Michigan Law Review

Volume 39 | Issue 2

1940

TRUSTS -- SELF-DEALING PURCHASE OF SECURITIES BY CORPORATE FIDUCIARY FROM ITS OWN BOND DEPARTMENT

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TRUSTS — SELF-DEALING PURCHASE OF SECURITIES BY CORPORATE FIDUCIARY FROM ITS OWN BOND DEPARTMENT — The will of Henry Binder, deceased, probated in 1909, created a testamentary trust of which the Guardian Savings & Trust Company, later the Guardian Trust Company, was appointed trustee. Several years later, the corporate trustee invested part of the trust fund in various land trust certificates. In 1933 when the trust company was taken over by the superintendent of banks, the final accounting of the Binder trust, filed in the probate court, listed the land trust certificates as part of the trust assets. The land trust certificates were purchased by the corporate trustee for the trust from a syndicate of which the trustee was a member, directly from the bond department of the trust company, and from other sources. *Held*, that the purchases from the syndicate and from the trustee's own bond department were illegal because of self-dealing. *In re Binder's Estate*, 137 Ohio St. 26, 27 N. E. (2d) 939 (1940).

The fundamental duty of loyalty of a fiduciary is breached when a corporate trustee purchases for the trust securities owned by its bond department or securities in which it has a substantial interest.[1] Such a breach of fiduciary duty makes the transaction voidable at the option of the beneficiary within a reasonable time after he discovers the breach,[2] and the trustee is held accountable to the trust for all profits or losses,[3] even though the transaction was reasonable and made in good faith.[4] However, there are instances when such a transaction may be valid,

[1] 1 TRUSTS RESTATEMENT, § 170, comment i (1935); First Nat. Bank of St. Petersburg v. Solomon, (C. C. A. 5th, 1933) 63 F. (2d) 900; Joliet Trust & Savings Bank v. Ingalls, 276 Ill. App. 445 (1934); Larson v. Security Bank & Trust Co., 178 Minn. 209, 224 N. W. 235, 226 N. W. 697 (1929); 16 TEX. L. REV. 285 (1938); Scott, "The Trustee's Duty of Loyalty," 49 HARV. L. REV. 521 at 539 (1936).

[2] Baxter v. Union Industrial Trust & Savings Bank, 273 Mich. 642, 263 N. W. 762 (1935); First State Bank of Pineville v. Catron, 268 Ky. 513, 105 S. W. (2d) 162 (1937).

[3] City Bank Farmers Trust Co. v. Evans, 255 App. Div. 135, 5 N. Y. S. (2d) 406 (1938).

[4] Barker v. First Nat. Bank of Birmingham, (D. C. Ala. 1937) 20 F. Supp. 185; United States Nat. Bank & Trust Co. of Kenosha, Wisconsin v. Sullivan, (C. C. A. 7th, 1934) 69 F. (2d) 412; Bold v. Mid-City Trust & Savings Bank, 279 Ill. App. 365 (1935).

as in the case of ratification by the beneficiary, provision in the trust agreement permitting self-dealing and provision by statute.[5] In these three instances the transaction to be valid must be made in good faith and in the exercise of reasonable care.[6] In the case of ratification, the beneficiary must approve the transaction with full knowledge of all the facts surrounding it.[7] Where provision is made in the trust indenture, the settlor may permit self-dealing by the corporate trustee, and most courts, in the absence of statutory prohibition, uphold such permission provided it is specific.[8] Broad discretionary power in the trustee as to the investment of trust funds, however, is not considered sufficient to permit the corporate trustee to indulge in self-dealing.[9] In the case of statutory permission, the provision must be explicit because the courts tend to interpret such statutes strictly, not only because they are in derogation of the common law but also because they probably feel that the beneficiaries of a trust need the protection.[10] It should be noted that the few states which have legalized self-dealing transactions by trustees have placed strict limitations upon such self-dealing in an attempt to safeguard the beneficiaries' interest.[11] The Pennsylvania statute [12] expressly prohibits trust companies and banks from purchasing with funds held by them as fiduciaries any asset of their respective commercial departments, but the prohibition does not apply to investments in government bonds, mortgage participations, and to "any other case otherwise specifically provided for by the act." Under the California statute,[13] the most liberal one found, a bank can purchase securities for one department from other departments "upon receipt of the actual value thereof, if such bonds, securities or loans are, under the pro-

[5] Annotation, 112 A. L. R. 780 (1938).

[6] In re Flint's Will, 240 App. Div. 217, 269 N. Y. S. 470 (1934); Welch v. Welch, (Wis. 1940) 290 N. W. 758.

[7] Re Long Island Loan & Trust Co., 92 App. Div. 1, 87 N. Y. S. 65 (1904); In re Tuttle's Estate, 162 Misc. 286, 294 N. Y. S. 230 (1937); Gates v. Plainfield Trust Co., 121 N. J. Eq. 460, 191 A. 304 (1937).

[8] Re Balfe's Will, 245 App. Div. 22, 280 N. Y. S. 128 (1935); Finley v. Exchange Trust Co., 183 Okla. 167, 80 P. (2d) 296 (1938). Cf. Ohio Gen. Code (Page, 1938), § 10506-49, forbidding such power to be given to the corporate fiduciary, and therefore any clause in a trust agreement giving corporate trustee power to buy from itself is void. This statute was passed after the Binder trust was established and therefore had no application in the principal case.

[9] Re Peck, 152 Misc. 315, 273 N. Y. S. 552 (1934); United States Nat. Bank & Trust Co. of Kenosha, Wisconsin v. Sullivan, (C. C. A. 7th, 1934) 69 F. (2d) 412. *Contra*, Welch v. Welch, (Wis. 1940) 290 N. W. 758.

[10] In re Tuttle's Estate, 162 Misc. 286, 294 N. Y. S. 230 (1937); Larson v. Security Bank & Trust Co., 178 Minn. 209, 224 N. W. 325, 226 N. W. 697 (1929); Kelly v. First Minneapolis Trust Co., 178 Minn. 215, 226 N. W. 696 (1929).

[11] The New York statute formerly allowed bank trustees to indulge in self-dealing, provided the cestui qui trust was notified, the records showed the whole story clearly, and the transaction involved only a part interest in securities. N. Y. Banking Law, § 188 (7), as amended by Laws (1917), c. 385. It has now been amended to permit no self-dealing whatever by corporate trustees. N. Y. Laws (1937), c. 619, Banking Law (McKinney, 1939), § 100b.

[12] Pa. Stat. Ann. (Purdon, Supp. 1939), tit. 7, § 819-1111.

[13] Cal. Gen. Laws (Deering, 1937), art. 652, § 25.

visions of this act, a legal investment for the department purchasing the same." In recent years the development of mortgage participating investments has also caused a new problem in regard to self-dealing. There is a conflict of authority in respect to the legality of such investments.[14] But even those courts which uphold their legality, in the absence of statutory authorization, are not likely to approve an investment where the original purchase by the corporation is made in its individual capacity and there is no earmark made at the time or soon thereafter that the mortgage will be used for participating trust investments.[15] The reason for this stand is that the trustee by taking the morgage in its own name becomes in effect the owner, and any subsequent transfer to a trust involves self-dealing and is therefore invalid.[16] But where the trustee at the time of purchase in his own name intends the investment to be for the trust and earmarks it as such, but keeps it just long enough for the trust to accumulate sufficient funds to pay for it, this rule does not apply because the first purchase was essentially a purchase for the trust.[17] The instant case in invalidating purchases involving self-dealing takes the sound view, which is in line with the overwhelming majority of the courts.[18] It is for the legislature, not the courts, to permit such transactions, because it can protect the interests of the beneficiary by proper safeguards.

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[14] In re Shaw's Estate, 122 N. J. Eq. 536, 195 A. 525 (1937); Barker v. First Nat. Bank of Birmingham, (D. C. Ala. 1937) 20 F. Supp. 185; McKinney, "The Legality of Participating Mortgage Certificates as Investments for Trustees," 24 YALE L. J. 286 (1915). *Contra*, In re Harton's Estate, 331 Pa. 507, 1 A. (2d) 292 (1938); Springfield Safe Deposit & Trust Co. v. First Unitarian Society, 293 Mass. 480, 200 N. E. 541 (1936).

The courts which uphold the mortgage participation investments feel that the benefit gained, namely that of investment advantages for smaller trusts, overbalance the disadvantage of encroachment upon the common-law duties of the trustee, especially since the disadvantages are minimized by proper bookkeeping methods. The courts holding contra, however, feel that the danger involved in encroaching upon the common-law safeguards is too great to allow the mortgage participation investments.

[15] First Nat. Bank of Birmingham v. Basham, 238 Ala. 500, 191 So. 873 (1939); noted, 26 VA. L. REV. 523 (1940); 38 MICH. L. REV. 935 (1940).

[16] 2 SCOTT, TRUSTS, § 170.14 (1939).

[17] Ibid.

[18] In In re McGuffey's Estate, 123 Pa. Super. 432, 187 A. 298 (1936), the court seemed to favor self-dealing by a corporate fiduciary, but did not lay down any general rule which has been followed by the Pennsylvania courts.

A recent decision dealing with corporate fiduciaries held that the various departments of a corporate fiduciary are separate entities, and therefore dealings between the various departments are not self-dealing. Breedlove v. Freudenstein, (C. C. A. 5th, 1937) 89 F. (2d) 324, noted 37 COL. L. REV. 1405 (1937). However, the great majority of courts support the view that a corporate fiduciary is one entity though it may have several departments. Flack v. Hood, 204 N. C. 337, 168 S. E. 520 (1933); Kittson v. St. Paul Trust Co., 62 Minn. 408, 65 N. W. 74 (1895). If the courts in the future follow the example of the Breedlove case, then the law against self-dealing as to corporate fiduciaries will be relaxed, even though as the note in 37 COL. L. REV., supra, points out, calling the various departments of a trust company separate entities does not change the situation.