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If a debtor, who owes several separate amounts to one creditor, makes a payment which is less than the total debt or less than any one of its constituent parts, the problem of applying the payment arises. Since the accountant may have the duty of solving this problem, a general knowledge of the legal principles governing such applications should prove helpful to him. Some of the more important legal aspects of payment applications are considered in this article.

The debtor has the right to indicate his wishes in respect to the application of a voluntary payment. According to Chief Justice Marshall in the leading case of *Tayloe* v. *Sandiford* (1822) 7 Wheat. (U. S.) 13:

> "A person owing money under distinct contracts has undoubtedly a right to apply his payments to whatever debt he may choose; . . ."

In *Monidah Trust Company* v. *Hruze* (1921) 62 Mont. 444, the court said:

> "The reason for the rule which confers upon the debtor the right primarily to direct the application of a paymens voluntarily made by him is apparent. Until the money it actually paid over, it belongs to him, and he may do with it as he sees fit."

If the creditor accepts the payment, he is bound by this action to obey the directions of the debtor, even though at the time he refused to admit them (*In re Interborough Construction Corporation* (1923) 288 Fed. 334). The court, in *Monidah Trust Company* v. *Hruze*, expressed the principle in these words:

> "If he (the debtor) makes a specific direction, the creditor must observe it or refuse to accept the payment. If he (the creditor) accepts and retains the money, the law will treat the payment as having been applied as directed."

In *Reed* v. *Boardman* (1838) 20 Pick. (Mass.) 441, the debtor sent the creditor a sum of money with notice as to which account it was to pay. The creditor refused to accept the payment on those terms and refused to admit the payment on that account

but did receive and retain the money. The court held that the retention of the payment bound him to make the application specified by the debtor.

The direction of the debtor is usually in the form of an express declaration, although it may be a written or an oral agreement between the debtor and the creditor (*Hansen* v. *Rounsavell* (1874) 74 Ill. 238). If the application is in words, these words must reach the creditor in order to bind him (*Pearce* v. *Walker* (1875) 103 Ala. 250). However, the debtor is under no obligation to make a definite statement in regard to the appropriation, since his intent, if this is made known, is sufficient. Chief Justice Marshall, in *Tayloe* v. *Sandiford*, cited above, said in regard to this point:

> ". . . although prudence might suggest an express direction of the application of his (the debtor's) payments at the time of their being made; yet there may be cases in which this power would be completely exercised without any express direction given at the time."

If no precise designation has been made, it may, of course, be necessary for the debtor to prove facts that will lead a jury to infer that he actually intended the specific application which he claims (*Hall* v. *Marston* (1822) 17 Mass. 575).

Circumstances may reveal the debtor's intent as to payment applications as well as words could indicate. For example, the denial of one debt and the acknowledgment of another with delivery of the sum due upon it would be conclusive evidence of the payer's intention (*Marryatts* v. *White* (1817) 171 reprint 586). If there are two debts, of one of which the debtor is aware, of the other of which he is ignorant, an intention to pay the known debt is presumed (*Burchard* v. *Western Commercial Travelers' Association*, 139 Mo. A. 606). Should the creditor demand payment of one of two or more debts and the debtor pay, the law considers the payment to be on the demanded debt (*Smith* v. *Mould* (1914) 149 N. Y. S. 552). Where the debtor inquires as to the amount of a particular debt and then pays that amount, the intention to pay the debt about which he inquired may be reasonably inferred (*New York* v. *Angelo* (1911) 129 N. Y. S. 713). However, if circumstances are depended upon to indicate the application, it is essential that knowledge of them reach the creditor, because the mere intention on the part of the debtor to appropriate, of which the creditor is unaware, will not bind the

latter (*Delaware Dredging Company* v. *Tucker Stevedoring Company* (1928) 25 Fed. (2d) 44).

Should the debtor pay with one intent and the creditor receive with another, the intent of the former will govern.

After the debtor has made the application, the creditor has no right to divert the money without the consent of the payer (*Treadwell* v. *Moore* (1852) 34 Me. 112). Should the creditor apply the money upon a debt, other than the designated obligation, and the debtor fail to object, such failure to act is not necessarily an acquiescence to the appropriation made by the creditor (*Ballantine* v. *Fenn* (1914) 88 Vt. 166) because the debtor may be ignorant of the diversion (*Fargo First National Bank* v. *Roberts* (1891) 2 N. D. 195).

An entry made by the debtor on his records when the payment is made is an appropriation if this fact is communicated in some way to the creditor (*Stone* v. *Rich* (1912) 160 N. C. 161). If the creditor receives a payment and credits a particular item in the debtor's account and then notifies the payer of that entry, and he makes no objection, such action is considered a consent to the application by the creditor (*Seymour* v. *Marvin* (1851) 11 Barb. (N. Y.) 80). If the creditor fails to notify the debtor of the entry, the creditor's action is taken as evidence of an application by some of our courts (See 3 Williston, *Contracts* (1920), Section 1799). However, the English view, that such entries have no effect, seems more reasonable (*Simson* v. *Ingham* (1823) 2 B. & C. 65).

The law sets a time for application of the debtor by stating that he must make it at or before the time the creditor receives the money (*California Bank* v. *Webb* (1884) 94 N. Y. 467). One court (*Petty* v. *Dill* (1875) 53 Ala. 641) maintained that the debtor must act, at least, before the creditor has applied; but, even where the creditor has not applied, the debtor is not permitted to direct application long after the payment has been made (*Dean* v. *Womack*, 2 Tenn. Ch. A. 72) without the consent of the creditor (*Royal Colliery* v. *Alwart* (1916) 276 Ill. 193). The court, in *In re American Paper Company* (1919) 255 Fed. 121, held that the debtor may not apply a payment after litigation in regard to it has been instituted.

The debtor may, at the time of payment, change a direction previously given (*Ray* v. *Borgfeldt* (1915) 169 Cal. 253) but after payment has been made he has no right to change the appropria-

tion without the creditor's consent (*Hodge* v. *Hoppock* (1878) 75 N. Y. 491). But should the creditor consent to change of application after payment he will be bound by such agreement (*Thompson* v. *Reeves* (1926) 170 Ark. 409).

Where the debtor makes a voluntary payment and fails to make a definite designation and gives no indication of his intention as to the application of the payment, the creditor, with certain restrictions which will be taken up later, is given the right to apply the payment to any one of the several debts that he sees fit (*United States* v. *Kirkpatrick* (1824) 9 Wheat. (U. S.) 720; *Jones* v. *United States* (1849) 7 How. (U. S.) 681; *In re Lindau* (1910) 183 Fed. 608). Chief Justice Marshall, in *Field* v. *Holland* (1810) 6 Cranch. (U. S.) 28, said:

> " . . . When a debtor fails to avail himself of the power which he possesses, in consequence of which that power devolves on the creditor, it does not appear unreasonable to suppose that he is content with the manner in which the creditor will exercise it."

The performance of some act which shows the intention specifically to apply the payment to a particular debt constitutes appropriation on the part of the creditor (*Reynolds* v. *Patten* (1894) 30 N. Y. S. 1050). Circumstances as well as express declarations may indicate the creditor's intent (*Felin* v. *First Mortgage Guarantee* (1915) 248 Pa. 195). However, the mere intent to apply is not sufficient, according to the court in *Schoonover* v. *Osborne* (1902) 117 Iowa 427).

These are some of the acts which are evidence of application on the part of the creditor: entry of credit on a particular account (*Jones* v. *United States* (1849) 7 How. (U. S.) 681); indorsement of payment on a note (*Sanborn* v. *Cole* (1891) 63 Vt. 590) if notice be given the debtor; institution of a suit by the creditor, in the jurisdictions where the creditor may apply at any time prior to judgment or verdict (*State* v. *Blakemore* (1918) 275 Mo. 695).

Naturally, the creditor will wish to apply the payment to the item or items which he thinks are least likely to be paid, and, with certain restrictions, the law will support him if he makes such an appropriation (*Hildreth* v. *Davis*, 6 Kulp (Pa.) 336). If other rules do not prohibit, he is given the right to apply the payment to debts not secured (*Turner* v. *Woodard* (1919) 259 Fed. 737) or he may select the most precarious of the secured claims. (*In*

re Lysaght (1903) 1 Ir. 235). If one of the debts is the sole obligation of the debtor, and the others are with surety, guarantor or joint debtor, the creditor may apply a general payment by the debtor from his own funds to the debt which is not protected and continue to hold the surety or others bound. If one debt is a bond, or covenant under seal, and the other is by a simple contract or open account, the creditor may appropriate a payment to the latter (*Mayor* v. *Patten* (1808) 8 Cranch (U. S.) 317). Should one debt be by judgment and the other by simple contract, the creditor has the privilege of application to the latter (*Richardson* v. *Washington Bank* (1842) 3 Metc. (Mass.) 536). In case of two different accounts, one of which is later than the other, the creditor, if he so desires, may apply the payment to the later account (*Henry Bill Publishing Company* v. *Utley* (1892) 155 Mass. 366) or he may apply half of the payment to each of the accounts if neither is barred by the statute of limitations (*Beck* v. *Haas* (1892) 111 Mo. 264).

Although there are some contrary decisions, the general rule, in respect to running accounts, is that the creditor may apply the payment as he chooses (*Sheppard* v. *Steele* (1870) 43 N. Y. 52). Consequently, he may apply to the oldest items (*Jones* v. *United States* (1849) 7 How. (U. S.) 681) even though these items are barred by the statute of limitations (*Brown* v. *Osborne* (1910) 136 Ky. 456). However, if he applies without making known his intention to apply to a specific item, the presumption is that he applies to the oldest (*American Woolen Company* v. *Maaget* (1912) 86 Conn. 234).

There are some restrictions upon the rights of the creditor to apply when the debtor fails to exercise his privilege of appropriation. The courts insist that the debtor must have known and have voluntarily given up his right to direct the application of the payment which he has made before the creditor may apply. In *Bancroft* v. *Dumas* (1849) 21 Vt. 456, the court went so far as to hold that the creditor must make the application in such a way that the debtor could have no reasonable objection. In some circumstances, on account of the relation in which he stands to third persons, or from agreement with them, expressed or implied, he may be obliged to make a particular appropriation. For example, if the debtor who owes the creditor also owes a party for whom the creditor is trustee, a general payment by the debtor must be applied pro rata between the creditor's debt and

that of the party for whom he is trustee, since a trustee is bound to take the same care of his cestui que trust's interests that he does of his own (*Scott* v. *Ray* (1836) 18 Pickering (Mass.) 361). A prior legal debt must be given preference over a later debt in equity. If there are several debts, and only one of these is valid, the creditor must apply the payment to this debt, without any consideration whatever of the order in point of time in which this item appears on the records (*Backman* v. *Wright* (1855) 27 Vt. 187).

If a debt is due at the time an unappropriated payment is made, the courts assume that the creditor will apply the payment to such debt, in preference to those which are not due at that time (*Baker* v. *Stackpoole*, 9 Cow. (N. Y.) 420). The creditor may apply the payment to debts which are not due, if he has an express agreement with the debtor to that effect (*Shaw* v. *Pratt* (1839) 22 Pick. (Mass.) 305) but he is under no obligation to receive payment of such a debt and if he accepts the money he must apply it as the payer orders (*Levystein* v. *Whitman* (1877) 59 Ala. 345).

The creditor has no right to apply unappropriated funds to claims that are illegal and consequently are not recoverable at law (*Caldwell* v. *Wentworth* (1843) 14 N. H. 431). In *Richardson* v. *Woodbury* (1853) 12 Cush. 279, it was held that if payments made on account by a debtor be applied by the creditors, under a previous agreement, to certain items of the account which are illegal, such payments are valid, and can not afterwards be revoked by the debtor. This seems to be a recognition of the principle that a debtor may elect to have his payment applied to an illegal debt. In an early Maine case, *Treadwell* v. *Moore* (1852) 34 Me. 112, the court decided that debts resulting from the sale of liquor, which was illegal in Maine by statute, might be legally credited if the payment was applied by the debtor.

The courts have refused to allow a creditor to apply an unappropriated payment to debts barred by the statute of limitations with the object of reviving them (*Pond* v. *Williams* (1854) 1 Gray (Mass.) 630). However, the debtor has the right of waiving the bar of the statute and may permit such an application as will renew the former obligations. If he remains silent after learning that the creditor has applied the payment so as to revive the outlawed debt, he will be estopped from denying that the money was paid on such debt (*Watt* v. *Hoch* (1855) 25 Pa. 411). Usually, the creditor has the burden of proving the intent of the

debtor to renew the outlawed obligation. This intent may be inferred from accounting entries which were made before the payment or from the fact that the debtor has paid interest on the renewed debt. The payment, if part, will generally be applied toward the barred debt if such is the desire of the debtor, but the balance of the debt is not revived (*Pond* v. *Williams* (1854) 1 Gray (Mass.) 630). In *Ayer* v. *Hawkins* (1846) 19 Vt. 26, the court decided that a creditor may apply a general payment to any one of several barred accounts, and this payment will revive the balance of that particular account, but he will not be permitted to distribute the credit among the several accounts, so as to revive them all.

The civil law requires that the creditor make the application of a general payment very soon after receiving the money from the debtor; but the common law is more liberal. There is considerable conflict among the decisions as to how long the right exists for the creditor. A few dicta indicate the necessity of applying within a reasonable time. Between debtor and creditor, the weight of authority is that an application by the latter at any time before a controversy arises or a suit is brought will be good (*Bacon* v. *Dollar Steamship Lines* (1923) 290 Fed. 964; *Pierce* v. *Knight* (1859) 31 Vt. 701). If third parties are involved, the creditor must act within a reasonable time (*Robinson* v. *Doolittle* (1840) 12 Vt. 249). When the time arrives for the creditor to declare his election, he may not refuse to do so, and he will not be permitted, to the inconvenience and injury of others, to hold the application in reserve to await the turn of future events. The rule is different in England, for in that country a creditor has been allowed to apply in the witness box (*Seymour* v. *Pickett* (1905) 1 K. B. 715).

Application by the creditor may become fixed by oral declaration; by the terms of the receipt rendered; by rendering an account; by bringing a suit based upon a specific appropriation; or by any other act showing an intent or inducing a belief that a particular application has been made (*Allen* v. *Kimball* (1839) 23 Pickering (Mass.) 473).

After the appropriation has been made by the creditor, he can not change it without the consent of the debtor (*The Sophia Johnson* (1916) 237 Fed. 406). If the debtor consents, any change agreeable to both parties is generally permissible (*Thompson* v. *Reeves* (1926) 170 Ark. 409).

The creditor has no option with regard to application if the payment is involuntary on the part of the debtor (*Blackstone Bank* v. *Hill* (1830) 10 Pickering (Mass.) 129). He is under obligation to apply the payment pro rata to all the unpaid accounts. This rule is followed where the creditor obtains the money through judicial proceedings. The share received by a creditor from an insolvent debtor through an assignment must be applied pro rata to all the claims against the debtor and not only to such debts as are otherwise unsecured (*Bank of Portland* v. *Brown* (1843) 22 Maine 295).

If no application has been made or indicated by either the debtor or the creditor, the duty of appropriation falls upon the court which will usually apply the payment as it sees fit with due consideration to the interests of both parties (*Harker* v. *Conrad* (1825) 12 Serg. & R. (Pa.) 301; *Pope* v. *Transparent Ice Company* (1895) 91 Va. 79). According to Justice Story, in *United States* v. *Kirkpatrick* (1824) 9 Wheat. (U. S.) 720:

> "The general doctrine is that the debtor has a right, if he pleases, to make the appropriation of payments; if he omits it, the creditor may make it; if both omit it, the law will apply the payments, according to its own notions of justice."

In some circumstances, the jury, acting on the evidence and under instructions of the court, will apply (*Oliver* v. *Phelps* (1843) 20 N. J. L. 180).

The court will attempt to follow the intention or understanding of the parties, before or at the time of payment, if this can be inferred or implied from the circumstances (*Emery* v. *Tichout* (1841) 13 Vt. 15; *Gillett* v. *Depuy* (1900) 63 N. Y. S. 49) but if this is impossible, it will be guided by a general presumption of intention founded on reason, probability and justice. In *The Martha* (1887) 29 Fed. 708, it was held that that application is presumed to have been agreed upon to which it is most probable that the parties would have assented.

The law will usually apply a general payment to a debt which is due, in preference to one that is not due, since the presumption is that the debtor intends a payment, not a deposit (*Upham* v. *Lefavour* (1846) 11 Metc. (Mass.) 174). A certain debt is preferred to one which depends upon the happenings of some contingency (*Snyder* v. *Robinson* (1871) 35 Ind. 311; *President* v. *Brown* (1843) 22 Maine 295). The application will generally be made to the oldest of several debts (*Kloepfer* v. *Maker* (1903)

84 N. Y. S. 138). If priority is not involved, that debt which is unsecured or is least secured will receive the credit in the states following the common-law rule (*Barbee* v. *Morris* (1906) 221 Ill. 382). In case the debt which is least secured is not prior to the others, there are several decisions to the effect that the time element should be ignored and the application made to the least secured obligation (*Schuelenberg* v. *Martin* (1880) 2 Fed. 747; *Smith* v. *Lewiston Steam Mill* (1891) 66 N. H. 613). However, the weight of authority favors application to the earliest debt (*Moses* v. *Noble* (1888) 86 Ala. 407; *Wortheley* v. *Emerson* (1874) 116 Mass. 374). Payment will not be applied to debts contracted after payment (*London* v. *Parrott* (1899) 125 Cal. 472) nor to a future indebtedness (*Harrison* v. *Johnson* (1855) 27 Ala. 445) nor to demands which are not enforceable.

In case of continuous accounts, payment will be applied to the earliest, if there is no express direction or inference to the contrary (*Winnebago Paper Mills* v. *Travis* (1894) 56 Minn. 480). This point was settled more than a century ago when Justice Story, in *United States* v. *Kirkpatrick* (1824) 9 Wheat. (U. S.) 720, said:

> "In cases . . . of long and running accounts, where debts and credits are perpetually accruing, and no balances are otherwise adjusted than for the mere purpose of making rests, we are of the opinion, that payments ought to be applied to extinguish the debts according to the priority of time: so that the credits are to be deemed payments pro tanto of the debts antecedently due."

Application will not usually be made to disputed items (*Banner Grain Company* v. *Burr Farmers' Elevator* (1925) 162 Minn. 334. Where some of the items are illegal, payment will be applied to the earliest legal items.

If there is no evidence to the contrary, and the amount paid by the debtor is exactly equal to one of the several debts, there are decisions to the effect that the jury may infer that the debtor intends that the money be applied to that obligation (*Seymour* v. *Van Slyck*, 8 Wend. (N. Y.) 403). Whether the debts are of a higher or a lower order makes no difference in application of payments to them. (*Pennypacker* v. *Umberger* (1854) 22 Pa. 492). For example, if one debt is a specialty and the others are simple contracts, all will be treated alike in respect to order of payment when the court applies. If the simple contracts were prior to the specialty they will be paid before the specialty. Priority is the determining factor, while dignity of the contract is ignored.

If the creditor of an old firm continues his business with a new partnership which has taken over the business of the old one, payments will be applied to the old debt, unless a different intention of the debtor can be proved. If a firm creditor is also creditor to a partner, a payment by a partner of partnership funds should be applied to the partnership debts in preference to the partner's personal obligations (*Codman* v. *Armstrong* (1848) 28 Maine 91).

Where interest is due on any account, the courts will use the payment to settle the interest, and, if there is anything left, it will be applied upon the principal of the debt (*Sheppard* v. *New York* (1915) 216 N. Y. 251; *Jacobs* v. *Ballenger* (1891) 130 Ind. 231). If there are several debts of the same degree, all carrying interest, a general payment will be applied to all of the interest before reducing the principal of any one of the obligations. In *Steele* v. *Taylor* (1836) 4 Dana (Ky.) 445, the court said:

> "When a debtor fails to make a prompt payment of his debt, the law has fixed a rate of interest that he shall pay, as a reasonable compensation to the creditor for the delay. And, as interest will not bear interest, though it be as justly due as the principal, the creditor is deprived of the use of the interest without compensation for it. It is, therefore, just and equitable, when the credit is left to be applied by the chancellor, that it should be first applied to the extinguishment of the whole interest, or that portion of the fund, which is withheld by the debtor, that draws no interest."

Let us summarize. The debtor has the right to direct the application of a voluntary payment; if he fails to use this right, it passes to the creditor, who, with certain restrictions, may apply the money as he thinks best. If both the debtor and the creditor fail to indicate their intention in respect to the appropriation, the court will take over the right and will apply the payment according to its idea of justice.