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 Respondent

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,

v.

FIRST SECURITY BANK OF
UTAH, N.A., a corporation,
Defendant and Appellant.

Case No.
11768

RESPONDENT'S BRIEF

**Appeal from a Judgment of the District Court
of Salt Lake County
Hon. Stewart M. Hanson, Judge**

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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,

v.

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

Defendant and Appellant.

Case No. 11768

RESPONDENT'S BRIEF

NATURE OF CASE

This is an action under Section 60b of the Bankruptcy Act (11 U.S.C. §96) to recover on behalf of the bankruptcy estate three separate sums transferred, in the form of bank deposits, by the bankrupt (Wheat Bros.) to defendant First Security Bank of Utah within

four months before the voluntary petition in bankruptcy was filed.

DISPOSITION IN LOWER COURT

After a trial without a jury, the court found that the three deposits were made and received for the purpose of paying an antecedent debt, were not in the ordinary course of business, and were voidable preferences under the Bankruptcy Act. Accordingly, it entered judgment in favor of the plaintiff and against the defendant in the amount of $27,331.25, together with interest of $3,624.62, and $52.60 costs.

RELIEF SOUGHT ON APPEAL

Respondent seeks affirmance of the judgment.

STATEMENT OF FACTS

The facts set out in appellant's brief are essentially correct, but incomplete. Failure to set out all of the material evidence presented at the trial creates a serious problem, because notwithstanding that appellant's brief is cast primarily in the form of legal argument about application of certain sections of the Bankruptcy Act, the appeal is essentially an attack upon the sufficiency of evidence to support findings of fact made by the trial court.

Under Section 60 of the Bankruptcy Act any transfer made by the bankrupt is to be set aside if the trustee establishes the following:

(1) There was a transfer of property by the bankrupt;

(2) At the time of the transfer the transferee was a creditor of the bankrupt;

(3) The transfer was made in payment of an antecedent debt;

(4) The bankrupt was insolvent at the time of the transfer;

(5) The transfer was made wtihin four months before the filing of a petition in bankruptcy;

(6) The transfer enabled the transferee to obtain a greater percentage of its debt than other creditors of the same class; and

(7) At the time of the transfer the transferee had reasonable cause to believe that the bankrupt transferor was insolvent.

[Sec 3 *Collier on Bankruptcy* (14th Ed.), Para. 60.02; 9 Am. Jur. 2d, Bankruptcy, §1057.]

The trial court made findings in plaintiff's favor on each of the above issues (R. 18-21), and most of the findings have not been challenged. For the purpose of this appeal it must be deemed to be established that there were three transfers of property by Wheat Bros.

to defendant (Findings Nos. 5, 10, 14); defendant was a creditor (Findings Nos. 4, 9, 13); Wheat Bros. was insolvent at the time of each transfer (Finding No. 18); each transfer was made within four months before the petition in bankruptcy was filed (Finding No. 17); and the transfers enabled defendant to obtain a greater portion of its debt than other creditors of the same class (Finding No. 21).

The findings challenged in this appeal are that the transfers were for the purpose of paying antecedent debts (Findings Nos. 8, 12, 16), and that defendant had reasonable cause to believe (and in fact knew) Wheat Bros. was insolvent at the time of each transfer (Findings Nos. 19, 20).

Both of the challenged findings involve states of mind best known to defendant and its officers. In considering the findings, therefore, the court should give weight to the facts that most of the information surrounding the deposits is in the hands of the defendant; that the plaintiff, representing the general creditors of Wheat Bros., had to rely upon circumstantial evidence to establish the relevant state of mind as it existed at the time the transaction were entered into; and that defendants were not likely to publish their intent.

The facts and circumstances surrounding the dealings between Wheat Bros. and defendant — both before and after the transfers — affect the credibility of testimony presented by defendant. Most of them are set

out immediately below. Others will be dealt with specially in the argument.

Wheat Bros., a partnership consisting of James L. Wheat, John Wheat and Joseph Wheat (R. 47), was a customer of defendant First Security Bank. Prior to the filing of the petition in bankruptcy, Wheat Bros. maintained a general checking account at the Sugarhouse office of defendant bank (R. 73), and from time to time also borrowed money from it (R. 74). During the period immediately preceding the deposits in question, Wheat Bros. was indebted to defendant on two separate $5,000.00 notes, one dated May 19, 1965, maturing August 17, 1965, and one dated July 13, 1965, maturing October 11, 1965 (R. 74; Ex. P-14).

In August, 1965, the Wheat Bros. account went into an overdraft condition (R. 76), which gradually increased (R. 76) until at the close of business on September 21, 1965, Wheat Bros. was indebted to defendant for overdrafts in the amount of $18,768.26 (R. 81; Ex. P-12).

The bank officers were concerned about the partnership overdraft (R. 112) and during the weeks preceding September 21 made frequent contacts with one or another of the partners to find out when it would be cleared (Ex. D-18; R. 83, 86, 87). During these conversations the bank officers were told they were accounts receivable that would be paid to the partnership and that deposits would be made to clear the overdraft

(R. 83, Ex. D-14). On about September 16, 1965, Jacobsen Construction Company drew a check in the amount of $18,150.00 payable jointly to "Wheat Bros. and Kaymac Sales" (Ex. P-11). Wheat Bros. obtained the endorsement of Kaymac Sales Company on the check and in return gave Kaymac a Wheat Bros. check for $12,000.00, drawn on defendant (Ex. P-13).

On September 21, 1965, Wheat Bros. deposited the $18,150.00 check at defendant's Sugarhouse office together with some other checks in a total deposit of $21,320.08 (Ex. P-10, P-12).

Jacobson Construction Company, drawer of the $18,150.00 check, was known to be a company of financial stability, and the bank had no worry about the availability of funds to pay the check (R. 84). Nevertheless, the check was given special handling. Instead of sending it through with the rest of the deposit, the bank endorsed it "For Collection Only," and had it carried by special messenger to the drawee, Zions First National Bank (Ex. P-11; R. 75, 82, 85). Defendant obtained a cashier's check from Zions payable to defendant, then deposited that check — not the Jacobsen check — in the Wheat Bros. account (R. 85).

Defendant uses a computer system in connection with its checking accounts, and as soon as a deposit is placed into an account it is applied automatically against an overdraft. This happened with respect to the deposit made on September 21 (R. 86). Defendant dishonored

the check given to Kaymac (Ex. P-13), and immediately ceased its practice of honoring Wheat Bros. overdrafts (R. 86). As soon as Wheat Bros. checks had used the balance of the September 22 deposit, defendant began returning checks unpaid whenever an overdraft was encountered. Thereafter, overdrafts were not countenced, though at times Wheat Bros. maintained a balance in the account and drew checks on that balance (R. 94).

With respect to overdrafts in the Wheat Bros. account, it was the practice of defendant's officers to consider each overdraft *before* it was paid (R. 78); in other words, Wheat Bros. was not permitted to maintain an overdraft position unless the payment of a particular item was expressly approved by a bank officer.

On October 4, 1965, Wheat Bros. left with defendant for deposit to its account the sum of $7,384.00, whereupon defendant immediately applied $5,131.25 of the deposit to pay itself the entire principal and interest on the note of May 19, 1965, which had become due on August 17, 1965 (R. 94-95). Defendant's records show that the deposit was received and the application made the same day (Exs. P-12, P-14).

Shortly before October 18, 1965, Joseph Wheat found it necessary to collect various sums in order to make a deposit to meet the partnership payroll, and on that date he took to defendant for deposit the sum of $4,153.48 (Ex. P-12). He handed the deposit to a

teller in the presence of the assistant manager, Boyd A. Lindquist (R. 53, 54). No comment was made about setting this amount off, but on that same day defendant took $4,050.00 (which depleted the amount on deposit) and applied it against the $5,000.00 note that had become due on October 11, 1965 (Ex. P-12, R. 97). October 18 was the first date after the note's due date when there was enough in the account to pay any substantial portion of the note (Ex. P-12), a fact of some significance inasmuch as Mr. Lindquist, the bank officer handling the account, believed that once an offset was made it had to be continued until the entire item was paid (R. 96).

The application of the deposit to the note on October 18, 1965, was the last transaction in the account except for service charges, debit memos for returned checks, and two small deposits totaling $83.87.

The partnership ceased to do business, though Joseph Wheat himself finished up the remaining work on the Kennecott Building. At the time of Mr. Wheat's meeting with the bank officers, shortly after the October 18 set off, liabilities of Wheat Bros. totaled something in excess of $70,000.00 while the receivables totaled about $18,000.00 (R. 57).

On December 8, 1965, voluntary petitions in bankruptcy were filed by Wheat Bros. and the three partners (Exs. P-1 through P-4). The schedules showed that the liabilities of the partnership and the partners substantially exceeded the assets, which was true at all

times within the four month period preceding bankruptcy (R. 59-60).

ARGUMENT

POINT I

SECTION 68 OF THE BANKRUPTCY ACT (11 U.S.C. §108) HAS NO APPLICATION TO THIS CASE.

Plaintiff agrees that if the Wheat Bros. deposits had been made in good faith, and in the ordinary course of business, defendant would have a right of set off by virtue of §68a of the Bankruptcy Act. But it is plaintiff's position in the present case that the preferential transfers occurred when the deposits were made, not when the bank set off the deposits in payment of Wheat Bros. debts. In order for §68a to apply, the deposits must have been made in good faith, in the ordinary course of business, and in a general account subject to withdrawal.

In actions brought under Section 60 of the Bankruptcy Act, bank deposits have frequently been given special treatment, with and without reference to Section 68, for the reason that although there is admittedly a "transfer of property" by the depositor to the bank, the transfer is often made in the regular course of business, the depositor having the right to draw checks upon the amount so deposited. All of the cases recognized, how-

ever, that whether a bank deposit is a voidable preference depends upon the circumstances under which the deposit was made. This is pointed out in 3 *Collier on Bankruptcy* (14th Ed.), Para. 60.15:

> "As a general proposition it has been asserted that such a deposit of funds differs from other payments or transfers of money or property as contemplated by Section 60, in that it is withdrawable at the will of the depositor and does not operate actually to diminish the depositor's estate. The reasoning has been that the ordinary deposit results in substituting for currency, bank notes, checks, drafts and other bankable items a corresponding credit with the bank which may be checked against or withdrawn, and which provides the depositor with the medium of exchange in universal use in the transaction of business. * * * "

Because of the possibility that banks, partly under authority of Section 68 of the Bankruptcy Act, might utilize deposits to effect prohibited preferences, the courts have gradually worked out a set of principles, governing bank deposits. They are summarized in 4 *Collier on Bankruptcy* (14th Ed.), Para. 68.16[2]:

> "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 depositor. * * *
>
> "It is only where affairs have reached such a point that the bank accepts the deposit for the

> purpose of payment, or of giving itself a subsequent advantage over other creditors through its right of set-off, or for some other special purpose, that the deposit and the subsequent application of it amounts to a recoverable preference."

The courts are in agreement that when a deposit is accepted for the purpose of payment of a debt, it constitutes a transfer of property which is voidable under Section 60 and is not protected by the set-off provisions of Section 68 of Bankruptcy Act.

In *Schmidt v. Bank of Commerce,* 150 N.M. 470, 110 Pac. 613 (1910), a trustee had brought action against a bank for recovery of a deposit as a voidable preference. The trustee prevailed in the lower court and on appeal the bank contended that it had the right to set off for the reason that the deposit had been received in due course of business. The New Mexico Supreme Court said:

> "The court finds that the appellant pursuaded and induced the bankrupt to pay to them the amount of money involved in this action for the express purpose and with the intent to apply the same upon the indebtedness then owing by the bankrupt to appellant. This being so, no question of the right of set-off for money deposited in the ordinary course of business, arises."

In *First National Bank of El Central v. Harper,* 254 Fed. 641 (9 Cir., 1918), it was held that where deposits are made not in the usual course of business, but to cover an overdraft, there is a preferential payment and the set off doctrine will not apply. And in *In re*

Henry C. Reusch & Co., 44 F. Supp. 677 (D.C .N.J., 1942), the court held that a bank deposit made not in the usual course of business, but with the intent that the deposit be applied to payment of an existing debt, is a transfer of property and a preference within the meaning of the Bankruptcy Act.

Kane v. First National Bank of El Paso, Texas, 56 F.2d 534 (5th Cir., 1932), was a case in which a particular set off was upheld, but the bank recognized the rule applicable to the present case, saying:

> "We think that a deposit, though made by an insolvent, if in due course of business and really and in good faith *intended* at the time *by the bank to create an equivalent liability to honor the checks* to the depositor, is not a present depletion of the depositor's estate, but is a valid banking transaction which may be set off thereafter; *but if the bank in accepting the deposit does not intend to become liable to the depositor, but intends to get payment by set-off, the advantage obtained is rendered voidable* by a bankruptcy within four month." [Emphasis added.]

The limitation on a bank's rights to receive deposits and apply them on indebtedness is well stated in *Citizens National Bank of Gastonia, N. C. v. Linberger*, 45 F.2d 522, 529 (1930), wherein the court stated:

> "Of course, where deposits are not made in the regular course of business, as where they are made fraudulently and collusively for the purpose of giving the bank a preference, *or where they are not in reality deposits at all, but are pay-*

> *ments, the right of set-off does not exist,* and they may be recovered as preferential." [Emphasis added.]

The rule is again well stated in 4 *Collier on Bankruptcy* (14th Ed.), Para. 68.16[2.1], where the following statement is found:

> "As previously indicated, it is absolutely essential that before a bank can exercise its right and use the bankrupt's deposits as an offset, the deposits in question must have been accepted in good faith in the ordinary course of business. *The usual general deposits made on an open checking account subject to withdrawal at will constitutes the type of deposits which will more often be considered above suspicion.* But *if the deposits* are not accepted in the ordinary course of business, or *are* procured, *accepted* or 'built up' *for the real purpose of permitting the bank to obtain a set-off,* the deposits will be considered voidable preferential transfers and *the right of set off is lost.* * * * " [Emphasis added.]

See also, Annotation, "Set-off by Bank Against Bankrupt's Deposit as a Preference Within the Bankruptcy Act," 85 A.L.R. 369; and 9 Am. Jur. 2d, Bankruptcy, §526.

The trial court found that the deposits in question were *not* made in the ordinary course of business, but for the purpose of paying an antecedent debt. They were accepted by defendant for that purpose, wtihout regard to the intent of the depositor, and as the foregoing cases show, a mutual intent in this regard is not

necessary. The question is whether defendant accepted the deposits to let Wheat Bros. draw checks on them or whether it accepted them for the purpose of paying its debts.

POINT II

THE TRIAL COURT'S FINDINGS OF FACTS SHOULD BE UPHELD UNLESS THEY ARE CLEARLY AGAINST THE WEIGHT OF EVIDENCE.

The argument of the defendant that the deposits made by Wheat Bros. were in good faith and in the regular course of business and that it did not know or have reasonable cause to believe that Wheat Bros. was insolvent at the time the deposits were made, must be considered in light of the fact that the issues were tried to the court on conflicting evidence, in a situation in which the court had an opportunity to consider the demeanor of the bank's officers. On the conflicting evidence the issues were determined against the defendant bank.

The Utah constitution, Article VIII, Section 9 provides that in equity cases the appeal may be on questions of both law and fact, while in cases of law "the appeal shall be on questions of law alone."

Under that provision this court has consistently recognized that in reviewing the findings and conclu-

sions in an action at law the trial court will be sustained unless that is no legitimate proof to support them, *Lyman v. Town of Price,* 63 Utah 90, 222 Pac. 599 (1924); or where there is "substantial evidence" to support them, *Osborn v. Peters,* 69 Utah 391, 255 Pac. 435 (1927) or unless the evidence "clearly through prepanderates" against the decision, *Barker v. Dunham,* 9 Utah 2d 244, 342 P.2d 867 (1959).

Article VIII, Section 9 does not define "law" or "equity" cases for the purpose of determining the scope of review, and admittedly, the question needs to be re-examined from time to time in light of new actions, statutory proceedings, and remedies which may be provided under our general statute relating to the right to trial by jury.

We have been unable to find any Utah cases in which a determination has been made as to whether an action to avoid preferences under Section 60b of the Bankruptcy Act is an "equity case" or a "case at law" for the purposes of review under the provisions of Article VIII, Section 9, Utah Constitution. But most other courts, including the federal courts, have regarded 60b proceedings as essentially law actions. Certainly they are more like law than equitable actions since there is nothing in them upon which the discretion of the judge or chancelor is required to operate.

The accepted principle is stated in 5 *Moore's Federal Practice,* Para. 38.30[4], as follows:

" * * * Section 60b of the Bankruptcy Act provides that 'Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona-fide purchaser from or a lienor of the debtor's transferee for a present fair equivalent value * * *' At one time, prior to the Federal Rules, there was a division of authority whether the trustee's plenary action, if brought in a federal district court, should be on the law or equity side of the court—in other words whether it was a 'jury' or 'court' case. The Court in Schoenthal v. Irving Trust Company [287 U.S. 92, 95, 53 Sup. Ct. 50, 77 L. Ed. 185 (1932)] settled the matter by applying the same principles that it was accustomed to apply to other civil actions * * * As applied to a plenary action under the Rules the case means simply that if either the plaintiff or the defendant makes a timely demand for jury, an action by the trustee to recover a money judgment or property preferentially transferred is legal in character and hence a jury action, unless there are facts or circumstances that render the legal remedy inadequate * * *."

See also, 3 *Collier on Bankruptcy* (14th Ed.), Par. 60.60 [1.2].

The action in this case is essentially one at law within the meaning of the Utah Constitutional provision relating to appellate review, and the appeal must be restricted to questions of law. In *Keller v. Deseret Mortuary Company,* 23 Utah 2d 1, 455 P.2d 197 (1969), in

which a trial court finding in a breach of contract was being reviewed, the court said:

> "The contract was silent as to the point of dispute just stated. The trial court properly heard extraneous evidence bearing on the issue, which he resolved in favor of the plaintiff. Inasmuch as there is substantial, reasonable and credible evidence to support his finding, it is not our prerogative to upset it. This same well-worn and time-honored rule of review likewise applies to and disposes of the defendant's contention that the trial court erred in finding that the plaintiff had performed the construction in a good and workmanlike manner; and to the issue raised that the amount of damages awarded was excessive, to which we next direct our attention."

Thus if there was any substantial evidence to support the findings of fact of the court below, the judgment should be affirmed. Determination of whether there is substantial evidence should be made in light of the fact that the trial court listened to the testimony of the two officers of defendant who were in charge of the branch which handled the transaction, and were directly involved in them.

In *Child v. Child,* 8 Utah 2d 261, 332 P.2d 981 (1958) which was essentially an equitable action the trial court entered a judgment compelling re-conveyance of certain land. On appeal the defendant contended, among other things, that the findings were not supported by the evidence, the plaintiff there having

had the burden of establishing right to re-conveyance by "clear and convincing evidence." In disposing of the contention on appeal, the court said:

> " * * * Inasmuch as the burden rests upon the defendants to demonstrate that the trial court was in error, *the findings and judgment should not be disturbed unless we can say affirmatively, and with some degree of assurance, that there is no reasonable base in the evidence upon which he could fairly and rationally have thought that the requisite degree of proof*, i.e., by clear and convincing evidence, *was met.*" [Emphasis added.]

With respect to the trial court's opportunity to observe the witnesses the court said:

> "Passing upon the credibility of witnesses involves to some extent the judging of what goes on in the minds of others and is therefore fraught with uncertainty. * * * [The witness's] appearance and demeanor, his manner of expression and his tone of voice, his apparent frankness and candor, or want of it; his forthrightness in answering, or his tendency to hesitate or evade, and in fact his whole personality go into the composite effect of the testimony. * * * In addition to the personality aspects involved in the interpretation and evaluation of testimony, there are also difficulties to be encountered because of the uncertainaties found in the fact situations themselves which must be correlated to the testimony of the witnesses. We have heretofore pointed out the trial court's advantages in judging the credibility of witnesses and determining the facts. It is due to these considerations that

it is firmly established that passing on such matters is exclusively within his province."

As will be pointed out hereafter, there is sufficient evidence to support the findings made by the trial court — whether the review is at law or in equity.

POINT III

THE EVIDENCE SUPPORTS THE COURT'S FINDINGS THAT THE DEPOSITS MADE BY WHEAT BROS. WERE NOT MADE IN GOOD FAITH AND IN THE REGULAR COURSE OF BUSINESS.

The burden on the appellant in this appeal is to demonstrate that there is no substantial evidence to support the findings of the trial court. The findings relating to the making of the bank deposits were as follows:

> "5. On September 21, 1965, Wheat Bros. delivered to the defendant what was designated a deposit in the said checking account. The deposit included, among other things, a check in the amount of $18,150.00 drawn by Jacobsen Construction Company payable jointly to 'Wheat Bros. & Kaymac Sales.'
>
> "6. The deposit of said $18,150.00 check was made by Wheat Bros. and received by defendant for the purpose of clearing all or a portion of the overdraft indebtedness referred to above, and said check was applied by defendant upon payment of said overdraft. * * *

"8. The deposit was not made and received in the ordinary course of business, but for the purpose of paying an antecedent debt.

"9. On October 4, 1965, Wheat Bros. was indebted to defendant on a promissory note in the face [amount] of Five Thousand Dollars, dated May 19, 1965, and with a maturity date of August 17, 1965.

"10. On October 4, 1965, Wheat Bros. left with defendant a deposit in the amount of $7,384.00 to be placed in its checking account, whereupon the defendant immediately applied $5,131.25 in payment of the entire principal and interest of said note.

"11. The deposit was not made in the ordinary course of business, but was accepted and received by the defendant for the purpose of applying it immediately in payment of the said promissory note.

"12. At the time of the deposit and the application thereof to the said note, no new consideration was given by the defendant to Wheat Bros. and the deposit was made in payment of an antecedent debt.

"13. On October 18, 1965, Wheat Bros. was indebted to the defendant on a promissory note dated July 13, 1965, in the face amount of $5,000.00, the note having become due on October 11, 1965.

"14. On or about October 18, 1965, Wheat Bros. left with defendant a deposit of $4,153.48 to be placed in its checking account, whereupon the defendant immediately applied $4,050.00 toward payment of the said note.

"15. The deposit was not in the ordinary course of business, but was accepted and received by defendant for the purpose of immediately applying it upon the payment of said promissory note."

The findings make it clear that the court was not dealing with the bank's right of set off as such, but with the intent and purpose for which particular deposits were made by Wheat Bros., or received by the defendant. Since it is the *deposit* and not the *set off* which is the matter in controversy, defendant's extensive discussion of Section 68 of the Bankruptcy Act has no bearing upon the accuracy of the court's findings of fact, or the validity of its conclusions of law.

The defendant seem to recognize this in its brief when it states at page 11 that the "deposit is the key factor in the allowability of set off and not the set off."

In this case there is ample evidence not only to support the findings made by the trial court but to demand them, particularly when considered in light of the failure of the respondent to come forward with forthright explanations of the transactions in question.

With respect to the $18,150.00 deposit, the first in the series, the evidence demands a finding that it was not accepted and received by defendant in the ordinary course of business. Prior to September 21, 1965, Wheat Bros.' overdraft had been building up for a number of weeks and the bank officers had been after the partners to make a deposit to "clear the over-

draft" (R. 83). The deposit made on September 21 contained the $18,150.00 check in question together with several small checks and one over $2,800.00 (Ex. P-10). All but the $18,150.00 check were processed in the usual manner, but it was singled out, removed from the deposit, endorsed "for collection only" by an officer of the bank, and hand-carried to the drawee bank where a cashier's check payable to defendant was obtained. It was this cashier's check that was deposited in the Wheat Bros. account, and the overdraft was applied against it simultaneously. As soon as the overdraft was cleared, defendant changed its policy with respect to Wheat Bros. and overdrafts were no longer permitted (R. 86).

Defendant's endorsing officer, Mr. Boyd Lindquist, admitted that the $18,150.00 check was not handled in the regular course of business:

> "Q. In the usual checking transaction, or deposit transaction, the bank does not endorse the check for collection, does it, send it by messenger or things of that kind, to obtain the funds, or not in the normal course?
>
> A. No." (R. 75).
>
> "Q. That is to say that the Jacobsen check that is 'P-11' was endorsed for collection, is that correct?
>
> A. That is correct.
>
> Q. And was taken over to Zions by messenger, was it?
>
> A. Yes.

Q. And collected at Zions, and was a cashier's check obtain from Zions?

A. Yes.

Q. Now, who decided to handle that item in that particular way?

A. I would say Mr. Vincent and myself.

Q. Did you discuss the matter?

A. Yes.

Q. And discussed with Mr. Vincent the advisability of having the item collected *rather than run through the ordinary course?*

A. Yes." (R. 82-83.

Other testimony indicated that such special handing would be given deposits only if the depositor requested it, or if the checks were large and there was a question of their not being good, or of payment being stopped. There was no concern on the part of defendant that the check was no good or that payment would be stopped inasmuch as the drawer, Jacobsen Construction Company, was one of the largest and most reputable contracting firms in the State.

Of great importance also is the fact that the $18,150.00 deposit was specifically looked toward and earmarked for the purpose of covering the overdraft. The law is summarized in 4 *Collier on Bankruptcy* (14th Ed.) Para. 68.16[2.1] as follows:

" * * * the deposits in question must have been accepted in good faith in the ordinary course of

> business. The usual general deposits made on an open checking account subject to withdrawal at will constitutes the type of deposits which will more often be considered above suspicion. But if the deposits are not accepted in the ordinary course of business, *or are procured, accepted or 'built up' for the real purpose of permitting the bank to obtain a set-off*, the deposits will be considered voidable preferential transfers and the right of set-off is lost. * * * [Emphasis added.]

Defendant's argument that there must be "collusion," or at least a mutual intent or understanding between the depositor and the bank that the deposit will be used to cover antecedent obligations, is not supported by the authorities. As stated in the annotation at 85 A.L.R. 380:

> "Thus, if a bank permits its debtor to continue in business and to make deposits, knowing that he is in failing circumstances, and with the intention of obtaining a greater share of his property than other creditors, the deposits so made cannot be set off against the bank's demands against the depositor, *although there is no proof of collusion between the parties.*" [Emphasis added.]

In any event, the court could have found a mutual intent. Mr. Lindquist testified as follows:

> "Q. (By Mr. Allen). Will you relate the conversation between yourself and Mr. John Wheat on that occasion relative to the financial condition, or obligations of Wheat Bros.?
>
> A. At that time we made our visit there it was primarily concerning the overdraft which we

were carrying on their account, and wished to talk to him concerning clearing the overdraft. They indicated to us at that time that they would give us a list of accounts receivable from various contractors that would be deposited to the account.

* * *

Q. Was there further specific conversation, Mr. Lindquist relating to which of the receivables would be used for liquidation or clearing up of their overdraft in your bank?

A. *I am sure that we were looking to the Jacobsen deposit for clearing the immediate overdraft that we had.*" (R. 102, 103) [Emphasis added.]

Subsequently Mr. Lindquist testified:

"Q. No assignment was made to you by the Wheats of the Jacobsen money, was there?

A. No.

Q. And there was no set agreements, as far as you are aware, that any particular moneys would be used to clear the overdraft?

A. *Well, we had a conversation that the Jacobsen check would be deposited to the account,* but there was no assignment taken on it as such." (R. 110).

The defendant's officers had even called Jacobsen Construction Company to verify that the check would be received by Wheat Bros. (R. 108).

Of equal importance is the fact that Wheat Bros. was never given any opportunity to draw against the deposit. Thus, the rationale for excepting certain bank

transactions from the effects of Section 60 are not applicable. The rationale stated in 9 Am. Jur. 2d, Bankruptcy, §525 is as follows:

> "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 replace the bank in position, in the event of 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 definite items thereof if the intent at the time of the deposit was that the 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.*" [Emphasis added.]

When the total deposit made on September 21 is analyzed, the distinction becomes readily apparent. Of that deposit the sum of $18,150.00 (evidenced by the Jacobsen Construction Company check) was a preferential transfer. The balance was handled differently, and probably was not. The bank had been waiting for the Jacobsen check to cover the overdrafts, and as soon as it was received it was given special handling and used to pay the overdraft before Wheat Bros. had any chance to draw against any part of it.

While the circumstances are somewhat different

with respect to the two subsequent deposits found by the trial court to have constituted preferential transfers, it is clear that the bank accepted each deposit for the purpose of paying existing indebtedness.

When the Wheat Bros. overdraft was cleared on September 22, a small balance remained in the account from which some checks were paid, but as soon as the balance was exhausted, no checks were honored until September 24 when a deposit of $999.56 was made. Another deposit of $3,283.03 was made on September 29 and Wheat Bros. was permitted to draw on it. Even before checks totaling the whole amount of the deposit had been drawn defendant applied debit memos and service charges against the account and commenced to return checks and debit the account for their return. Wheat Bros.' checks were paid (from a credit balance —not by way of ovedraft) between September 30 and October 4, at which time a deposit of $7,384.00 was made. Immediately defendant set off $5,131.25, the full principal and interest of a note which had become due on August 17. It seems quite clear that the bank had theretofore decided that as soon as the large enough deposit was received, it would be used to pay the note. This is consistent with Mr. Lindquist's understanding that once set off is made, the bank must continue to set off until the note is paid. The bank had allowed two previous smaller deposits (neither large enough to pay the note) to be drawn against (R. 96). These facts, considered in light of the bank's knowledge, its termination

of overdrafts, and the constant vigilance with respect to the Wheat Bros. account constitute ample evidence to support a finding that the deposit was received for the purpose of paying the note.

After appliction of the deposit to payment of the first note, additional Wheat Bros. checks were paid from small credit balances until October 6, when the account was depleted. Defendant ceased paying checks and debited the account $2.00 at a time for returned items. A deposit of approximately $3,700.00 was made on October 8; but on October 11, when the second $5,000.00 note became due, there was only $1,200.00 in the account. Wheat Bros. drew checks on this amount until the account was again depleted. Thenceforth checks were returned and charges made. When a deposit sufficient to pay most of the second $5,000.00 note was received, the bank again decided to set off. On October 18, 1965, the date of Joseph Wheat's deposit of $4,153.48 to meet the partnership payroll, defendant applied a small portion of this to clearing an overdraft (resulting primarily if not exclusively from debit memos) and the balance in payment on the note.

In determining whether deposits are made in the ordinary course of business the courts may consider all the circumstances surrounding the deposits including the bank's knowledge of the depositor's financial condition and may make inferences from the failure of the bank to come forward with any explanation surrounding the time sequence and the methods followed

by the bank in making the offsets against the note. The rule is well stated in 9 Am. Jur.2d Bankruptcy, §526 as follows:

> "A deposit may be preferential, where made in the 4-month period, and not in the ordinary course of business, but for the purpose of benefiting the bank by affording a setoff. Any state of facts which takes a deposit within the 4-month period out of the class of deposits made in good faith in the ordinary course of business, subject to the depositor's check—in other words, *any situation under which the deposit is merely a form of payment to the bank—marks the deposit a preferential transfer* which, if the necessary knowledge of, or reasonable cause to believe in, the insolvency of the depositor is present on the part of the bank, constitutes a voidable preference precluding the possibility of a setoff. The settled rule, it has been said, is that *if the deposits are made in order that the bank may apply them to the reduction of the depositor's indebtedness, there is in effect a preferential payment,* voidable in the event the bank had 'reasonable cause to believe the debtor to be insolvent.'
>
> "The same circumstances of preferential payment may be created where, although a deposit is made in the usual course of business, the bank intends thereby to obtain a preference, so that the ordinary relation of banker and depositor, whereby the depositor receives in return for his deposit the obligation of the bank to repay him, does not obtain." [Emphasis added.]

In a footnote to the above citation it is said:

> "If at the time the deposits are received there

> is not an intent in good faith to increase the checking account, but to arrange for an offset, there is in truth not a deposit, but a payment which is a preference."

From a review of defendant's brief it would appear that there is not much disagreement between the parties over the principles of law relating to the above point. Rather, the dispute is centered around the application of such principles to the facts of this case. Most of the cases cited by defendant hold that if the deposit was made or accepted for the purpose of paying existing indebtedness there is no right of set off. They also recognize that there is no right of set off unless the deposit is subject to withdrawal at the will of depositor. Both propositions are made abundantly clear in almost every case and authority quoted by defendant in its brief.

Defendant cites *New York County National Bank v. Massey,* 192 U.S. 138, 40 L. Ed. 380, 24 Sup. Ct. 199 (1904), but in that case the court specifically noted that there was no diminution of the bankrupt's estate because he had a right to draw upon the deposit. That case involved the usual situation where the bank is both a creditor and a debtor of the bankrupt at the time of the bankruptcy. The court allowed the bank to set off amounts on deposit against an overdue promissory note. This is a far different thing than accepting deposits before bankruptcy with the intent of applying them against a debt

Defendant also cites *White v. Pacific Southwest Trust & Savings Bank*, 9 F.2d 650 (D.C. Calif., 1926) and erroneously states that the court did not require the two banks to return the money. Following the quotation which appears in appellant's brief, is this:

> "Now, were the deposits in the two banks, which were offset, general deposits made in the ordinary course of business? I think not. Not only was each bank fully acquainted with Foley's financial difficulties from December, 1922, but each bank had signed the agreements by which Foley divested himself of his property and business.
>
> * * * *
>
> "I conclude the main question in these cases by holding that, as between the plaintiff trustee in bankruptcy and each defendant bank, all of the money sued for should be delivered to the plaintiff for administration and distribution in accordance with the National Bankruptcy Law, and each bank may enlarge, modify, or file claims against the proper bankrupt estates for the amounts of their claims, respectively, affected by this decision."

Hughes v. Machen, 164 F. 2d 983 (4th Cir., 1947), cited by defendant, involved two banks taking over deposits which had existed for some time and applying them to large notes when they learned of the insolvent condition of the bankrupt. In addition, one of the banks, having received a check from the government payable to the bankrupt, had delivered half of the proceeds to a third party and credited the balance against

the bankrupt's notes. The trustees of the bankrupt entered into a compromise agreement under which one-half would be returned to the trustee, but it was allowed to retain the balance that existed in the account prior to the set off. Certain creditors of the bankrupt objected. The court noted that the creditors could not show that deposits were built up in an abnormal way in order to give the bank an opportunity to credit them on the notes and reduce the debt and also there had been no restrictions placed on withdrawal from the accounts. The court stated:

> "Of course the application of these principles presupposes that there has been a bona fide deposit made in due course of business. Thus where there has been a deliberate building up of the account for the purpose of enabling the bank to obtain a preference, or where the deposit is *accepted by the bank with the intent of applying it to the depositor's obligations* rather than subjecting it to his power of withdrawal, an attempt on the part of the bank to set off the deposit will result in a preference as long as the other conditions of Section 60 are satisfied. (Citing cases.) This result is reached because the apparent deposit is in fact a payment to the bank and the bankruptcy court will look through form to substance and treat the deposit as a transfer of property for or on account of an antecedent debt." [Emphasis added.]

Defendant also relies upon *Farmers Bank of Missouri v. Julian*, 383 F. 2d 314 (8th Cir., 1967). The facts in that case are quite different from those in the

present case. There the bank had the understanding that its obligations would be paid as soon as the bankrupt obtained a long-term operating loan from Commercial Credit Corporation. The bank's officers had gone to the banqrupt's place of business to attend a meeting with officers of the bankrupt and the credit corporation. At the meeting, it learned that the long-term operating loan was not going to be made. Consequently the officer returned to the bank and applied funds which had been on deposit and subject to withdrawal by the bankrupt right up until that moment, against a $16,000.00 promisory note. The court noted that certain checks had been honored that very day from the existing account and indicated that there was no evidence to show that the bank had decided to apply the set off any earlier than that day. This is considerably different than the present case where the bank waited to receive a specified check and immediately grabbed it.

In the fairly recent case of ***Mayo v. Pioneer Bank & Trust Company,*** 270 F. 2d 823 (5th Cir., 1959), the court held that a deposit made under similar circumstances was a voidable preference, and said:

> " * * * [T]he trustees could attack the set off as a voidable preference if: (1) at the time of the deposits *either the company or the bank* intended them to operate as payment of the debt rather than as an ordinary deposit subject to the depositor's withdrawal; (2) at the time of the deposit the depositor was in fact insolvent; and (3) the bank had reasonable cause to believe the

depositor was insolvent at that time. Under the facts surrounding the Twin City deposit we think the deposit was for the purpose of payment of the debt. As soon as Gray received the proceeds under the contract he transferred them by debit memorandum to the Bank. *The deposit was made solely to repay the loan.* It was a cloak for payment." [Emphasis added.]

POINT IV

THE EVIDENCE SUPPORTS THE COURT'S FINDING THAT AT THE TIME THE DEPOSITS WERE MADE BY WHEAT BROS., DEFENDANT HAD REASONABLE CAUSE TO BELIEVE THAT WHEAT BROS. WAS INSOLVENT.

After hearing evidence, watching the demeanor of the witnesses and reviewing the exhibits admitted, the trial court was satisfied that at the time of each of the transfers, defendant not only had reasonable cause to believe that Wheat Bros. was insolvent but it actually knew that it was (R. 21, Findings Nos. 19-20).

Admittedly there is no direct testimony in this case that defendant actually knew of Wheat Bros. insolvency at the time of the three transfers. However, the evidence leads inescapably to that conclusion. Moreover, the evidence is abundant that defendant had reasonable grounds to believe that Wheat Bros. was insolvent—which is all the statute requires.

While the question is primarily one of fact the cases are helpful in describing the kinds of evidence establishing reasonable cause to believe.

One such case is *Dean v. Planters National Bank of Hughes,* 176 F. Supp. 909, 914 (D.C. Ark., 1959):

> " * * * [T]here are a number of recurrent factors which are usually weighed and considered, such as: under capitalization of the debtor, sales below cost, checks drawn on a bank account and payment refused by reason of insufficient funds, a consistent pattern of overdrafts, operating losses, irregular, unusual or criminal conduct, secretiveness, slow payment, collective measures taken by other creditors, rescue of debtor from embarrassment by friends or relatives, and reliance on financial statements or reports."

In *Boston National Bank v. Early,* 17 F. 2d 691 (1st Cir., 1927) a finding of reasonable cause to believe was upheld. The court of appeals regarded it as significant that the president of the bank had renewed the bankrupt's note several times and knew that deposit balances were low, that checks were held until deposits were made to meet them, that the bank had demanded maintenance of a larger balance, that return of checks was threatened, and that the bank finally took perishable merchandise as security.

Additional cases supporting respondent's position are *Waite v. Second National Bank,* 168 F. 2d 984 (7th Cir., 1948), and *In re Shelley Furniture, Inc.,* 283 F. 2d 540 (7th Cir., 1960).

Moreover, it is clear that a creditor may not bury his head in the sand and ignore warning signals which, if followed up, would disclose insolvency. He may not rely entirely upon the statements and representations of the debtor, particularly when there are suggestions that the debtor's representations may not be true. The courts have uniformly followed the principle that if the creditor has notice of facts which would cause a reasonably prudent person to make inquiry he is chargeable with knowledge of what the inquiry would have revealed.

The principle is explained in 3 *Collier on Bankruptcy* (14th Ed.) Para. 60.53[1] as follows:

> "Knowledge of insolvency is not necessary, nor even actual belief thereof; all that is required is a reasonable cause to believe that the debtor was insolvent at the time of the preferential transfer. A creditor has reasonable cause to believe that the debtor is insolvent when such a state of facts is brought to the creditor's notice, respecting the affairs and pecuniary condition of the debtor, as would lead a prudent business person to the conclusion that the debtor is insolvent. Of course, a creditor may not willfully close his eyes that he might remain in ignorance of his debtor's condition. On the contrary, where circumstances are such as would incite a man of ordinary prudence to make inquiry, the creditor is chargeable with notice of all facts which a reasonably diligent inquiry would have disclosed. In such case, an inquiry of the debtor alone is generally insufficient, where his answer, under the circumstances, could readily have been found to be untrue. As a matter of fact, it is

> the creditor's cause for belief and not the debtor's knowledge, or lack of it, that is important. And if the creditor fails to make an inquiry when he has a duty to do so, he will be charged with all the knowledge which he would have acquired had he conducted the investigation."

In a case decided by the United States Court of Appeals, for the Tenth Circuit, *Carroll v. Holliman*, 336 F. 2d 425 (10th Cir., 1964) it was said:

> "[I]f the creditor has knowledge or notice of facts and circumstances which would incite a person of reasonable prudence under similar conditions to make an inquiry and, if such an inquiry would lead to the development of facts essential to the knowledge of the situation, the creditor is chargeable with such knowledge."

Examining the evidence in the present case in light of the foregoing principle it is apparent not only that defendant had reasonable cause to believe that Wheat Bros. was insolvent, but that in fact (through its officers) it so believed. For several months prior to September 20, 1965, there had been a consistent pattern of overdrafts in Wheat Bros.' account and they had been increasing steadily (R. 76). For weeks preceding September 20, the bank officers had on various occasions contacted Wheat Bros. about clearing the overdrafts (R. 83). On September 20, two checks payable to Granite National Bank were presented to appellant's officers for a decision as to whether they should be honored (R. 77). As a result, an inquiry was made and appellant's officers learned that Wheat Bros. owed the

Granite National Bank $5,000.00, plus interest, on a note (R. 79). This was one of a number of liabilities which had not been disclosed on any financial statement furnished by Wheat Bros. to defendant. At about the same time, and prior to the deposit of the $18,150.00 check on September 21, officers of defendant made inquiry to Intermountain Association of Creditmen and learned that Wheat Bros. had two substantial accounts payable to Bennetts and Fuller Paint which also had not been disclosed on the financial statement (R. 87). The $18,150.00 check drawn by Jacobsen Construction Company was made payable to Wheat Bros. and Kaymac, and contemporaneously with the making of the deposit a check drawn payable to Kaymac, in the amount of $12,000.00, was presented to appellant for payment. Payment was refused which, consistent with the bank's practice would indicate that either the manager or assistant manager or assistant manager had reason to know that there was another very large obligation which had not been disclosed to appellant. In fact, a few days later, and prior to the payment of the first $5,000.00 note, one of the bank officers had a conversation with an officer of Kaymac in which the bank officer was told that the indebtedness to a Kaymac was approximately $23,000.00 and the company was insisting on payment (R. 92, R. 109). Moreover, Wheat Bros. continued to draw checks on insufficient funds, which were not honored, and the bank inquired from time to time of persons who were said to have owed money to Wheat Bros. The above circumstances were such that any reasonable

person in the position of defendant would have made a thorough inquiry as to the financial condition of Wheat Bros.—and there are some indications that this is exactly what defendant did.

There is little question that if an inquiry and particularly an examination of Wheat Bros.' books and records had been made by defendant the insolvent condition of Wheat Bros. would readily have become apparent. After appellant took the deposit collected to meet Wheat Bros.' payroll, one of appellant's officers suggested to Joseph Wheat that the books and records of the company be brought in. This was done and the bank officers were immediately aware that Wheat Bros. was insolvent (R. 106). Mr. Wheat was told that the only hope for it was bankruptcy or a composition of creditors (R. 62). Moreover, one of the bank officers at an earlier date had told Joseph Wheat that he had noticed that ever since Jim Wheat had left the management of the business it had gone down hill (R. 60). And, Jim Wheat had been out of the business about four years (R. 61).

The circumstances surrounding the Wheat Bros.' affairs were such that defendant must have known that it was insolvent, and the obligation of defendant to have made inquiry must be considered in light of its access to various sources of financial information, as well as that it had in fact received. It would be difficult to see how the court could have failed to find that the bank had reasonable cause to believe Wheat Bros. was in-

solvent on each of the dates on which transfers were made.

CONCLUSION

The policy of Section 60 of the Bankruptcy Act is to place creditors of the same class on an equal footing, so as to prevent one creditor, through the exercise of one type of pressure or another, from making itself whole, or nearly so) at the expense of the others.

Under Section 68 of the Bankruptcy Act a bank may take advantage of a right of set off—but only if the deposits were received by the bank in the ordinary course of business and for the purpose of permitting the depositor to use the account, as by withdrawal.

Circumstances surrounding the handling of the Wheat Bros. account make it clear that the deposits in question were not made in the ordinary course of business. The two officers in charge of the bank's Sugarhouse office exercised a continuing surveillance of the Wheat Bros. account during all periods in which overdrafts were permitted. At no time was Wheat Bros. permitted to draw checks against its account at will. Although the bank had some customers who were "preferred," and for whom tellers were generally authorized to pay overdrafts, this was not the case with Wheat Bros. Before any Wheat Bros. overdraft was paid, the item was presented to either Mr. Lindquist or Mr. Vin-

cent for consideration, at which time a determination was made as to whether the item would be paid or not.

The trial court might well have found that the entire deposit made on September 21, insofar as it was applied against the overdraft, was not received by the bank in the ordinary course of business. It is arguable, indeed, that where a bank's computer automatically charges deposits against overdrafts, without first giving the depositor an opportunity to draw against them, such deposits cannot be made in the "ordinary course of business" as that term is used in the older cases. Such handling of an account becomes a personal matter in which the bank officers, on a day-to-day basis, decide whether to extend additional credit, and deposits and withdrawals are incident to this activity.

At the time of receipt of the $18,150.00 check the bank's officers had abundant information to the effect that Wheat Bros. was not telling the truth about its financial condition, that the condition was steadily worsening, and that the company was, in fact, insolvent. From that day forward, the information obtained by and available to the bank with respect to the involvency of Wheat Bros. never decreased. The "reasonable cause to believe" was an ascending one.

Banks should be required to come forward with forthright, believable testimony to a trial court respecting the circumstances surrounding deposits and set offs. After all, what does a bank have to lose by taking a preference? The most that is required of it under the

Bankruptcy Act is that it pay back what it took, and stand in line with its fellow creditors. Defendant should do so in this case.

Respectfully submitted,

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