1969

Herschel J. Saperstein, Trustee In Bankruptcy of the Estate Of Wheat Bros. Painters & Decorators v. First Security Bank of Utah, N. A. : Brief of Appellant

Clerk, Supreme Court, Utah

NOV 2 - 1969

FILED

IN THE

SUPREME COURT

OF THE

STATE OF UTAH

HERSCHEL J. SAPERSTEIN,
Trustee in Bankruptcy of
the ESTATE OF WHEAT BROS.
PAINTERS & DECORATORS, a
partnership,

Plaintiff and Respondent,

vs.

FIRST SECURITY BANK OF UTAH,
N. A., a corporation,

Defendant and Appellant.

BRIEF OF APPELLANT

Appealed from a judgment
granted by Third District Court
for Salt Lake County, State of
HONORABLE STEWART M. HA

RAY, QUINNEY &
DON B. ALLEN,
M. JOHN ASHTON,
400 Deseret Building
Salt Lake City, Utah

Attorneys for Appellant

BRYCE E. ROE
510 American Oil Building
Salt Lake City, Utah

Attorney for Plaintiff and Respondent

FILED

NOV 5 - 1969

Clerk, Supreme Court, Utah

TABLE OF CONTENTS

AUTHORITIES CITED

STATUTES OR REGULATIONS

TEXT

IN THE

SUPREME COURT

OF THE

STATE OF UTAH

HERSCHEL J. SAPERSTEIN, Trustee in Bankruptcy of the ESTATE OF WHEAT BROS. PAINTERS & DECORATORS, a partnership, *Plaintiff and Respondent,* vs. FIRST SECURITY BANK OF UTAH, N. A., a corporation, *Defendant and Appellant.*	Case No. 11768

STATEMENT OF THE NATURE OF THE CASE

Plaintiff seeks to set aside alleged preferential transfers of money under Section 60 of the Bankruptcy Act, claiming that defendant obtained money in violation of the Act from Wheat Bros. Painters & Decorators, a partnership, for which plaintiff is the trustee in bankruptcy.

DISPOSITION OF THE LOWER COURT

The case was tried February 24, 1969, before the Honorable Stewart M. Hanson, sitting without a jury, subsequent to which a judgment was rendered in favor of plaintiff and against defendant for the sum of $27,331.25, together with interest in the amount of $3,624.62, and costs. Defendant's motion to amend the findings, conclusions and decree was denied on June 30, 1969.

RELIEF SOUGHT ON APPEAL

Appellant seeks reversal of the lower court judgment, claiming that no preferential transfers were effected which could be voided or recovered by the trustee.

STATEMENT OF FACTS

Wheat Bros., painters and decorators, was a partnership consisting of James L. Wheat, John Wheat and Joseph Wheat (R. 47), which had been a customer of First Security Bank since about 1950 (R. 74). During the months preceding the filing of the petition in bankruptcy, the partnership maintained a checking account at the Sugarhouse Office of the Bank. The partnership also borrowed money from the Bank from time to time.

On May 19, 1965, the Company signed a ninety day note in favor of the Bank for $5,000.00 (Exhibit P-14). On or about June 1, 1965, the Company submitted a financial statement to the Bank which showed assets of $95,342.00 and liabilities of $16,000.00 (Exhibit D-15). On July 13, 1965, the Company signed a second ninety day note for $5,000.00 (Exhibit P-14)

From August 9th through September 21st, the Company had a continuous overdraft which became increasingly larger until at the close of business on September 21st the Company had an overdraft of $18,768.28 (Exhibit P-12). During the period of the overdraft, officers of the Bank visited the Company and also talked with the partners over the telephone concerning the overdraft. The Company reassured the Bank that deposits would soon be forthcoming which would more than cover the overdraft (Exhibit D-18). On

September 10th the Company made a deposit of $3,986.70 and on September 15th it made another deposit for $3,411.00 (Exhibit P-12).

After the close of business on September 21st, the Company made a deposit of $21,320.08 (Exhibit P-10). No conversations were held regarding the purpose or effect of that deposit (R. 81). The bulk of that deposit was a check from Jacobsen Construction Company for $18,150.00 (Exhibit P-11). The next morning, September 22nd, the Bank endorsed the Jacobsen check for collection and sent it by messenger over to Zions Bank where a cashier's check was obtained for the amount of the Jacobsen check (R. 82). Thereafter, the Wheat Bros. deposit was automatically set off against the overdraft giving Wheat Bros. a credit balance against which they drafted checks (R. 85-6).

On September 24th a deposit was made by the Company for $997.56 and another deposit was made on September 29th for $3,283.03 (Exhibit P-12). On or about September 28th the Company submitted another financial statement to the Bank. Although this financial statement presented a different picture to the Bank than had been seen previously, the statement still showed assets of $68,800.00 and liabilities of only $38,800.00 (Exhibit D-19, R. 104-5). During the period of time from September 22nd to October 4th, the Company continued to draw checks against their credit balance with the Bank.

On October 4, 1965, the Company made a deposit with the Bank of $7,384.00, with no prior conversations regarding the purpose of the deposit. Later on that same day, the Bank set off $5,131.25 against the note that had fallen due on August 17, 1965 (R. 96). After that setoff, the Company again had a credit balance against which it drafted checks. Another deposit was made on October 8, 1965, of $3,696.38 (Exhibit P-12).

On October 14, 1965, John Wheat collapsed in the office of the Company and was taken to the hospital where he remained for a period of one month (R. 53). The next day the Wheat Bros.' payroll was due and upon checking, Joe Wheat found insufficient funds in the bank account to pay the employees. Therefore, Joe collected enough accounts receivables to meet the payroll and on October 18th made a deposit of $4,153.48 to cover the payroll checks. The Bank officers did not know of the purpose of the deposit, nor was any arrangement made with respect thereto (R. 53-4). Later that day, the Bank made a setoff of $4,050.00 against the second note which had fallen due on October 11, 1965 (R. 97).

On October 19, 1965, Joe Wheat laid off all employees and shut the Company down except for some minor jobs which he finished himself. The next day, October 20th, Joe and Jim Wheat went to the Bank to talk with Mr. Bentley W. Vincent and Mr. Boyd A. Lindquist, the manager and assistant manager, respectively, of the Sugarhouse Office. Joe told Mr. Vincent that the Company had receivables of $18,000.00 and debts of over $70,000.00 (R. 57).

On December 8, 1965, voluntary petitions in bankruptcy were filed by Wheat Bros. Painters & Decorators, a partnership, and its three partners individually (Exhibit P-1 through P-4). The partnership schedules in bankruptcy show liabilities in the amount of $73,053.99 and assets in the amount of $17,127.00 (Exhibit P-1).

ARGUMENT

POINT I

A. THE DEPOSITS AND SETOFFS BETWEEN WHEAT BROS. AND THE BANK DO NOT CONSTITUTE PREFERENTIAL TRANSFERS UNDER SECTION 60 OF THE BANKRUPTCY ACT

The most pertinent parts of Section 60 of the Bankruptcy Act state:

> "*Section 60. Preferred Creditors.*
>
> a. (1) A preference is a transfer, as defined in this act, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this Act, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.
>
> * * * * *
>
> "b. Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent."

Plaintiff alleged and the lower court held that the deposits and setoffs were preferential transfers under Section 60 of the Bankruptcy Act. Appellant strongly urges that such a holding is in error, and that this case clearly comes under Section 68(a) of the Act which is set forth and discussed under Point B hereinafter. Therefore, defendant asserts that the elements of a preferential transfer on which plaintiff relies are irrelevant in this case and ought not to be considered.

As the Court is well aware, when a deposit is made with a bank a relationship of debtor and creditor is created. Since the depositor owed the bank debts because of the overdraft and overdue notes, a condition of mutual debts was created between the Bank and the Bankrupt. That brings the fact situation under Section 68(a) and not under Section 60. Had the bank not exercised its right of setoff, the referee in bankruptcy would have been required to set off the mutual debts.

That Section 68 is the governing Section in this case is clear from a statement found in 4 *Collier on Bankruptcy* (14th Ed.) par. 60.15:

> "The basic problem, however, becomes infinitely more complex when the situation arises, as is often the case, where the bank is a creditor of depositor and the depositor is insolvent. *Tested by the requirements of Section 60, deposits made in the ordinary course of business in such situations are not preferential transfers.* As pointed out by the Supreme Court, there is nothing in the Act which prevents an insolvent from conducting his business in the usual way, or prohibits banks from dealing with him on that basis. But a complication arises due to the fact that Section 68 of the Act permits a setoff in the case of Mutual Debits

and Credits, and the use of this privilege, which in reality effects a legal preference, by a creditor bank in connection with the deposit of insolvent debtor obviously opens the way to an indirect accomplishment of results generally prohibited by Section 60.

"In an effort to reconcile these provisions of the Bankruptcy Act, and at the same time prevent abuse, the courts have long since evolved a workable set of principles. . . . Summarized briefly, *it was well settled, prior to the Act of 1938, that deposits made in the ordinary course of business generally upon an open account and subject to withdrawal by check, were not preferential transfers, even if made while the debtor was insolvent and the bank had knowledge or notice of the depositor's insolvency. . . .*

"The doctrine that banks could under certain conditions accept deposits of a known insolvent and yet subsequently exercise the privilege of setoff gave rise to criticism in some quarters. Consequently, when the Act of 1938 was in its preliminary stages, certain amendments to Section 68 were proposed which would have altered the recognized rules. The amendments were not adopted, however, when the bill was finally enacted into law. Therefore, *despite the fact that the term 'transfer' under Section 60 now has a wider significance than formerly, and notwithstanding also that Section 68 was extensively revised to strike down preferences, whether effected directly or by remote obscure devices, it is quite clear that there was no intention to alter the accepted law as to make deposits.*

"It has been suggested by one well known authority that while the principles relating to bank deposits and bank setoffs are grounded in common-sense and practical business policy, they can hardly be reconciled with the express terms of the Act. However, this may be, the principles here stated and analyzed more fully under Section 68 have the sanction of the overwhelming weight of authority and should still govern where applicable." (emphasis added)

An annotation found at 85 ALR 369, 372 (1933) also states that the general rule is that a bank setoff is not a preference:

"The general rule is that the deposit by an insolvent, in a bank to which he is indebted, though within four months of the filing of the petition in bankruptcy, is not a transfer of property amounting to a preference within the meaning of the Bankruptcy Act, so as to preclude the bank's right of setoff accorded by the act, provided the deposit is in the usual course of business, to the open or general account of the depositor, subject to check (as subsequently shown, this rule applies even though the bank knows at the time that the depositor is insolvent.)"

In the case of *Citizens' National Bank vs. Lineberger*, 45 F.2d 522 (4th Cir. 1930), the Court, after stating that an ordinary deposit is not a "transfer" within the meaning of the Bankruptcy Act, said:

"A deposit in a bank is not a sale or parting with property, or its possession, as a payment, pledge, mortgage, gift, or security. It does not deplete the estate of the depositor, but results in substituting for currency, bank notes, checks, drafts, and other bankable items a corresponding credit with the bank, which may be checked against, and which provides the depositor with the medium of exchange in universal use in the transaction of business. A deposit of funds differs from a payment in the essential particular that it is withdrawable at the will of the depositor. Of course, a deposit may be made the cloak for some other transaction, such as payment or the giving of security; and in such case equity, which looks through form to substance, will treat the transaction according to its real nature. But if the deposit is in reality a deposit, made in good faith as such, subject to the withdrawal of the depositor, and not made as a cloak for a payment or other forbidden transaction, it is not a transfer within the meaning of the Bankruptcy Act and cannot be attacked as preferential, even though it may have been made when the depositor was insolvent, and even though the bank, by applying it as a setoff, may have obtained a greater percentage on a debt which it holds against its insolvent depositor than his other creditors can obtain." *Lineberger* at 527-28

Appellant claims that the case of *Hall vs. Rochester Trust Co.*, 9 F. Supp. 797 (D.C.N.H. 1935), correctly states the law as to when Section 68(a) is applicable as opposed to Section 60:

"It is true that if the deposits by the company had been made in the defendant bank for the purpose of creating a right of setoff or if there had been any collusion between the bankrupt and the bank to enable the bank to receive a greater percentage of its debts than any other unsecured creditor, then the transaction might be held to create a preference under section 60a. But such is not the fact in the instant case. I find there was nothing unusual or out of the ordinary in the transaction between the parties. They continued doing business in the usual and ordinary way right up to the time of the common-law assignment. The deposits were not made for the purpose of giving the bank a preference and the bank had no reasonable cause to believe that the Leavitt Company was insolvent to the extent that it would not continue to meet its obligations.

"I hold that the bank was within its rights when it on November 4, 1932, charged the bankrupt's account with \$3,718.52, and that the case is governed by section 68a of the Bankruptcy Act and not by section 60a as New York County Bank v. Massey, supra; In re Scherzer (D.C.) 130 F. 631; In re Myers (D.C.) 99 F. 691; Toof v. City National Bank of Paducah (C.C. A.) 206 F. 250." *Hall* at 800.

In the case on appeal, the Court should apply Section 68(a) and not Section 60. The record evidences absolutely no collusion between the Bank and the Company. The Bank clearly had a right to set off the deposits it received from the bankrupt, and such setoff is governed by Section 68(a).

POINT I.

B. UNDER SECTION 68(a) OF THE BANKRUPTCY ACT, THE BANK HAD A RIGHT TO SETOFF THE DEPOSITS MADE BY WHEAT BROS. AGAINST THE DEBTS OWED BY WHEAT BROS. TO THE BANK.

Section 68(a) of the Bankruptcy Act provides that:

a. In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the value only shall be allowed or paid.

The rule that a bank may set off deposits against debts owed to it by the depositor is clear and supported by the great weight of authority. When Wheat Bros. made deposits on September 21, October 4 and on October 18, the Bank was within its rights to set these deposits off against the overdraft and notes that were owing to the bank.

Collier, who is considered the foremost expert on bankruptcy, states that:

> "The general rule may first be stated that where an insolvent debtor makes general deposits within four months of his bankruptcy, which deposits are accepted in good faith and in the regular course of business, the bank has a right to set off such deposits against an obligation owing to it by the debtor . . .
>
> It is only where affairs have reached such a point that the bank accepts the deposits for the purpose of payment, or of giving itself a subsequent advantage over other creditors through its right of setoff, or for some other special purpose, that the deposit and the subsequent application of it amounts to a reasonable preference. *4 Collier on Bankruptcy* (14th Ed.) par. 68.16.

Another text states that the *deposit* is the key factor in the allowability of a setoff and not the *setoff*.

> The right of setoff existing under the Bankruptcy Act raises some peculiar questions of preference in the case of deposits in a bank which holds obligations of the depositor. *It is the making of the deposit, and not the subsequent application of it by way of setoff to the debt of the bank, that constitutes the preference, if any, under the Bankruptcy Act.*
>
> A deposit in the usual course of business in good faith to the open or general account of the depositor, subject to his check, does not result in a preferential transfer,

> notwithstanding it may place the bank in position, in the event of the depositor's bankruptcy, to set off the deposit against his debt to the bank. The rule applies to a deposit made subject to the collection of the different items thereof if the intent at the time of the deposit was that checks against it would be honored when the items were collected. The principal reason which the courts have assigned for the rule is that when a deposit is made under the circumstances indicated, there is no diminution of the depositor's estate, since he thereby receives an equivalent credit, which is immediately available to him. 9 Am. Jur. 2d Bankruptcy Sec. 525 (1963). (emphasis added)

That the deposits were made in the usual course of business will be discussed under Point II.

There are many cases wherein the court has upheld a bank's right to a setoff under Section 68. Perhaps the most frequently cited case is the United States Supreme Court case of *New York County National Bank vs. Massey,* 192 U.S. 138, 48 L.Ed. 380 (1904). In that case the Court specifically approved a setoff by the bank from a depositor's account, to pay part of an overdue note. The Court held that the setoff was not a voidable transfer, and that it was a permissible setoff under Section 68 of the Act. The following statements are of importance:

> "As we have seen, a deposit of money to one's credit in a bank does not operate to diminish the estate of the depositor, for when he parts with the money he creates at the same time, on the part of the bank, an obligation to pay the amount of the deposit as soon as the depositor may see fit to draw a check against it. It is not a transfer of property as a payment, pledge,

mortgage, gift, or security. It is true that it creates a debt, which, if the creditor may set it off under Section 68, amounts to permitting a creditor of that class to obtain more from the bankrupt's estate than creditors who are not in the same situation, and do not hold any debts of the bankrupt subject to set-off. But this does not, in our opinion, operate to enlarge the scope of the statute defining preferences so as to prevent set-off in cases coming within the terms of Section 68a.

* * * * *

"It is true, as we have seen, that in a sense the bank is permitted to obtain a greater percentage of its claim against the bankrupt than other creditors of the same class, but this indirect result is not brought about by the transfer of property within the meaning of the law. There is nothing in the findings to show fraud or collusion between the bankrupt and the bank with a view to create a preferential transfer of the bankrupt's property to the bank, and in the absence of such showing we cannot regard the deposit as having other effect than to create a debt to the bankrupt, and not a diminution of his estate." *Massey* at 147.

We submit that the case at bar falls directly within the rule announced by the United States Supreme Court in the *Massey* case. A very similar holding is given by the Supreme Court in *Studley vs. Boylston National Bank of Boston,* 229 U.S. 523, 57 L. Ed. 1313 (1913), where the Court again specifically approved setoffs by a bank within four months before bankruptcy and declared them not to be voidable transfers.

"For there is nothing in the statute which deprives a bank, with whom an insolvent is doing business, of the rights of any other creditor taking money

> without reasonable cause to believe that a preference will result from the payment. The Bankruptcy Act contemplates that by remaining in business and at work, an insolvent may become able to pay off his debts. It does not prevent him from continuing in trade, depositing money in bank, drawing checks and paying debts as they mature, either to his own bank or any other creditor." *Studley* at 526.

The case of *White vs. Pacific Southwest Trust & Savings Bank,* (9 F.2d 650 (D.C.S.O. Cal. 1926), contains a rather extensive discussion on many factors of bankruptcy law in a case where disgruntled creditors were attempting to set aside a court approved agreement under which two banks were permitted to retain funds received by them from the setoff of the bankrupt's accounts, even though the banks had been parties to creditors' agreements during a period of insolvency. The Court did not require the banks to return the money, stating as law:

> "It must be conceded that it is clearly established by the authorities that, where deposits are made by a depositor in good faith in the regular course of business, and not for the purpose of enabling the bank to secure a preference, the bank has a right to set off a deposit against a claim held by it against a depositor who subsequently becomes a bankrupt. Collier on Bankruptcy (13th Ed.) p. 1612; New York County National Bank v. Massey, 192 U.S. 138, 24 S. Ct. 199, 48 L. Ed. 380. And the bank's right to set-off in such cases is not defeated because it has knowledge or notice of the insolvency of its depositor. In re Wright-Dana Hardware Co. (D.C.) 207 F. 636; New York County National Bank v. Massey, supra; Studley, etc., v. Boylston Bank, 229 U.S. 523, 33 S. Ct. 806, 57 L. Ed. 1313." *White* at 658.

In another interesting case the Court sustained the validity of two setoffs by two banks who were approached by an admittedly insolvent customer, and one bank said it would follow the lead of the other in deciding whether to extend new credit. Instead, both banks set off against overdue accounts the funds on deposit in the customer's checking account. Because the testimony proved that the deposits had been made in the regular course of business and not fraudulently and collusively for the purpose of giving the bank an unlawful preference, there was no reason to hold the setoffs to be voidable preferences. No attempt had been made to build up the balances and no restrictions had been placed on the withdrawal thereof, according to the Court. Also of importance was the following:

> "It is firmly established that the act of a bank in taking over the deposit of a bankrupt and setting it off against his debt to the bank under Section 68 is not a transfer within the meaning of the other sections referred to, provided the deposits were made in good faith and not as a cloak for a payment or other forbidden transaction.
>
> "But if the deposit is in reality a deposit, made in good faith as such, subject to the withdrawal of the depositor, and not made as a cloak for a payment or other forbidden transaction it is not a transfer within the meaning of the Bankruptcy Act and cannot be attacked as preferential, even though it may have been made when the depositor was insolvent, and even though the bank, by applying it as a set-off, may have obtained a greater percentage on a debt which it holds against, its insolvent depositor than his other creditors can obtain See also Kane v. First National Bank, 5 Cir., 56 F.2d 534, 85 A.L.R. 362; Cusick v. Second Na-

tional Bank, 73 App. D.C. 16, 115 F.2d 150." *Hughes vs. Machen* 164 F.2d 983, 986-87 (4th Cir. 1947).

In the case of *Jandrew vs. Guaranty State Bank of Ovilla, Texas,* 294 F. 530 (5th Cir. 1923), the Court allowed the debtor to pay off a note owed to the bank by a check drawn on its deposits at the bank. The Court reasoned that under Section 68 the trustee would be required to do after bankruptcy what the bank and the depositor had done before bankruptcy.

> "The bankruptcy Act itself would do what the parties voluntarily did, had they omitted to do it. What the payment of the check transferred to the bank was only what the bank would have obtained as against other creditors of the same class, upon the filing of the petition, through the obligation of the trustee to apply the deposit to the payment of the notes in stating the account between the bank and the bankrupt. The payment of the check could have no effect to give the bank a greater percentage of its debt than other creditors of its class, since it would receive through payment by check only what the Bankruptcy Act would give it, though no such payment had been made to it. As the payment of the check was not a preferential payment, but merely a voluntary accomplishment of an offset, which was provided for by the Bankruptcy Act in the absence of voluntary action, we see no reason for disallowing the offset because the parties anticipated the action of the law even though the bankrupt was then insolvent within the knowledge of the bank." *Jandrew* at 531.

In the case of *Farmer's Bank of Clinton, Mo. v. Julian,* 383 F.2d. 314 (8th Cir. 1967), the bank set off a deposit of $9,733.88 against $16,000.00 owed the bank. The amount set off was in a general checking account used in the ordinary course of business by the bankrupt. In allowing the setoff the Court said:

> "Section 68(a) of the Bankruptcy Act, 11 U.S.C. § 108 applies and allows a setoff to the Bank unless the account has been accepted or built up for the real purpose of permitting the Bank to obtain a preference by way of setoff of the account. A bank account at the time of filing the petition in bankruptcy is a debt due to the bankrupt from the bank, and in the absence of fraud or collusion between the bank and the bankrupt, the bank may set the account off against any indebtedness owed by the bankrupt.
>
> "The issue is: Was the account of the bankrupt built up, with the understanding of the Bank, for the purpose of allowing the Bank to use it as an offset and thereby obtain a preference?" *Julian* at 324.

In addressing itself to this issue the Court held that the referee was in error in concluding that the account had been built up so that a setoff could be made even though the account went from a balance of $34.84 to $11,197.14 in four days. The Court noted that the account was an active one and that checks were paid between the deposits. The bankrupt had testified that he had made no effort to build up the account or to make deposits other than to cover checks and that the deposits were made in the usual course of business. The Court also said:

> "The Bank on the same day had already honored a number of checks totaling some $1,400.00. This evidence clearly indicates that there was no collusive build-up of the bank account and that the Bank only

decided to make the setoff on the day the setoff was actually executed. The refusal of Commercial Credit to proceed with the long-term capital loan triggered the Bank's decision to avail itself of its setoff right. The pattern of deposits and withdrawals throughout the month is fairly uniform and is certainly in line with the normal business operation of the bankrupt.

"The fact that checks were outstanding against the account at the time of setoff negatives any intent on Woody's part to build up the account for the purpose of setoff, and there is absolutely no evidence of any collusive or pre-arranged plan of action between Woody and the Bank to build up this account." *Julian* at 325.

Defendant submits that the *Julian* case is very much in point with the case on appeal. The Bank paid Wheat Bros. checks before each of the deposits in question. The account was an active one. There is no evidence of a collusive build-up of the account so that the Bank could make a setoff; in fact, the Bank did not know deposits would be made until they were brought into the Bank. The deposits were made in the regular course of business to cover checks with no thought of a build-up. Furthermore, the Bank only decided to make the setoff on the day it was made with the exception of the overdraft which was automatically set off. In short, there is absolutely no evidence of any collusive or prearranged plan between Wheat Bros. and the Bank.

The *Julian* case and the numerous other cases cited by defendant conclusively show that the case on appeal falls under Section 68(a) and not Section 60. Therefore, since plaintiff has failed to meet his burden of proof in showing collusion or a pre-arrangement, the setoffs must be allowed to stand.

POINT II.

THE DEPOSITS MADE BY WHEAT BROS. WERE MADE IN GOOD FAITH AND IN THE REGULAR COURSE OF BUSINESS.

The cases and other authorities that refer to a bank's right of setoff under Section 68(a) state in various language that the deposit must be made in good faith; made in the regular or ordinary course of business; made to depositor's open or general account; deposit subject to his check; made without fraud or collusion between depositor and bank; intended as a deposit and not as a payment to the bank, etc. See, e.g., *Rector v. Commercial Nat. Bank*, 200 U. S. 420, 50 L. Ed. 533 (1906); *Kane v. First Nat. Bank*, 56 F. 2d 534 (5th Cir., 1932); and *Hughes v. Machen*, 164 F. 2d 983 (4th Cir., 1947).

The appellant contends that the deposits were made in good faith by Wheat Bros. and in the regular course of business. There is absolutely no evidence whatever of any collusion or fraud between the Bank and Wheat Bros. to allow a preference.

Although the Bank had been in contact with Wheat Bros. prior to the deposit of September 21, 1965, because of the overdraft, the deposit was still made in the regular course of business. The Company had been depositing its payments for work completed with the Bank since 1952.

The deposit was made in the same way the Company always made deposits with the Bank, and there was nothing said about the deposit at the time it was made. The Bank did not have prior notice of any of the deposits in question, nor did the Bank have any intent to prefer itself over any other creditors. The clearing of an overdraft is an automatic process which required no decision on the part of the Bank. After the overdraft was cleared, Wheat Bros. was left with a credit balance against which it drafted checks.

In the trial court the appellee sought to show that the deposit was not in the regular course of business because the Jacobsen check, which was part of the September 21st deposit, was given special handling. Such handling is irrelevant to this point. The law requires that the *deposits* be made in good faith and in the regular course of business. The law says nothing about the *collecting* of deposits. The decision to give the Jacobsen check special handling was made after the deposit because of the size of the check, and was not related to receipt of the deposit.

In the case of *Wilson v. Citizens' Trust Co.*, 233 F. 697 (D.C.S.D. Geo. 1916), the Court had to answer the question as to whether a bank, which was aware of the depositor's insolvency, could draw a check on the bankrupt's account to setoff the deposit against debts owed to the bank. In dealing with that question the Court held that it was the making of the deposit, and not the subsequent application of the same by way of setoff to the debt of the bank, that constituted the preference, if any, under the Bankruptcy Act.

It is submitted by an appellant that the abuse the Bankruptcy Act is trying to guard against is agreements by banks and insolvent depositors whereby the insolvent depositor makes a deposit with the intent to give the bank a preference. There is no evidence of such intent shown here on the part of Wheat Bros.

That the deposits of October 4th and October 18th were made in good faith and in the regular course of business is also very clear. Between September 10th and October 18th, Wheat Bros. made eight separate deposits totaling $48,232.23. The Bank did not know in advance that any one of the deposits would be made, nor had the Bank made arrangements with the Company for any of the deposits to be made. Each of the deposits was made in good faith by the Company with the intent to draw checks against them, and, in fact, the Bank paid all Wheat Bros.' checks up until September 20th and thereafter the Bank paid all Wheat Bros.' checks drafted against a credit balance.

Concerning the deposit of October 18th, Joe Wheat's testimony clearly shows that the deposit was made specifically with the intent of meeting a payroll.

In the case of *McGuigan v. Dime Bank Title & Trust Co.*, 47 F.2d. 760 (2nd Cir. 1931), the bank had set off $38,994.09 against debts that the bankrupt owed the bank. The setoff was made the same day that the deposit was made, and, at the time of the setoff the bank was aware of depositor's insolvency. In holding that the bank had a right of setoff, the Court said:

"The depositor, the Whitenight's, Inc. was indebted to the bank, and the bank had the right to set off its debt to the depositor, arising by the deposit, against the debt the depositor owed it, and *it makes no difference whether the deposit was one day old or one year old,* or whether checks to the order of other creditors had been honored by the bank or not. The bank did only what it had a right to do, and should do." (emphasis added)

* * * * *

"The right of setoff is given by the Bankruptcy Act itself, and the test in cases where the right of setoff by a bank is questioned is always whether, after insolvency, the money was deposited for the purpose of enabling the bank to secure a preference. If not, the setoff should be made. New York County National Bank v. Massey, 192 U.S. 138, 24 S. Ct. 199, 48 L. Ed. 380. The statement of claim in this case contains no averment to the effect that the deposits were made for the purpose of enabling the bank to secure a preference. Therefore, the setoff was properly and legally made, and did not constitute a preference which may be recovered by the trustee."

"In Studley, Trustee, v. Boylston National Bank, 229 U.S. 523, page 527, 33 S. Ct. 806, 808, 51 L. Ed. 1313, Mr. Justice Lamar said, in delivering the opinion of the court:

" 'The money so deposited was the proceeds of the sale of tickets to a large party of round-the-world tourists, and was put in bank, not for the purpose of preferring it, but in the expectation of being used for carrying on the business in the future as in the past. Indeed, the payments were made with the statement that the company would expect the Bank to discount

> other notes. We find nothing in the record to indicate that the deposits were made for the purpose of enabling the bank to secure a preference by the exercise of the right of set-off. The case, therefore, comes directly within the decision in New York County Nat. Bank v. Massey, 192 U.S. 138, 24 S. Ct. 199, 48 L. Ed. 380, where $3,884 deposited by an insolvent customer, in good faith, four days before the filing of the petition against him, was allowed to the bank by way of set-off on notes of the bankrupt held by it.' " *McGuigan* at 762

The case on appeal falls within the language of the *McGuigan* case. The setoffs were made the same day as the deposit and there is no proof that the deposits were made with the purpose of enabling the bank to secure a preference.

In the case of *In re Empire Flooring Co.* 43 F. 2d. 748 (D.C.W.D. Pa. 1930), the Court said that:

> "Therefore, unless the trustee is in a position to show that the bank balance at the time of the adjudication in bankruptcy had been created with a special purpose of giving a preference to the bank, the bank would legally be entitled to have a set-off." *Empire Flooring* at 749.

In the case of *In re Wright-Dana Hardware Co.*, 212 F. 397 (2nd Cir. 1914), the Court held that the right of a bank to apply a deposit on a debt due it within four months before the filing of a petition in bankruptcy cannot be denied upon a mere suspicion or bare inference that it had reasonable cause to believe that a preference would be effected.

> "And the court declared in its opinion that there was no evidence, unless by inference, that bankruptcy

was contemplated, or that any preference was intended by the company, prior to January 1, 1912. We think that as to the set-offs thus allowed, the court below was right in sustaining them, as it was not made to satisfactorily appear that the bank had reasonable cause to believe, at the time they were made, that a preference would be thereby effected. *The right of the bank to make the set-offs made prior to January 1, 1912, cannot be denied upon a mere suspicion or a bare inference.* If courts were to proceed so to administer the law, banks could not safely do business with insolvents. The intention of the act that insolvency should not deprive one of his right to remain in business would be destroyed in large part, and bankruptcy in many cases would be precipitated, if the courts should, upon slight inferences, deny the right of set-off." *Wright-Dana Hardware* at 402. (emphasis added)

POINT III.

THE BANK'S RIGHT OF SETOFF APPLIES TO OVERDRAFTS AS WELL AS TO OVERDUE NOTES.

The majority of cases which deal with a bank's right of setoff under Section 68(a) involve a setoff by the bank against notes the bank is holding. However, the principles of setoff also apply where the depositor has an overdraft with the bank.

The case of *Tomlinson v. Bank of Lexington,* 145 F. 824 (4th Cir. 1906), is factually similar to the case on appeal. In that case a partnership owed the bank about $13,000.00 in notes, and for about two years preceding bankruptcy, the company had carried an overdraft with the bank to pay for the day-to-day expenses of running the business.

The bank and the company had a distinct understanding and agreement that the next succeeding deposits would discharge the overdraft. The bank allowed the overdrafts "because of the promise of the company to deposit the proceeds of certain good accounts held by the company to the payment of the overdraft."

The Court held that the bank did not receive a voidable preference by permitting the customer to overdraw its checking account on the express agreement that the customer would assign good accounts for collection to pay the overdrafts. The Court stated:

> The transfer, too, was made as found by the referee, not only in the regular and due course of business, but on a distinct understanding and agreement to that effect. It should be borne in mind none of these overdrafts or the proceeds of assigned accounts were credited on the bank debt of $13,100, evidenced by notes endorsed by Montcastle and Ward, officers of the bank, but were credited on the overdrafts permitted under the express agreement; "a fair exchange of values," as expressed in Cook v. Tullis, 18 Wall. 332, 21 L. Ed. 933, "which may be made at any time even if one of the parties is insolvent." *Tomlinson* at 828.

It is to be noted in connection with the rule of the *Bank of Lexington* case that Wheat Bros. began incurring overdrafts in 1964. In September of 1965 the Bank contacted the Company and was assured that receivables would soon be forthcoming from Jacobsen Construction and others. Thereupon the Bank contacted those from whom the Company claimed money was owed and merely confirmed that fact.

was contemplated, or that any preference was intended by the company, prior to January 1, 1912. We think that as to the set-offs thus allowed, the court below was right in sustaining them, as it was not made to satisfactorily appear that the bank had reasonable cause to believe, at the time they were made, that a preference would be thereby effected. *The right of the bank to make the set-offs made prior to January 1, 1912, cannot be denied upon a mere suspicion or a bare inference.* If courts were to proceed so to administer the law, banks could not safely do business with insolvents. The intention of the act that insolvency should not deprive one of his right to remain in business would be destroyed in large part, and bankruptcy in many cases would be precipitated, if the courts should, upon slight inferences, deny the right of set-off." *Wright-Dana Hardware* at 402. (emphasis added)

POINT III.

THE BANK'S RIGHT OF SETOFF APPLIES TO OVERDRAFTS AS WELL AS TO OVERDUE NOTES.

The majority of cases which deal with a bank's right of setoff under Section 68(a) involve a setoff by the bank against notes the bank is holding. However, the principles of setoff also apply where the depositor has an overdraft with the bank.

The case of *Tomlinson v. Bank of Lexington,* 145 F. 824 (4th Cir. 1906), is factually similar to the case on appeal. In that case a partnership owed the bank about $13,000.00 in notes, and for about two years preceding bankruptcy, the company had carried an overdraft with the bank to pay for the day-to-day expenses of running the business.

The bank and the company had a distinct understanding and agreement that the next succeeding deposits would discharge the overdraft. The bank allowed the overdrafts "because of the promise of the company to deposit the proceeds of certain good accounts held by the company to the payment of the overdraft."

The Court held that the bank did not receive a voidable preference by permitting the customer to overdraw its checking account on the express agreement that the customer would assign good accounts for collection to pay the overdrafts. The Court stated:

> The transfer, too, was made as found by the referee, not only in the regular and due course of business, but on a distinct understanding and agreement to that effect. It should be borne in mind none of these overdrafts or the proceeds of assigned accounts were credited on the bank debt of $13,100, evidenced by notes endorsed by Montcastle and Ward, officers of the bank, but were credited on the overdrafts permitted under the express agreement; "a fair exchange of values," as expressed in Cook v. Tullis, 18 Wall. 332, 21 L. Ed. 933, "which may be made at any time even if one of the parties is insolvent." *Tomlinson* at 828.

It is to be noted in connection with the rule of the *Bank of Lexington* case that Wheat Bros. began incurring overdrafts in 1964. In September of 1965 the Bank contacted the Company and was assured that receivables would soon be forthcoming from Jacobsen Construction and others. Thereupon the Bank contacted those from whom the Company claimed money was owed and merely confirmed that fact.

In the case of *Steere v. Stockyards Nat. Bank,* 266 S. W. 531 (Tex. 1924), the bankrupt had maintained an account with the bank for more than three years prior to bankruptcy. The bankrupt was often allowed to draw checks which caused overdrafts which were subsequently paid by deposits. At one point within four months of bankruptcy the bankrupt had an overdraft of over $45,000. At that point the bank president called the bankrupt to inquire for information. The bank was told that a large deposit would soon be made, and, in fact, a few days later, a deposit in excess of the overdraft was made. Thereafter, the bankrupt's checks were honored until the bank learned of the insolvency. The Court held that the bank had a right to apply the deposits to the overdraft and that such application did not amount to an undue preference. The Court in so ruling said:

> The same case is authority for the conclusion that the mere fact that an overdraft, or overdrafts, from time to time may occur in a depositor's account, does not amount to notice either of his insolvency or of the trust character of the fund deposited. *Steere* at 535.
>
> "The general rule is well settled that when a depositor is indebted to a bank, the bank may apply his deposits, or such portion thereof as may be necessary, to the payment of his indebtedness; unless there be an agreement to the contrary, or unless the deposit be specially applicable to some other particular purpose, or unless the bank has notice that the funds do not belong to the customer. This right to apply the deposit to the customer's indebtedness is called the banker's lien, or right of setoff, and does not depend upon the customer's assent. Instances of its application are most frequently found in the case of antecedent debts. We have

found no case holding that the consent of the customer was a prerequisite of the bank's right to assert its lien." *Steere* at 536.

In the case of *American Bank of Alaska v. Johnson,* 245 F. 312 (9th Cir. 1917), the bankrupt would alternately have an overdraft and then clear it with a deposit. At the time of the transaction in question, the bankrupt owed the bank $13,000 on notes and $4,096.14 on an overdraft. The bankrupt then made a deposit of $3,750.14 in gold dust which the bank setoff against the overdraft. The Court allowed the setoff even though the bank had often asked the bankrupt about the overdraft. The Court said:

> The transaction established the relationship of debtor and creditor. There having been a general deposit in course of business when the credit was made, the bank had a right to set off the notes and to dismiss the overdraft. Cumberland Glass Co. v. De Witt, 237 U. S. 447, 35 Sup. Ct. 636, 59 L. Ed. 1042; In re Wright-Dana Hardware Co., 212 Fed. 397, 129 C. C. A. 73.
>
> * * * * *
>
> There is no showing of fraud in the transaction. The bank had paid checks for the half month preceding July 31st, when the firm was owing the bank a considerable amount, and, although the officers were solicitous about the account, they had no reasonable ground to believe that the condition of the firm was desperate, or that it would not be able to go on with its mining. *Johnson* at 315.

The appellant readily admits that it was desirous of having Wheat Bros.' overdrafts cleared, as were the banks in the cases cited above, and that it did contact some of

Wheat Bros.' debtors to ascertain if funds would be forthcoming, but it is strongly contended that such concern and caution does not take the deposits out of the ordinary course of business.

Section 68(a) makes no distinction between notes or overdrafts as far as its right of setoff is concerned.

POINT IV

A. THE BANK DID NOT KNOW OR HAVE REASONABLE CAUSE TO BELIEVE THAT WHEAT BROS. WAS INSOLVENT AT THE TIME THE DEPOSITS WERE MADE.

The lower court found that, "at the time of each of the transfers above referred to, the defendant had reasonable cause to believe that Wheat Bros. was insolvent," and also that, "at the time of each of said transfers, the defendant knew that Wheat Bros. was insolvent." It is appellant's contention that the findings of the lower court are not supported by the facts of this case. The appellant certainly did not know that Wheat Bros. was insolvent nor did they have reasonable cause to believe such.

Under Section 1(18) of the Bankruptcy Act, a person is insolvent if the ". . . aggregate of his property . . . shall not in a fair valuation be sufficient in amount to pay his debts." Against this definition we measure the knowledge of the Bank.

It is well to keep in mind that Wheat Bros. had been a good customer of the Bank since 1950. On February 24, 1964, Wheat Bros. submitted a financial statement to the Bank which showed total assets of $59,845.00 and total liabilities of only $2,050.00. On June 1, 1965, Wheat Bros. submitted another financial statement to the Bank which showed assets of $95,342.00 and liabilities of $16,000.00 (Exhibit D-15). While it is true that Wheat Bros. had a continual overdraft with the Bank from the period of August 9, 1965 to September 22, 1965, the Bank had enough confidence in Wheat Bros. that none of their checks were returned with the exception of two checks written to Granite National Bank, one being for the amount of $5,000.00, the other for interest on that sum, which were returned on September 20, 1965. The checks were returned only because of the amount of money involved and the fact that such debt had not been listed on the financial statement of June 1, 1965 (R. 79). On September 9, 1965, Wheat Bros. made a deposit of $3,900.00, against which they drafted checks. Then, on September 21, 1965, the Company made a deposit of $21,320.00, the bulk of which was the Jacobsen Construction Company check for $18,150.00. Therefore, at the time of the September 21st deposit, the Company had a fairly substantial overdraft and an overdue note for $5,000.00. However, it must be kept in mind that the Bank had checked with Jacobsen Construction Company and knew that the funds would be forthcoming from Jacobsen (R. 108). The Bank also relied on the fact that Wheat Bros. was a long standing customer and upon the financial statements which the Company had submitted to the Bank over a period of time.

After the deposit of September 22nd was set off against the overdraft, Wheat Bros. had a credit balance and drafted checks against that balance. On September 24th and again on September 29th, Wheat Bros. made fairly substantial deposits to the Bank, against which they also drafted checks. Then, on October 4th Wheat Bros. made a deposit of \$7,384.00, against which the Bank set off the amount of \$5,131.25 for a note that was then overdue to the Bank. On October 8th, the Company made a deposit of \$3,696.38, against which the Bank made no setoff. On October 18th, the Company made a deposit of \$4,153.48, against which a setoff was made of \$4,050.00 against a note which was also overdue at that time.

The few days surrounding that last transaction are vital. The testimony of Mr. Joe Wheat was to the effect that when his brother, John, who had been keeping the books ended up in the hospital, he began searching around to determine the financial condition of the partnership. Of critical importance is the fact that one of the partners himself did not know of the detailed financial condition until he had thoroughly searched the records (R. 53, 56, 67). He made a deposit in the Bank on October 18th which he intended to utilize for payment of payroll checks, but as was mentioned above, the Bank exercised its right of setoff because no arrangement had been made for the use of the money for special purposes and the Bank was not advised in advance of the impending deposit (R. 54). When Joe Wheat first visited the Bank during that week, the Bank advised him of the information it had received from John Wheat regarding the financial condition of the Company. Two days later and after receipt and application of the October 18th deposit, Joe brought to the Bank the books and records of the Company which evidenced some financial problems. *It was on October 20th, two days after the last setoff, that the Bank first learned of the sad financial condition of Wheat Bros.* (R. 62, 64). Up until that time, it had been relying in good faith and with good cause on the financial statements that Wheat Bros. had submitted to the Bank. The discovery of serious financial trouble was as much a surprise to the Bank as it was to Joe Wheat. The fact that the bankers discussed at that time various alternative insolvency proceedings does not in the least suggest that the bankers had knowledge of insolvency at an earlier time.

Even during the months prior to September 21st, the inquiries of the Bank resulted in favorable information regarding Wheat Bros.' financial condition. On September 2, 1965, the Bank received information from John Wheat regarding the accounts receivable from three contractors and confirmed receivables with all of them (Exhibit D-18, R. 102). The Dun & Bradstreet report confirmed the fact that the business continued to operate on a profitable basis with work capital restricted because of difficulty in collection of accounts receivable (Exhibit D-17). The Bank knew of that precise problem and for that reason extended credit from time to time because of the expectation of subsequent collection of the accounts receivable. The end result of all available financial information would be that Wheat Bros. had large accounts receivables which exceeded the obligations due and the Bank could not, even if under a duty to do so, have discovered the full extent of the accounts payable which were subsequently listed in the bankruptcy petitions. The books of account themselves did not reflect the accounts payable (Exhibits P-7, P-8; R. 50, 51, 64).

The appellant vigorously denies that it knew that Wheat Bros. was insolvent at the time of any one of the three deposits in question. It likewise denies that it had reasonable cause to suspect that Wheat Bros. was insolvent. At the very most, some of these circumstances surrounding the deposits and some of the activities of the Company may have caused the Bank to become somewhat dubious concerning the ability of the Company to meet its current debts, but no facts were evident which would suggest insolvency. However, it is widely held that mere suspicion of insolvency is not the same as knowing of insolvency or having reasonable cause to believe that someone is insolvent. Am. Jur. states the general rule:

> Reasonable cause to believe is not the equivalent of actual knowledge or actual belief. It is sufficient to satisfy this element that the creditor have such knowledge or be put upon notice of such facts and circumstances as would incite a person of reasonable prudence under similar circumstances to make inquiry as to the financial condition of the debtor. Facts which are sufficient to put such a man upon inquiry charge the creditor with all the knowledge he could have acquired by the exercise of reasonable diligence. Mere cause to suspect the debtor's insolvency, however, is not the equivalent of reasonable cause to believe him to be insolvent. A mere suspicion in the creditor's mind is insufficient to put him upon inquiry concerning the financial condition of the debtor or charge him with notice that the debtor is insolvent. 9 Am. Jur.2d Bankruptcy Sec. 1083 (1963).

The case of *McDonald v. Lawson,* 356 P. 2d 1041 (Wyo. 1960), states the general rule that mere suspicion is not sufficient to charge the creditor with knowledge of insolvency. That Court said:

All the cases agree that it is not enough that a creditor have some cause to suspect insolvency but he must have knowledge of facts to induce him to believe that his debtor is insolvent. A case often cited is Grant v. National Bank, 97 U.S. 80, 81, 24 L. Ed. 791, where the Supreme Court of the United States stated:

". . . It is not enough that a creditor has some cause to suspect the insolvency of his debtor; but he must have such a knowledge of facts as to induce a reasonable belief of his debtor's insolvency, in order to invalidate a security taken for his debt. To make mere suspicion a ground of nullity in such a case would render the business transaction of the community altogether too insecure. It was never the intention of the framers of the act to establish any such rule. A man may have many grounds of suspicion that his debtor is in failing circumstances, and yet have no cause for a well-grounded belief of the fact. He may be unwilling to trust him further; he may feel anxious about his claim, and have a strong desire to secure it,—and yet such belief as the act requires may be wanting. Obtaining additional security, or receiving payment of a debt, under such circumstances is not prohibited by the law. Receiving payment is put in the same category, in the section referred to, as receiving security. Hundreds of men constantly continue to make payments up to the very eve of their failure, which it would be very unjust and disastrous to set aside. And yet this could be done in a large proportion of cases if mere grounds of suspicion of their solvency were sufficient for the purpose."

In Gray v. Little, 97 Cal. App. 442, 275 P. 870, 871, 872, the court succinctly stated some of the principles applicable as follows:

> "The fact alone that a creditor knows his debtor to be financially embarrassed and is pressing for a payment of his claim is not sufficient to charge him with having reasonable cause to believe his debtor to be insolvent. Sharpe v. Allender (C.C.A.) 170 F. 589; Page v. Moore, (D.C.), 179 F. 988. Mere suspicion that the debtor may be insolvent is not sufficient to render payments received by a creditor voidable as preference, but he must have such knowledge of facts as to induce a reasonable belief of insolvency. Bassett v. Evans (C.C.A.) 253 F. 532; City National Bank of Columbus v. Slocum (C.C.A.) 272 F. 11; Homan v. Hirsch, 106 Or. 98, 211 P. 795. It is not enough that a creditor has cause to suspect the insolvency of the debtor, but he must have such a knowledge of facts as to induce a reasonable belief of his debtor's insolvency, in order to invalidate a security taken for his debt. Grant v. National Bank, 97 U.S. 80, 81, 24 L. Ed. 971; In re Campion et al. (D.C.) 256 F. 902. In the case last cited the court said that the burden is on the trustee in bankruptcy to show that the creditor to whom the transfer was made shortly before bankruptcy had reason to believe that a preference would result. The trustee has failed to sustain this burden in this case. . . ."
>
> See further In re Solof, 9 Cir., 2 F. 2d 130; In re Salmon, 2 Cir., 249 F. 300; Cate v. Certainteed Products Corporation, 23 Cal. 2d 444, 144 P. 2d 335." *McDonald* at 1044.

At most, appellant had mere suspicion of Wheat Bros.' inability to pay its debts as they matured. Nothing in the record shows that the Bank had reason to doubt the excess of Wheat Bros. assets over its liabilities as clearly expressed in the financial information available to the Bank.

POINT IV.

B. EVEN IF THE BANK KNEW OR HAD REASON TO KNOW OF WHEAT BROS.' INSOLVENCY, SUCH FACT IS IRRELEVANT IN THIS CASE.

Notwithstanding the argument made in Point IV A, supra, and notwithstanding that appellant strongly denies that it had reason to suspect that Wheat Bros. was insolvent, it is submitted that such knowledge or suspicion of insolvency would make no difference in the outcome of this case.

The general rule is:

> "The fact alone that the bank, at the time of the making of the deposit, knows that the depositor is insolvent or in financial difficulties will not affect its right of setoff. The mere fact that at the time a bank applies a depositor's balance on his indebtedness to it, the bank is charged with knowledge that the depositor is insolvent, does not make the application a preferential payment. If the deposit is made more than 4 months before the filing of a petition in bankruptcy by the depositor, the mere exercise by the bank of the right of setoff, though within this period, or even after the institution of bankruptcy proceedings, does not constitute a preferential transfer. It seems, generally speaking, to be immaterial that the debt owing by the depositor to the bank arose from an overdraft on the part of the depositor. 9 Am. Jur. 2d *Bankruptcy* Sec. 525 (1963)."

The Supreme Court case of *Massey,* supra, supports this rule. Also, the Court is reminded of the above quoted statement found in 4 *Collier on Bankruptcy* (14th Ed.) par.

60.15 which said in part, ". . . were not preferential transfers, even if made while the debtor was insolvent and the bank had knowledge or notice of the depositor's insolvency."

In the case of *In re Wright-Dana Hardware Co.*, 212 F. 397 (2nd Cir., 1914), the Court discusses a bank's right of setoff under Section 68(a):

> "Our attention is called to the fact that the referee found that the Wright-Dana Company was insolvent on September 15, 1911 (four months before bankruptcy), and continued to be insolvent to the date of its adjudication in bankruptcy on February 5, 1912, and that during the whole of that time the fact of its insolvency was known to the bank. All this may be true and yet not deprive the bank of its right to set-off. A bank may do business in the usual manner with one it knows to be insolvent. The mere fact of insolvency, or mere knowledge of the insolvency of the depositor, is not alone sufficient to take away the bank's right of setoff. *Wright-Dana Hardware* at 401.

In the case of *In re Cummins Const. Corp.,* 72 F. Supp. 409 (D.C. Md., 1947), the Court said:

> If a bank, in the ordinary course of business, receives deposits from a depositor before and during four months next preceding such depositor's adjudication in bankruptcy, and if during such four month period, with notice that such depositor is in financial difficulties, the bank applies his deposits against his indebtedness to the bank, has the bank thereby received a voidable preference? The law is very clear that this question must be answered in the negative. The Supreme Court so decided as early as 1904, in New York County Bank v. Massey, 192 U. S. 138, 24 S. Ct. 199,

48 L. Ed. 380, and again in Studley v. Boylston Bank, 229 U.S. 523, 33 S. Ct. 806, 57 L. Ed. 1313. See also United States v. Butterworth-Judson Corp., 267 U. S. 387, 45 S. Ct. 338, 69 L. Ed. 672 and Citizens National Bank of Gastonia, N. C. v. Lineberger, a decision of the Circuit Court of Appeals, Fourth Circuit, 45 F. 2d 522. *Cummins Const.* at 413-14."

POINT V.

THE TRUSTEE HAS THE BURDEN OF PROOF IN PROVING A VOIDABLE PREFERENCE BY A PREPONDERANCE OF THE EVIDENCE AND RESPONDENT HAS NOT MET THAT BURDEN.

In the case of *Farmer's Bank v. Julian,* 383 F. 2d 314 (8th Cir., 1967), which involved a bank's right of setoff, the Court said that:

> The Trustee has the burden of proof of proving a voidable preference by a preponderance of the evidence. City Nat. Bank v. Slocum, 272 F. 11 (6 Cir. 1921) cert. denied 257 U. S. 637, 42 S. Ct. 49, 66 L. Ed. 409; Moran Bros., Inc. v. Yinger, 323 F. 2d 699 (10 Cir. 1963). *Julian* at 324.

The case of *Moran Bros., Inc. v. Yinger,* 323 F. 2d 699 (10th Cir., 1963), deals with reasonable cause to know of insolvency under Section 60. The Court held that the trustee has the burden of proof in establishing a preference and that there is a presumption of good faith on the part of a creditor who receives a payment of his debt.

> And, finally, as a corollary to the rule imposing the burden of proof upon the trustee, there is a presump-

> tion of good faith on the part of a creditor who receives a payment of his debt which must be overcome by evidence of reasonable cause to believe that the debtor is insolvent. Canright v. General Finance Corporation, & Cir., 123 F. 2d 98; Republic National Bank of Dallas v. Vial, 5 Cir., 232 F. 2d 785. *Yinger* at 702.

In the case of *City Nat. Bank v. Slocum,* 272 F. 11 (6th Cir. 1921), the Court held that the trustee had the burden of proof in establishing that a transfer of a mortgage was a preferential transfer.

It is submitted to the court that the trustee in the case on appeal has not met the burden of proof to establish a preferential transfer. There is no substantial evidence in the record to show that either the appellant had knowledge of insolvency or that any of the deposits in question were made other than in the regular course of business. That being the case, the bank was completely within its right in setting off the deposits against the debts owed to the Bank. Such right of setoff is explicitly allowed under Section 68(a) of the Bankruptcy Act.

Therefore, the appellant requests that this court reverse the lower court and allow appellant to retain the setoffs that it made.

CONCLUSION

Based on the foregoing arguments, this Court should reverse the judgment rendered against appellant for the following reasons:

(a) The receipt of deposits of Wheat Bros. and the right of setoff exercised by appellant were not preferential transfers;

(b) The Bank, through its officers, had no knowledge and no reasonable cause to believe, that Wheat Bros. was insolvent at the time the Bank exercised its right of setoff;

(c) The setoff between mutual obligors provided by Section 68 of the Bankruptcy Act places the transactions between appellant and Wheat Bros. directly in harmony with existing law, and not subject to avoidance by the trustee; and

(d) Respondent failed to meet its burden of proof in the lower court.

Respectfully submitted,

DON B. ALLEN
M. JOHN ASHTON of
RAY, QUINNEY & NEBEKER
400 Deseret Building
Salt Lake City, Utah 84111
Attorneys for Appellant