

Security, Mortgages, and Other Creditors' Rights

BERNARD A. RIEMER *and* WILLIAM E. HOGAN

A. SURETYSHIP

§8.1. **Premature payment of retained percentages: Surety's rights.** A contest among a construction contractor for the federal government, his subcontractor, and the surety for performance under the subcontract confronted the Supreme Judicial Court in *Veneto v. McCloskey Co.*¹ The compensated professional surety failed to escape all liability on the bond despite the fact that the principal, the subcontractor, had been paid in excess of what was due him under a subcontract, providing for retention of a specified amount of the money due to the principal. The Court discharged the surety only to the extent of the overpayment, holding that a compensated surety is not entitled to a general release where such overpayment is slight and does not materially alter the risk of the surety. The result follows the dictum in the earlier Massachusetts case of *Museum of Fine Arts v. American Bonding Co.*²

The overpayment of retained percentages in construction contracts presents a twofold problem. First, it can be viewed as an alteration of the principal's obligation and as to compensated sureties it appears to be well established that a compensated surety will be released only to

BERNARD A. RIEMER is a member of the firm of Cohn, Riemer and Pollack, Boston. He is a member of the Boston and Massachusetts Bar Associations.

WILLIAM E. HOGAN is Assistant Professor of Law at Boston College Law School and a member of the Massachusetts Bar. He was formerly Special Assistant to the Chief of the Armed Services Medical Procurement Agency.

The authors are indebted to the following members of the Board of Student Editors of the ANNUAL SURVEY for research notes in preparation of this chapter: to John H. Doermann, on Section 8.3; to Paul A. Kelley, on Section 8.4; and to Margaret M. Heckler on Section 8.5.

§8.1. ¹ 1955 Mass. Adv. Sh. 859, 128 N.E.2d 337.

² 211 Mass. 124, 97 N.E. 633 (1912). Here the Court avoided the issue of the effect of premature payments of retained percentages by holding that the moneys involved were loaned by the obligee to the principal in a transaction separate from the secured contract. The Court said, however, that a release of security by the principal would discharge the surety only to the extent of the amount released.

the extent of his injury unless the alteration materially increases his risk.³ The fact that it is also a release of security by the obligee is an extension of this notion since the surety can claim he is injured to the extent of the impairment of his right to be subrogated to that security. Secondly, the retention of payments by the obligee may benefit the surety so long as they are withheld by inducing the principal to perform his obligation and get the retained moneys. It may be in a given case that by premature payment of such retained percentages the obligee can be said to have contributed to the principal's default by the payment. This possibility in itself has been held in another jurisdiction to be sufficient for a general release of even a compensated surety.⁴

Apparently the granting of such a general release on the "loss of an incentive to performance" argument does not consider the possibility that the overpayment may actually benefit rather than injure the surety. The Wisconsin Court, in a case cited by the Massachusetts Court in the *McCloskey* case, held that a compensated surety may not be released to any extent if the premature payment actually benefited the surety.⁵ In that decision it appeared that the principal would have been forced to default on the contract earlier if he had not received and used in performance the premature payment. In these circumstances the early payment could only have benefited the surety. The present Massachusetts decision apparently would permit the principal to avail himself of such facts and prevent even the partial discharge of the surety. One may, perhaps profitably, wonder if we are approaching rules of law, at least as to the compensated surety, based on the consideration so vigorously urged by Dean Arant that the surety should not be released to any extent where the principal has exercised good business judgment in dealing with the security.⁶

§8.2. Construction bonds: Filing of claims. Mechanical applications of statutory language offer some comfort to lawyers and judges alike. Determinations rendered on this basis may be effortlessly made and defended by merely pointing to the words of the statute. Unfortunately, such decisions often produce unfair results and not infrequently evoke remedial legislation. An opportunity to travel this attractive but somewhat treacherous path was effectively and sensibly rejected in *Belanger & Sons, Inc. v. Concannon Corp.*¹

The Court had previously held that the statutory provisions governing bonds for materials furnished in connection with county, city, or

³ Restatement of Security §§128, 132.

⁴ *O'Neil v. Title Guaranty & Trust Co.*, 191 Fed. 570 (6th Cir. 1911). An excellent compilation of cases pertinent to this entire problem is contained in an annotation in 127 A.L.R. 10 (1940).

⁵ *Maryland Casualty Co. v. Eagle River Union Free High School District of Vilas County*, 188 Wis. 520, 205 N.W. 926 (1925).

⁶ Arant, *Suretyship* §64 (1931).

town public building construction did not apply to bonds related to housing authority contracts.² This decision was based upon the sound consideration that such housing authorities are distinct corporate entities separate from the municipal corporations by whom and within whose territory they are established. Then the General Court enacted G.L., c. 277, §40 in 1946, providing that G.L., c. 149, §§28 and 29 shall be applicable to housing authorities. These incorporated sections are the provisions governing bonds under public construction contracts for cities, towns, and counties. In those sections there is the affirmative requirement that to obtain the benefit of the security the subcontractor must, within a specified period, file a sworn statement of his claim with the county or city treasurer or the town clerk. The claimant in this case had within the time limitations filed his statement with the housing authority but had filed no statement elsewhere. The surety sought to defeat the claim on this basis.³

The Court rejects this mechanical approach and affirms a decree for the claimant. The opinion reviews the development of the statute in light of the *Johnson-Foster Co.* case and the futility of filing with any official other than the housing authority officer because of the independent character of the authority. The Court then offers a caveat to anyone tempted to use unthinkingly the mechanical approach, by quoting as follows from an opinion⁴ of rather ancient vintage by Mr. Justice Wilde. The Court stated, "It is a 'canon of interpretation . . . that . . . [the words of a statute] are to be construed according to the common and approved usage of the language considered in connection with the cause of its enactment, the preexisting state of the law, the mischief to be remedied and the main object to be accomplished.' "

§8.3. Wife's liability as husband's surety. In *H. F. Reisser's Sons v. Parker*,¹ Judge Aldrich of the United States District Court furnished an analysis and construction of a contract under Massachusetts law which is both interesting and illuminating as to the usefulness of surety concepts. The action against a wife individually and as administratrix was brought by the seller under a written contract, somewhat indefinite as to price, for the sale of chickens and poultry supplies. The contract was signed by both the defendant wife and her now deceased husband. The seller was to be paid from the proceeds of the resale of the chickens, but because of a diseased condition the

² *Johnson-Foster Co. v. D'Amore Construction Co.*, 314 Mass. 416, 50 N.E.2d 89 (1943). The provisions as to bonds on county, city, and town construction contracts were embodied in G.L., c. 149, §§28, 29.

³ The Court had previously held that a total failure to file a notice of the claim under this type of transaction resulted in the supplier losing his rights to the security. *Philip Carey Mfg. Co. v. Peerless Casualty Co.*, 330 Mass. 319, 113 N.E.2d 226 (1953).

⁴ *Somerset v. Dighton*, 12 Mass. 383 (1815).

§8.3. 1 126 F. Supp. 1 (D. Mass. 1954).

resale did not bring an amount equal to the price. The resale price was paid by check made payable jointly to the husband and the plaintiff. The husband, however, refused to endorse the check. The court held that the ambiguity as to price was resolved by the husband's subsequent conduct in accepting supplies at invoiced prices and acknowledging the gross amount due when he repudiated. The court held the wife liable as administratrix only for the check, accepting the contention that a Massachusetts statute limiting liability of administrators and executors applied to the balance claimed.² Further, the court concluded that even though the wife individually signed the contract, she could not be held bound to it. Although she could contract with a third party, she could not be held to be bound by the husband's subsequent conduct resolving the ambiguity in this contract, because she could not as a matter of law be a joint venturer with her husband,³ and was not as a matter of fact his principal conferring upon him authority to agree on the price.

But the plaintiff, as the court said, had "one more string to its bow" since the contract contained a promise that the "Consignees [the husband and wife] hereby guarantee the full payment of all bills and accounts for chicks and feed and fire insurance premium, furnished by the consignor [seller] possession of which may be delivered to them hereunder." The court held that this provision made the wife liable as a surety even though she may have been active in the transaction as a principal in a legally ineffective manner. There is apparently no violence done in this result either to the terms of the contract nor to the statutory disabilities of the wife. The construction also gives effect to a provision of the contract which would otherwise have little or no meaning.

If the wife is not the sole beneficiary of the deceased's estate, a question as to her rights qua surety against the estate may arise. She appears to be clearly entitled to exoneration and subrogation under prior case law.⁴ There is some doubt however as to her right of reimbursement or indemnification from the principal or his estate, since

² G.L., c. 197, §1 provides "An executor or administrator shall not be held liable to answer to an action by a creditor of the deceased commenced within six months after his giving bond for the performance of his trust, unless such action is brought for the recovery of a demand which would not be affected by the insolvency of the estate . . ." The court held that since the plaintiff had at least a joint title to the check that question is not affected by the insolvency of the estate.

³ G.L., c. 209, §2 prohibits contracts between husband and wife and has been frequently held to invalidate partnerships as between husband and wife members, e.g., *Lord v. Parker*, 3 Allen 127 (Mass. 1861); *Voss v. Sylvester*, 203 Mass. 233, 89 N.E. 241 (1909).

⁴ *Browne v. Bixby*, 190 Mass 69, 76 N.E. 454 (1906) (exoneration); *Fitcher v. Griffiths*, 216 Mass. 174, 103 N.E. 471 (1913) (subrogation). The equitable nature of these actions avoided any objection based upon the wife's disability to sue the husband because statutes like G.L., c. 209, §6 are held merely to continue the common law disability to sue at law. *Frankel v. Frankel*, 173 Mass. 214, 53 N.E. 398 (1899).

this may be viewed as an implied in fact contract between the wife-surety and the husband-principal. The right of the surety to reimbursement can however also be viewed as a quasi-contractual obligation imposed solely by the law on the parties without any of the formalities of express contract. As such it should be a right available to the wife in the instant case.⁵ It seems hardly wise to conclude that the statutes at least partly designed to protect the wife do not prohibit her taking on the burdens of the surety but forbid her from availing herself of the protection normally given to the surety.

§8.4. Assignment for the benefit of creditors: Municipal tax collector's rights. In *Collector v. Slafsky*¹ a difficult problem of construction was resolved by the Court utilizing public policy considerations as to the payment of personal property and excise taxes. The municipal tax collector brought an action against the assignee for the benefit of creditors to recover such taxes assessed prior to the assignment. The purpose of the assignment as set forth in the instrument was to distribute the proceeds of the debtor's estate

in substantial conformity with the laws of said Commonwealth relating to the estates of insolvent debtors, paying debts of said part [sic] of the first part due and owing to the parties of the third part entitled to priority under said laws, in full, should the net proceeds of the trust property be sufficient therefor, otherwise pro rata in the order provided for by the laws of said Commonwealth relating to the estates of insolvent debtors and applying the balance of said proceeds equally and ratably, without preference or priority, to the payment of such debts, obligations and liabilities of the party of the first part to the parties of the third part as are provable against the estate of insolvent debtors under the laws of said Commonwealth, and are not entitled to priority under said laws . . .

The Court held that the tax collector was not a creditor; therefore, he was not compelled to assent to the assignment. This result stemmed from the Court's reliance upon an earlier case, *Boston v. Turner*,²

⁵ *Major v. Holmes*, 124 Mass. 108 (1878), holding that wife is personally liable on promissory note signed by herself and deceased husband based solely on debt of husband since Acts of 1874, c. 184, does not prevent joint promises to third persons. The Court added that no contract of indemnity could be made or implied as between husband and wife in such a case but that was of no import in the case since the contract of indemnity between principal and surety is no part of, and nowise affects, their contract with the creditor.

§8.4. ¹ 1955 Mass. Adv. Sh. 667, 127 N.E.2d 309.

² 201 Mass. 190, 87 N.E. 634 (1909). The holding in this case that a tax is not a debt has had a wide influence. In *Nichols v. Commissioner*, 314 Mass. 285, 50 N.E.2d 76, 147 A.L.R. 130 (1943), it was held that interest paid on delinquent federal income tax was not deductible as interest on a debt for state income tax purposes. It is also noteworthy that the priority given to debts due to the United States by Rev. Stat. 3466, 31 U.S.C.A. §191 (1954), has been repeatedly assumed to include taxes, e.g., *Illinois v. Campbell*, 329 U.S. 362, 67 Sup. Ct. 340, 91 L. Ed. 348 (1946).

where it was clearly established as Massachusetts law that a tax is not describable as a debt.

Nonetheless the Court in the *Turner* case and now in the *Slafsky* case concludes that the tax collector is a beneficiary of the trust. The language in the *Turner* case quite clearly evidenced an intent to include other than creditors as beneficiaries,³ while here the instrument might fairly be read to evidence an intent to include only creditors. The Court held in the *Slafsky* case that the reference to distribution in accordance with insolvency laws of the Commonwealth is enough to make the collector a beneficiary since that law provides a preference to taxes assessed by municipalities.⁴

Basic considerations of public policy as to the collection of taxes seemed to move the Court to this interpretation.⁵ The *Slafsky* decision's use of this policy merely as a guide to the interpretation of the specific language of the instrument may prove awkward for the Court. If an instrument is in the future presented which provides only for distribution to creditors generally or specifically excludes tax collectors as beneficiaries the approach of interpretation will result either in the erosion of the basic policy consideration as to the collection of taxes or the painful torturing of the language utilized in the instrument. Other jurisdictions have not hesitated to hold that although the state is not bound to the assignment as a creditor because a tax is not a debt, it has an automatic preference over other claims by reason of its sovereign prerogative.⁶ This approach escapes the necessity of squeezing language of the instrument to find a drop of an intent to include the tax authority as a beneficiary.

§8.5. Realty security as debt for another. The use of extrinsic evidence to show the indebtedness to secure which a real estate mortgage is given, is set forth in *Miller v. Perry*.¹ The finding in this case reaffirms that where a wife joins in a mortgage of her separate realty to secure a debt of her husband, her estate is security for his debt, even though the debt is the same for which the husband and his estate are primarily liable.

The wife executed the mortgage which included the words “. . . as

³ *Boston v. Turner*, note 2 *supra*. There, the instrument provided that the assignee was “to pay in full such claims against parties of the first part as are entitled to priority by law, including herein such claims as would be entitled to priority under the United States bankrupt law of 1898 as now in force.”

⁴ G.L., c. 216, §118. But for the reference to this statute in the instrument, its provisions would not control because of the Federal Bankruptcy Act.

⁵ Mr. Chief Justice Qua states, “It would be strange indeed if an assignment obviously intended as a means of liquidating the affairs of an insolvent should exclude all provisions for the payment of taxes which are so generally recognized as preferred claims in insolvency proceedings.”

⁶ *Courtney v. Byram*, 54 Cal. App. 2d 769, 129 P.2d 721 (1942); *In re Rockaway Paint Centre*, 294 App. Div. 66, 291 N.Y.Supp. 341 (1934); *In re Harris*, 184 Okla. 459, 88 P.2d 372 (1939).

§8.5. 1 1955 Mass. Adv. Sh. 926, 129 N.E.2d 143.

provided in our note," although she never did sign any such note. The Court held that the trial judge was not plainly wrong in finding that the wife executed the mortgage as security for a note previously executed by the husband. The case illustrates the propriety of introducing extrinsic evidence not only to identify the indebtedness secured by the mortgage but also to show the amount of that indebtedness. Coupling these considerations with the *Marshall v. Francis* decisions,² holding that a recorded mortgage can remain "dormant, unrecognized and unenforced for nearly a century and then be recognized as an encumbrance on the fee"³ simply because of the fact that a discharge has not been recorded, we find adequate grounds for agreeing with the warning of another commentator on the *Marshall* case, "Conveyancers beware!"⁴

B. MORTGAGES

§8.6. **Mortgagee in possession; Right to compensation.** The case of *Kacouris v. Loukas*¹ presents interesting facts dealing with the time of judgment, as well as with an accounting after mortgage foreclosure. On March 29, 1948, the plaintiff brought a tort action against the defendant and, by special precept, made valid attachments of the real estate of the defendant. On April 10, 1951, an agreement for judgment was reached by all interested parties which stated among other things that the further entry might be made, "execution may issue on or after March 20, 1951." On the same day, a Tuesday, the clerk of court made an entry of judgment and that execution be issued after March 20, 1955. On April 12, 1951, a Thursday, the defendant filed a motion to strike from the record the agreement for judgment filed on the previous Tuesday. This motion was denied on May 3, 1951, a Thursday. The clerk thereafter, allowing three days exclusive of Sunday for filing a claim of exceptions, and twenty days for filing exceptions or claim of appeal, on May 28, 1951, made the following entry on the docket: "Judgment for the plaintiff . . . Execution issued May 29, 1951." Between the entry of the tort action and the filing of the agreement for judgment, several mortgagees foreclosed on mortgages executed before the attachments, and there was in the hands of these mortgagees surplus proceeds. On June 21, 1951, the plaintiff brought the first of these suits to reach and apply the surplus proceeds. The plaintiff alleged that within thirty days from the date of judgment, May 21, 1951, he preserved his attachment by levying on

² 331 Mass. 51, 117 N.E.2d 145 (1954); 332 Mass. 282, 124 N.E.2d 803 (1955).

³ The authors of Chapter 10 of the 1954 ANNUAL SURVEY, in Section 10.3, seek the aid of the legislature in resolving the practical dilemma created by the *Marshall v. Francis* result.

⁴ Stein, *Conveyancers Beware*, 25 Boston Bar Bull. 295 (1954).

his execution. A second suit involved the same situation. A third suit was a petition to restrain Kacouris from levying an execution on another parcel of real estate.

The Court held among other things that the entry on April 10, 1951, was the only proper entry and issue of execution that was valid. All other entries were immaterial and void. The acceptance of the motion to strike the agreement from the record was a nullity. The defendant's proper course, if he had any rights, was by a petition to vacate the judgment. Under G.L., c. 235, §1, as changed by Rule 79 of the Superior Court Rules of 1932, judgment and civil actions shall be entered by the clerk on the Monday of each week on written agreement of the parties filed with the clerk. Judgment may be entered with the clerk on any day without further order. The filing of the agreement for judgment was a waiver of all exceptions and appeals, so that the time for filing such exceptions and appeals as provided in G.L., c. 231, §§113 and 96 need not be taken into account.

It was further held that a mortgagee who was also an attorney, and who also personally managed property upon which he had foreclosed, had a right to deduct from the proceeds of the foreclosure sale a reasonable amount for compensation to him for legal and management services.

C. CREDITORS' RIGHTS

§8.7. Security for rent; Effect of petition in bankruptcy; Creditors' rights. An interesting and significant case dealing with the rights of landlord and tenant, and the effect of proceedings in the bankruptcy court upon security deposit made by a tenant under a lease, for faithful performance of the terms of the lease, was decided in December, 1954, in *Ghoti Estates, Inc. v. Freda's Capri Restaurant, Inc.*¹ This was a suit to recover for use and occupation of premises and for water used on said premises between September 12, 1952, and November 3, 1952. Defendant alleged payment, eviction and surrender and by declaration in set-off sought to recover \$10,000 under a "security agreement" under a lease between the plaintiff and defendant.

The facts are as follows: The defendant entered into a lease with the plaintiff's assignor for a term of ten years beginning January 1, 1952. Among other usual provisions, there was provided the following: paragraph 8, "If a petition in bankruptcy is filed by the lessee . . . or if a receiver . . . shall be appointed . . . the lessor may . . . enter . . . the demised premises . . . and upon entry . . . this lease shall determine [indemnification for actual loss of rent for remainder of term]." Paragraph 9 provided: "And for the more effectual securing to the lessor of the rent . . . filing of any petition in bankruptcy or insolvency by the lessee . . . deemed . . . breach . . . and . . .

§8.7. 1332 Mass. 17, 123 N.E.2d 232 (1954).

ipso facto . . . lease terminated." (Immediate contract action with fair value mitigation.)

The parties also entered into a "security agreement" by which the defendant deposited \$10,000 with the plaintiff "as security for the full faithful and punctual performance of the lessee's terms, covenants and conditions contained in the said lease for the full term of the said lease." In June 9, 1952, the defendant filed a petition for an arrangement under Chapter XI of the Bankruptcy Act, which petition alleged insolvency in the equity sense. The petition rejected the lease with the plaintiff. On June 11, 1952, a receiver was appointed of the property of the debtor. On September 11, 1952, a referee in Bankruptcy confirmed the arrangement, apparently after acceptance by creditors. The receiver paid the plaintiff the fair rental value of the premises for the period of his receivership up to and including September 11, 1952. The plaintiff claimed a breach of the lease by virtue of the filing of a petition for an arrangement. On November 3, 1952, the plaintiff instituted an action of summary process to recover some of the premises which ended in an agreement for judgment for the plaintiff. The Court held that paragraphs 8 and 9 of the lease above referred to must be read together, and that the plaintiff could avail itself of the provisions of either paragraphs 8 or 9 of the lease in its discretion, and thus the filing of the petition or the appointment of the receiver constituted a breach of the lease. There was no payment of the rent for the whole period of the lease after breach, nor did the plaintiff's action to evict the defendant after confirmation constitute a defense, as this occurred after the breach of the defendant. Nor was there any surrender in a legal sense, as only negotiations for same were proved. The Court refused to order the return of the security deposit holding that the plaintiff could retain same until December 31, 1961, when it could determine the actual loss to it of the lease by virtue of paragraph 8 of the lease.

It is noted that paragraph 9 of the lease called for an automatic termination of the lease upon the filing of the petition of insolvency, while paragraph 8 of the lease stated (as to the facts here) that if a receiver was appointed, the lessor might enter the demised premises and upon entry this lease should determine. Up to the date of the action involved here, there was no showing that the lessor had entered the demised premises, and thus it did appear that the lease had not terminated. It is interesting to understand why the Court held that, on the facts before it, the lessor could avail itself of paragraph 8 of the lease. Without the availability of this paragraph, it would seem that the Court should have required the return of the deposit less any damages the plaintiff suffered according to paragraph 9 of the lease. Moreover, since paragraph 9 calls for an automatic termination upon filing a petition of insolvency, and since a receiver was appointed after such an automatic termination did occur, it would seem that the plaintiff could not then avail itself to its right to enter and terminate,

as such had already occurred. It is true that paragraphs 8 and 9 are inconsistent at least as to the filing of a petition in bankruptcy. Paragraph 8 provided for entry and termination in that event and paragraph 9 for automatic termination. The Court seems to feel that the language at the beginning of paragraph 9, "and for the most effectual security to the lessor of the rent," amounted to the inclusion in paragraph 9 of such language as "at the option of the lessor the lease shall be automatically terminated." This construction, impliedly made, without analysis, may be subject to some criticism.

In any event, the decision in this case points up the necessity for the detailed examination of bankruptcy clauses in leases, at least when a security deposit is put up. It is extraordinary that after a landlord evicts a tenant, in fact (if not in law), he can keep a security deposit until he has determined his actual loss of rent for the remainder of the term and without requiring him to deduct the fair value of the premises. If the defendant wished to continue his possession he could not have done so, although the full rental of the premises would be deducted from his deposit for the period when he would have occupied but while no other tenant was paying rent, either because of a lack of effort to obtain another tenant by the landlord, or because of the unavailability of such a tenant. (Note that the Court, although relying upon the defendant's rejection of the lease, did not go into the question of when such rejection became operative. Although the Bankruptcy Act provides that the confirmation of a Chapter XI plan constitutes the rejection of a lease mentioned in the plan, there is nothing in the act which indicates whether or not the rejection is operative as of the date of confirmation, or whether one can look back to the date of the filing of the petition.)