perhaps worthy of note that, by an act of 1934, this rule as to banks in liquidation was changed and the former equity or chancery rule, allowing double proof, was reinstated.

"(7) It is well understood, of course, that in bankruptcy cases the federal statute allows a preferred creditor to prove

[14] 92 Ky. 472, 18 S.W. 1 (1892).
[15] Kentucky Statutes (Carroll, 1936) sec. 3869.
[16] Kentucky Statutes (Carroll, 1936) sec. 74.

only the unsatisfied balance of his demand against free assets and consequently this rule is sometimes referred to as the "bankruptcy rule."

"It is thus seen that the present rules in Kentucky with reference to the rights of secured creditors in the distribution of the estates of insolvents are as follows:

"The secured creditor can prove against free assets only the balance of his demand, after giving credit for his security in the following circumstances:

(a) Where there has been a voluntary assignment.
(b) Where the insolvent is dead.
(c) Where there has been a preferential conveyance resulting in an involuntary assignment.
(d) Where the security was not obtained by contract with the insolvent.

"In all other cases the chancery or equity rule announced in *Logan* v. *Anderson*,[17] which allows a secured creditor to make double proof, still obtains."

[17] *Supra*, n. 2.