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TRUSTS - PARTICIPATION IN BREACH OF TRUST BY DEPOSITARY OF TRUST FUNDS - TRACING

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TRUSTS — PARTICIPATION IN BREACH OF TRUST BY DEPOSITARY OF TRUST FUNDS — TRACING — A township treasurer, elected custodian of school funds by the trustees of schools, paid a personal debt to the bank in which those funds were deposited with a check drawn by him as treasurer on the trust account. Subsequently, in like manner, he transferred some $2,000 from the trust account to his personal account in the same bank to meet an overdraft of $1,000, using the balance then left in his personal account for his personal advantage without benefit to the bank. *Held*, that the surety who had paid a judgment in favor of the school trustees for the total sum misappropriated did not establish a preferred claim against the receiver of the bank, since it failed to trace any portion of the misappropriated funds into the receiver's hands. *People ex rel. Barrett v. State Bank of Herrick*, 290 Ill. App. 130, 8 N. E. (2d) 71 (1937).

Anyone who participates[1] with a fiduciary[2] in a breach of trust violates

[1] In general, see 4 BOGERT, TRUSTS AND TRUSTEES, §§ 868-869, 901-913 (1935); 2 TRUSTS RESTATEMENT, §§ 321-326 (1935); Merrill, "Bankers' Liability for Deposits of a Fiduciary to his Personal Account," 40 HARV. L. REV. 1077 (1927); Scott, "Participation in a Breach of Trust," 34 HARV. L. REV. 454 (1921).

[2] The terminology adopted here is that of the Uniform Fiduciaries Act, 9 UNIFORM LAWS ANNOTATED 145 (1932), which was drafted to cover the "situations which arise where one person deals with another person whom he knows to be a fiduciary." Commissioners' Notes, 9 UNIFORM LAWS ANNOTATED 147 (1932). It includes two classes of fiduciaries: (1) those who hold property in their own names as fiduciaries, and (2) those who deal with property held in the name of their principals. 9 ibid. 148. Generally in the cases where the depositary of fiduciary funds is sought to be held as participant in a breach of trust, no distinction is drawn between the groups. 35 YALE L. J. 854 at 855 (1926). But it is there suggested that in fact the courts

one of the principal's [3] rights as equitable owner of the trust property [4] and may be held liable for money damages at law,[5] or as constructive trustee [6] in equity if it can be shown he has received and still holds the trust property or its proceeds.[7] A bank which is the depositary of known trust funds [8] participates in such a breach when, with notice [9] of his intent to put them to a wrongful use, it permits the fiduciary to do so. Thus, when the bank permits a prima facie wrongful use of trust credit—e.g., payment of the fiduciary's obligation to the bank, or transfer of trust funds to the fiduciary's private account to meet an overdraft—it is charged with notice of any actual breach which a reasonable inquiry would reveal,[10] and becomes liable as a participant therein.[11] But where the bank allows a presumably proper use of the trust funds—e.g., withdrawal or transfer to the fiduciary's personal account, without more—there is no such effect, and the bank is not liable.[12] In the instant case under these rules the

have been more lenient with banks when the faithless fiduciary had title, except in the case of public officers, whose trusts by their character preclude any justification for depositing the fund in a personal account. The fiduciary in the instant case was of the second type—he was an agent of a corporation, the trustees of schools. Ill. Rev. Stat. (State Bar ed. 1935), c. 122, §§ 20, 67.

[3] "any person to whom a fiduciary as such owes an obligation. . . ." Uniform Fiduciaries Act, § 1, 9 UNIFORM LAWS ANNOTATED 147 (1932). At the present time this act is the law of fourteen states and the District of Columbia. 9 ibid. 62 (Supp. 1936). It was adopted in Illinois in 1931, ten years after the breach of trust involved in the instant case. Ill. Rev. Stat. (State Bar ed. 1935), c. 140a, §§ 1-12.

[4] 4 BOGERT, TRUSTS AND TRUSTEES, § 865 (1935).

[5] New Amsterdam Casualty Co. v. Robertson, 129 Ore. 663, 278 P. 963 (1929) (action against a bank and a fiduciary for conversion).

[6] Farmers' & Traders' Bank v. Kimball Milling Co., 1 S. D. 388, 47 N. W. 402, 36 Am. St. Rep. 739 at 749 (1890). Or where equitable relief is sought, and refused, the court may allow damages in lieu thereof. English v. McIntyre, 29 App. Div. 439, 51 N. Y. S. 697 (1898); Duncan v. Jaudon, 15 Wall. (82 U. S.) 165, 21 L. Ed. 142 (1873). In general, for remedies of the principal against third persons participating in breaches of trust, see 4 BOGERT, TRUSTS AND TRUSTEES, § 869 (1935).

[7] 2 TRUSTS RESTATEMENT, § 291 (1935); Thompson's Appeal, 22 Pa. St. 16 (1853).

[8] As to when one is charged with notice that he is dealing with trust property, see L. R. A. 1915A 722; 4 BOGERT, TRUSTS AND TRUSTEES, § 894 (1935); 2 TRUSTS RESTATEMENT, §§ 296-297 (1935).

[9] 2 TRUSTS RESTATEMENT, § 297 (1935).

[10] 2 TRUSTS RESTATEMENT, § 324 (1935); L. R. A. 1915C 519 at 525. Colby v. Riggs National Bank, (App. D. C. 1937) 92 F. (2d) 183, decided under the Uniform Fiduciaries Act, held the bank liable where the fiduciary transferred trust funds to a private account to meet an overdraft; in the same case, the bank was held not liable where it accepted in payment of the fiduciary's debt a check drawn on this private account.

[11] 4 BOGERT, TRUSTS AND TRUSTEES, § 907 (1935).

[12] L. R. A. 1915C 518 at 528-529; 106 A. L. R. 836 (1937); 2 TRUSTS RESTATEMENT, § 324 (1935); 4 BOGERT, TRUSTS AND TRUSTEES, § 908 (1935); Goodwin v. American Nat. Bank, 48 Conn. 550 (1881); Allen v. Puritan Trust Co., 211 Mass. 409, 97 N. E. 916 (1912). Sections 7-9 of the Uniform Fiduciaries Act embody this rule. See Commissioners' Notes, 9 UNIFORM LAWS ANNOTATED 154

bank's liability ought to have been limited to the amount which it accepted in discharge of the fiduciary's obligations to it.[13] But it has been held that the notice the bank has of a prior breach of trust in which it participated puts it on inquiry as to all subsequent transactions, even those in which normally the presumption would be that the fiduciary is acting properly.[14] It is thought this is not too great a burden for the bank to bear if it is willing to continue business

(1932). A few courts, however, regard the transfer to the fiduciary's account as prima facie wrongful, putting the bank on inquiry as to any breach a reasonable investigation would reveal. Merrill, "Bankers' Liability for Deposits of a Fiduciary to his Personal Account," 40 HARV. L. REV. 1077 (1927); Bank of Hickory v. McPherson, 102 Miss. 852, 59 So. 934 (1912) (bank held liable where a check payable to "G. B. H., Commissioner" was properly indorsed and deposited in a personal account, from which it was withdrawn for the use of G. B. H. personally); United States Fidelity & Guaranty Co. v. People's Bank, 127 Tenn. 720, 157 S. W. 414 (1913) (bank liable on the theory that the entry of a trust fund in a private account is of itself a conversion). The cases are collected in the Merrill article, 40 HARV. L. REV. 1077 at 1080, notes 10-19, 1084-1085, notes 37-43 (1927).

[13] This would have been about $2,000 instead of more than $7,000, the amount of the judgment rendered, which was for the total sum misappropriated. This rule is said to be the sounder because it lessens the burden on business and facilitates the use of bank credit. Scott, "Participation in a Breach of Trust," 34 HARV. L. REV. 454 (1921); 4 BOGERT, TRUSTS AND TRUSTEES, § 910 (1935). But Merrill, "Bankers' Liability for Deposits of a Fiduciary to his Personal Account," 40 HARV. L. REV. 1077 (1927), favors the rule which puts the bank on inquiry in all cases where it allows known trust funds to be placed in personal accounts. This naturally leads banks to refuse to permit the practice, but causes them no great inconvenience, according to the writer. It affords more protection to the principal.

[14] This was the rule laid down in Bischoff v. Yorkville Bank, 218 N. Y. 106, 112 N. E. 759 (1916); it was followed in Fidelity & Deposit Co. of Md. v. People's Bank, (C. C. A. 8th, 1930) 44 F. (2d) 19, cert. denied 282 U. S. 901, 51 S. Ct. 213 (1930). But see Allen v. Puritan Trust Co., 211 Mass. 409, 97 N. E. 916 (1912), where the bank was charged only for amounts deposited to cover overdrafts, and not for subsequent withdrawals to the fiduciary's own order. An express purpose of sections 7-9 of the Uniform Fiduciaries Act was the abolition of this qualification established by the Bischoff case. Commissioners' Notes to §§ 7-9, 9 UNIFORM LAWS ANNOTATED 154 (1932). Those sections provide that where a fiduciary draws upon an account in his name as fiduciary, or where he deposits trust funds in his personal account, and subsequently draws on it, the bank is not liable unless it pays the check, or receives the deposit, with actual knowledge that the fiduciary is commiting a breach of trust, or with knowledge of such facts that its action in paying the check or receiving the deposit amounts to bad faith. Bad faith is not defined by the act, but sec. 1 provides that "a thing is done 'in good faith' . . . when it is in fact done honestly, whether it be done negligently or not." This section is intended to establish the same subjective test of bad faith as is adopted by the Negotiable Instruments Law. As to what constitutes bad faith, see BRANNAN, NEGOTIABLE INSTRUMENTS LAW, 5th ed., 572-582 (1932). In view of the discussion there, it would seem that knowledge of a prior breach of trust in which it had participated might be some evidence a depositary acted in bad faith in subsequent dealings with a fiduciary. In this connection see Colby v. Riggs National Bank, (App. D. C. 1937) 92 F. (2d) 183 at 195, where the court discusses and applies the test of 'bad faith' which the act contemplates.

with a presumably dishonest fiduciary.[15] The court's holding here is, in effect, a sanction of this view.[16] The theory of the bank's liability is important, for its insolvency renders any action for damages valueless.[17] The surety can recover a substantial amount only if it establishes a preferred claim. Thus, the misappropriated funds have to be traced. To do this, the surety argued that once it was shown the bank had received a portion of the misappropriated funds, there arose a presumption, based upon the presumption of the wrongdoer's rightful conduct,[18] that those funds remained undiminished among the bank's assets. And it was further contended that the burden was on the receiver to rebut that presumption of continuance by showing that the total assets of the bank were less, at some time after the misappropriation, than the amount misappropriated.[19] This argument was properly denied, for to have allowed it would have meant an abandonment of the tracing doctrine. The court's holding in this respect is in line with the better authority [20] and the sounder reason.[21]

[15] 4 BOGERT, TRUSTS AND TRUSTEES, § 912 (1935).

[16] The surety recovered for the total misappropriated by the fiduciary.

[17] Had the bank not been insolvent the surety might have attempted to establish a claim for damages for the total sum misappropriated on the theory that the bank had violated its deposit contract when it paid drafts drawn by the fiduciary without the order of the trustees of schools as required by statute. Ill. Rev. Stat. (State Bar ed. 1935), c. 122, § 81. This limited authority of the fiduciary to draw checks ought to have been known to the bank. Was it put on inquiry as to his authority each time he drew a check? An Oregon case, New Amsterdam Casualty Co. v. Robertson, 129 Ore. 663, 278 P. 963 (1929), apparently rejects the theory. But see Fidelity & Deposit Co. v. Queens County Trust Co., 226 N. Y. 225, 123 N. E. 370 (1919).

Apparently the surety sought to establish a preferred claim for the whole amount misappropriated, but obviously that portion which the bank did not receive could not be traced, and allowance of a preferred claim for it simply because trust funds were involved would have unjustly injured other creditors of the bank.

[18] See the discussion by Jessel, M.R., in In re Hallet's Estate, 13 Ch. Div. 696 at 712-720 (1879).

[19] In general, see Ames, "Following Misappropriated Property into its Product," 19 HARV. L. REV. 511 at 519 (1906); 4 BOGERT, TRUSTS AND TRUSTEES, §§ 921-930 (1935).

[20] 4 BOGERT, TRUSTS AND TRUSTEES, § 925 (1935); In re Marsh, (D. C. Conn. 1902) 116 F. 396; In re Hollins & Arrousez Electric & Engineering Co., (C. C. A. 9th, 1929) 31 F. (2d) 50; Matter of Hicks, 170 N. Y. 195, 63 N. E. 276 (1902). But other cases seem to indicate a willingness to let the principal rely on a presumption of continuance. Village of Monticello v. Citizens State Bank, 180 Minn. 418, 230 N. W. 889 (1930); Lusk Development & Improvement Co. v. Günther, 32 Wyo. 294, 232 P. 518 (1924) (but only if the period intervening between the wrongful act of the bank and its insolvency is relatively short).

[21] The claimant ought to have to identify the property as his before he is allowed a preference.