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Chapter 10: Security, Mortgages, and Other Creditor's Rights

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CHAPTER 10

Security, Mortgages, and Other Creditor's Rights

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It is said that the nexus of contract law holds together the business world. Certainly credit transactions form a great part of that web of contracts. A portion of the law in regard to the rights of creditors is treated in this chapter. It is treated as an interrelated subject, though the title of the chapter is taken from the usual law school courses and the legal research index headings under which the topics discussed would appear.

Of course, from time to time during any survey year this subject matter may be broken into one or more additional subjects depending on the significance and the volume of developments. It suffices to say that a combined treatment seemed warranted in the 1954 SURVEY.

§10.1. Subrogation on public contracts. An important issue with respect to a surety's right of subrogation under a statutory payment bond was resolved during the survey year in *Duteau v. Salvucci.*[1]

The Department of Public Works entered into a contract for the construction of a highway. The contract provided that a percentage of the amounts earned by the contractor as the work progressed might be retained by the Commonwealth, and the contractor also furnished a surety company bond for the payment of laborers and materialmen. Under the terms of the contract, the Commonwealth retained over $99,000. A number of laborers and materialmen, having given statutory[2] notice of nonpayment, brought suit against the contractor, the surety company, and the Commonwealth. Part of the claims were settled and paid by the surety company to the extent of some $145,000. Two claims of one claimant were litigated, and one of them was allowed to the extent of some $6000. The Commonwealth was ordered

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§10.1. [1] 330 Mass. 531, 115 N.E.2d 726 (1953).
[2] G.L., c. 30, §39.

to pay this amount to the claimant, and then to pay the balance of the retained percentage of the contract price to the surety company.

The Division of Employment Security in the Department of Labor and Industries filed an intervening petition in which it claimed as an offset against the retained percentages in the hands of the Department of Public Works some $1800 which the contractor owed in payroll taxes under the Unemployment Insurance Act. This petition was dismissed.

The intervening petition was based upon the twofold theory that (1) the retained percentages were assets of the contractor against which there existed a lien for payroll taxes which had priority over the right of the surety to participate in them, and (2) the surety, in any event, had no right to be reimbursed out of assets of the principal debtor (the contractor) while beneficiaries of the bond (the Commonwealth was obligee in the bond) were unpaid.

The second contention was rejected because, as the Court pointed out, the contractor's obligation to pay payroll taxes was not guaranteed by the bond, so that the surety was not, in fact, competing with a beneficiary of the statutory bond. In any event, the Court continued, the surety was entitled to the retained percentages, not by way of direct reimbursement from the assets of the principal debtor, the contractor, but by way of subrogation to the rights of the laborers and materialmen whom it had paid. The retained percentages constituted a fund primarily for the payment of these persons, and the surety, upon paying them, was entitled to step into their shoes.

The first contention of the Commonwealth posed a more difficult problem. The statute[3] provides that payroll taxes "shall have priority over all other claims against an employer, except wage claims." The record did not indicate which, if any, of the claims paid by the surety under its bond were for wages.

The Court met this problem by discerning a degree of inconsistency between the letter of this statute and that regarding payment bonds. The first statute is designed to aid those out of work, while the second is designed to secure payment for those who furnish labor or materials to contractors. Thus viewed, said the Court, the statutes "are concerned with different means of increasing the public welfare. . . . Each must be confined to its own particular field and construed harmoniously with the other." [4]

The Court then proceeded to resolve the perceived conflict by ruling that the retained percentages were not, after all, assets of the contractor, since he had no right (under his contract) to collect any part of that fund until the claims of laborers and materialmen were paid. It follows from this, concluded the Court, that the retained percent-

[3] G.L., c. 151A, §17. See also Section 16, which provides that the tax shall be a lien against the assets of the employer, "subordinate, however, to claims for unpaid wages."

[4] 330 Mass. 531, 537, 115 N.E.2d 726, 730 (1953).

ages constitute a fund to which unpaid laborers and materialmen may look before it is used for payments to others.

In thus grounding its decision, the Court seems to identify the materialman's right in the collateral security as a right separate and distinct from (although not unrelated to) his right to enforce his claim against the principal debtor, the contractor. This theory of legal relations is similar to that introduced into the law by the Louisiana statute[5] which provides for direct action by the victim of a tort-feasor against the latter's liability insurer without first prevailing in an action against the tort-feasor. This appears to be the substantive effect of the instant decision, although it is still the procedural law of the Commonwealth that, in order to enforce his right in the collateral security, the materialman must join the contractor as an indispensable party.[6]

§10.2. The Statute of Frauds. The suretyship section of the Statute of Frauds[1] was unsuccessfully invoked in *Duca v. Lord.*[2]

John Deferrari, a benefactor of the Boston Public Library, had given the library trustees a building which was in need of repairs. After some preliminary negotiations between Deferrari and Duca, the latter entered into a repair contract with the library trustees at a price of $9500. The work was done under the direction of Deferrari, and was "checked" by a member of the library staff. In addition to performing the contract fully, Duca did extra work in connection with the repairs to the value of some $10,000. He asked Deferrari for payment for the extra work, and was told, "If the library doesn't pay you, I will pay you."

After Deferrari's death, Duca brought suit against his executor for the value of the extra work. The defendant pleaded the Statute of Frauds. It was found that both Duca and Deferrari had expected the trustees of the library to pay for the extra work, and that if they failed to pay, Deferrari would do so. The trustees refused to enter into a contract for the extra work, and refused to pay for it.

The Court, affirming the judgment of the Superior Court, ruled that the oral promise of Deferrari did not come within the Statute of Frauds. The statute, the Court pointed out, is applicable only when there is an obligation of a third person which is guaranteed by a defendant's oral promise. Here, where there was no obligation of the library trustees to which Deferrari's promise could have been collateral, his promise was not one "to answer for the debt, default or misdoings of another."

[5] La. Rev. Stat. tit. 22, §655 (1950).

[6] The Duteau case and Lock Joint Pipe Co. v. Commonwealth, 1954 Mass. Adv. Sh. 375, 118 N.E.2d 869, are of interest also because they interpret and apply the provision of General Laws, Chapter 30, Section 39, that in order to exercise rights in the security required by that section, laborers and materialmen must file statements of their claims within sixty days after the claimant ceases to perform labor or furnish materials.

§10.2. [1] G.L., c. 259, §1.

[2] 1954 Mass. Adv. Sh. 53, 117 N.E.2d 145.

The principle is an easy one to state, but its application is frequently difficult. In fact, in the instant case, the Court found it necessary to overrule a statement in an earlier case.[3] There the "principal undertaking" was void for want of consideration, yet the Court said that a promise guaranteeing its performance was unenforceable by reason of the Statute of Frauds. In the *Duca* case, the Court conceded that this was an incorrect statement of the law, but pointed out that the statement was not necessary to the decision, as the promise of guaranty was held unenforceable for other reasons.

The difficulty of application of the basic principle involved in the *Duca* case is usually a factual difficulty. Thus, when A introduces B to C, and says to C, "Give B the goods he wants, and I will see you are paid," or similar words, there may be any one of several sets of legal relations created. A may be making a gift to B, in which case his promise, though oral, would be enforceable.[4] Again, A may be promising to underwrite B's express or implied undertaking to pay for the goods, in which case his promise, because it is oral, would be unenforceable. Yet again, A may make himself a joint promisor with B for payment of the purchase price, in which case his obligation, being independent of any default on B's part, would be enforceable. In the *Duca* case these factual difficulties were not present, since it was undisputed that Duca had made no contract with the library for the extra work, and at best both he and Deferrari merely hoped that the library would enter into such a contract.

§10.3. The case of the dormant mortgage. The case of *Marshall v. Francis*[1] came up on an extraordinary set of facts, and reached an even more extraordinary result.

In 1863 a mortgage was given and recorded to secure the purchase price of a parcel of land. After maturity of the debt the mortgage was assigned, and it appeared of record that the indebtedness had, by then, been reduced from $350 to $50. After the assignment, in 1868, there were several conveyances of the land, in none of which was there any reference made to the 1863 mortgage. In 1883 one Roderick, a successor in title of the mortgagor, gave a mortgage, which was foreclosed, and the title of the foreclosing mortgagee ultimately devolved upon Marshall, who brought a petition to register title to the land. The interest of the assignee of the 1863 mortgage (if there was any such interest) came to the respondent, Francis, under a residuary clause in the said assignee's will.

The Court noted that the record failed to show that any of the successive owners in the chain of title up to 1901 had occupied the property, and it ruled that, although a 1901 grantee entered into possession, there was a break in the continuity of that possession in 1919, when the then owner moved to another state. This led to the con-

[3] Crowley v. Whittemore, 255 Mass. 99, 130, 150 N.E. 880, 882 (1926).

[4] Arant, Suretyship 90 et seq. (1931); Simpson, Suretyship 122 et seq. (1950); cf. Simpson v. Penton, 2 Cromp. & M. 430 (1834).

§10.3. [1] 1954 Mass. Adv. Sh. 663, 120 N.E.2d 761.

clusion that there had been neither acquisition of title against the 1863 mortgage by adverse possession, nor a presumption of payment which would have grown out of occupation for twenty years after accrual of the right to foreclose, with nonrecognition of the mortgage. The Court ordered that title be registered in the name of the petitioner, subject to the 1863 mortgage.

The soundness of the decision has been questioned.[2] But, sound or not, it establishes the law of the Commonwealth, and is not likely to be overruled. It points out in a striking way, furthermore, a serious defect in the recording statutes. That a mortgage, simply because it was recorded and has not been discharged of record, can remain dormant, unrecognized, and unenforced for nearly a century and then can be recognized as an encumbrance on the fee, poses a real threat to the security and stability of titles. It is common knowledge that frequently a mortgagee, after receiving satisfaction, fails to give a discharge. More frequently, the mortgagor, after paying in full and receiving a discharge, fails, through ignorance or inadvertence, to place the discharge on record. The situation is one which calls for remedial legislation.

§10.4. Spendthrift trusts: Rights of creditors of the beneficiary. In general the interest of a beneficiary of a trust is subject to alienation by him and may be taken to satisfy the claims of his creditors. The settlor, on the other hand, may expressly provide that the beneficiary's interest shall be inalienable and that his creditors may not reach it in satisfaction of their claims; such a restraint on alienation wll generally be held to be valid. The decisions, however, are qute uniform everywhere in holding that where settlor and beneficiary are the same person, no restraint on alienation can be imposed: no one may create a trust for his own benefit so as to put the estate outside the reach of his creditors.

That this is the established policy of Massachusetts has recently been reaffirmed in *Merchants National Bank v. Morissey*.[1] To the uniform application of this policy there seemed, however, to have remained an exception. In *Crawford v. Langmaid*[2] the settlor created an estate for life in herself, reserved to herself a general power to appoint the remainder by her will, and in default made a gift to those who would take in the event that there was no will. In addition she gave the trustees power to sell, in their discretion, the trust property for her benefit. It was held that in this situation the creditors of the settlor could reach the principal of the fund. The debtor, the Court reasoned, never obtained a vested interest in the principal; the contingency provided for (the exercise of the trustees' discretion) might never happen at all.

To the extent of its holding that the discretion confided in the trus-

[2] Stein, Conveyancers Beware, 25 Boston Bar Bull. 295 (1954).

§10.4. [1] 329 Mass. 601, 109 N.E.2d 606 (1953).
[2] 171 Mass. 309, 50 N.E. 606 (1898).

tees precludes creditors from reaching the principal, the *Crawford* case has now expressly been overruled in *Ware v. Gulda.*[3] Here the defendant, the settlor of the trust, was to be its only beneficiary during her lifetime. It was left entirely in the discretion of the trustee whether to make any payments to her, either from the principal or from the income, and she was made incapable of assigning any of her interest under the trust. The Supreme Judicial Court held that although the trustee did not exercise the discretionary power conferred upon him by the settlor, this was no ground to distinguish the case in principle from the general rule as restated in the *Merchants Bank* case, *supra,* and that the creditor therefore could reach the maximum amount which the trustee under the terms of the trust could pay to the beneficiary or apply for her benefit. The Court asserted that although this may result in taking property away from the remaindermen, the objection has no force here, as the trustee had power to pay the entire principal to the beneficiary.

The creditor was the defendant's attorney in a previous suit in which she unsuccessfully tried to establish that her ratification of the trust instrument was procured by fraud. The Court found nothing incongruous in the settlor-beneficiary not succeeding in upsetting the trust and in her counsel being paid out of trust property. In her suit she had tried to prove fraud and failed. Her creditor, on the other hand, prevailed, not because the settlement was fraudulent, but because it is the policy of Massachusetts law not to protect the settlor-beneficiary of a discretionary trust against the claim of his creditors, in circumstances such as were involved in this case.

§10.5. Equitable liquidation: Priority of federal government claims. Where, in proceedings arising out of a bill for a receiverhip brought by a judgment creditor against a debtor corporation, the balance of the receivership assets is insufficient to pay both a claim of the United States for taxes and a claim of the Commonwealth of Massachusetts, is the claim of the United States entitled to priority?

Section 3466 of the Revised Statutes,[1] which provides for priority for debts due to the United States, has always been interpreted as not establishing such priority merely because the debtor is insolvent, but only when this insolvency is shown in any one of the three situations stated in that section: (1) where a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof; (2) where the effects of an absconding, concealed, or absent debtor are attached by process of law; or (3) where an act of bankruptcy has been committed.[2]

In *W. A. Robinson, Inc. v. Trawler Leretha, Inc.,*[3] on the basis of

[3] 1954 Mass. Adv. Sh. 73, 117 N.E.2d 137.

§10.5. [1] 31 U.S.C. §191 (1946).

[2] Bramwell v. U.S. Fidelity Co., 269 U.S. 483, 46 Sup. Ct. 176, 70 L. Ed. 368 (1926); United States v. Emory, 314 U.S. 423, 62 Sup. Ct. 317, 86 L. Ed. 315 (1941); United States v. Commissioner of Banks, 254 Mass. 173, 149 N.E. 883 (1925).

[3] 1954 Mass. Adv. Sh. 545, 120 N.E.2d 385.

such an interpretation, the Commonwealth appealed from a decree of the Superior Court authorizing the receiver to pay the balance of the receivership assets to the United States. The Commonwealth argued that although the debtor was insolvent, Section 3466 did not apply because no act of bankruptcy was committed.

The Supreme Judicial Court, however, affirmed the decree. While prior to the Chandler Act there might have been some doubt as to whether the appointment of a receiver to take charge of the debtor's property did constitute an act of bankruptcy, since the changes introduced by that legislation it is clear that such proceedings do constitute such an act. The condition required by Section 3466 is therefore satisfied.