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BANKS-FIDUCIARY DUTY-GUILTY PARTICIPATION IN A BREACH OF TRUST

Robert O. Hancox
University of Michigan Law School

COMMENTS

BANKS—FIDUCIARY DUTY—GUILTY PARTICIPATION IN A BREACH OF TRUST—The fiduciary relation which "involves a duty on the part of the fiduciary to act for the benefit of the other party to the relation as to matters within the scope of the relation"[1] is of broad scope, including not only the more strictly defined relations such as those involving trustees, guardians, and executors,[2] but also the more loosely knit relations such as found in the corporate field; i.e., directors and stockholders, promoters and subscribers to stock and the like.[3] In contrast to the

[1] 1 SCOTT, TRUSTS, § 2.5 at p. 34 (1939.

[2] Attorney & client; broker & principal; executor or administrator & heir, legatee or devisee; factor & principal; guardian & ward; husband & wife; partners; principal & agent; trustee & cestui que trust.

[3] Corporation directors or officers & corporation or stockholders; corporation in control & its subsidiaries; life tenant & remaindermen; majority or dominating stock-

confidential relation, where to set aside a transaction between the parties there must be shown fraud, undue influence, or the confidence otherwise abused, a transaction within the fiduciary relation may be set aside as a matter of course, for the consequences flow as a matter of law.[4]

Thus the liability of fiduciaries for diversions of trust funds is unquestioned and there is also unanimity in holding liable those third persons who are guilty participants in the breach of trust. However, the question of what constitutes a guilty participation evokes a variety of answers. This confusion arises in part from a difference in approach. The foundation of the fiduciary relation is the affirmative duty owed by fiduciary to principal and it follows that one who knowingly assists a fiduciary in his breach of this duty would also be liable. Out of this "knowledge," some courts have sought to create a duty on the part of the third person owed to the principal, while in reality, the true application of the third person's "knowledge," or lack thereof, is to determine whether he is to take subject to, or free of, the fiduciary's diversion.

This duty viewpoint was carried through to include a duty on the part of a person buying trust property from a trustee to see that the trustee applied to trust purposes the purchase price paid him,[5] thus placing on the purchaser a duty to inquire and, if the payment were misapplied, he became a guilty participant. The rule was severely criticized by Ames,[6] and rejected by statute in England[7] and by many of the states.[8] This duty was also applied where a trustee mortgaged property and wherever a third person was under an obligation to pay money to the trustee as such.[9] Although the prevailing view has now discarded this rule, there still seem to be vestiges of this duty approach.

The preferable approach is one that considers the good faith of the third person.[10] The good faith of the third person is dependent on his notice of the misapplication, or potential misapplication, by the fidu-

holders & minority; mortgages & mortgagor; parent & child; promoters of corporation & subscribers to its stock; receivers generally; see 36 C. J. S., Fiduciary, p. 740, and definition in Uniform Fiduciaries Act, § 1 (1922).

[4] 1 SCOTT, TRUSTS, § 2 (1939); 35 YALE L. J. 854 (1926), stating that no distinction in rules, applied to erring fiduciary whether agent or trustee.

[5] 4 BOGERT, TRUSTS, § 901 (1935).

[6] AMES, CASES ON TRUSTS, 2d ed., 269, note (1893).

[7] Trustee Act 1925, § 14.

[8] See list in 4 BOGERT, TRUSTS, § 901, note 4 (1935); Uniform Fiduciaries Act, § 2 (1922).

[9] 3 SCOTT, TRUSTS 1731 (1939).

[10] Uniform Fiduciaries Act, § 2 (1922), "A person who in good faith pays or transfers to a fiduciary any money or other property which the fiduciary as such is authorized to receive, is not responsible for the proper application thereof by the fiduciary"; 81 UNIV. PA. L. REV. 863 (1933), commenting on U.F.A.

ciary. The same test of good faith is embodied in the Uniform Negotiable Instruments Law where to be a holder in due course, the holder must take free of notice of infirmity,[11] that is, he must be free of actual knowledge of the infirmity or knowledge of such facts that his action in taking the instrument would amount to bad faith.[12] The seemingly obvious construction of these sections is to apply a subjective test and to ask what knowledge the taker had,[13] but another view has also developed that applies an objective test—whether a reasonably prudent man's bad faith would be established by the circumstances.[14] These problems concerning negotiable instruments blend naturally into those concerning diversions of trust funds, for so often are the diversions accomplished through checks and other negotiable instruments.

The application of this test of notice, requisite to make guilty a participation in the diversions of a fiduciary, has had an ample testing ground in the situation where a fiduciary deposits trust funds in his personal bank account and then draws out sums for personal expenditures.[15] The typical and frequent case presents the newly designated trustee seeking to reassemble the misappropriated trust funds diverted by his predecessor. If the bank in which the personal account of the former trustee was maintained and through which the peculations were accomplished can be made a guilty participant in these diversions, the new trustee has a sound source out of which the trust funds can be reestablished.

For recovery, the participation of the bank must be made guilty by its relationship with the trustee in either or both of his two acts—(1) the deposit of trust funds in his personal account, and (2) the withdrawal for personal use. In either of these instances, it must be remembered, guilt can only be predicated on knowledge, actual or implied, by the bank of the diversion, or intended diversion, of the trust funds by the trustee.

Lee v. Corn Exchange Bank Trust Co.,[16] a case decided recently in a jurisdiction replete with varying decisions in this field, affords a practical approach to the problem. The case involved one Johnson, the former trustee, who maintained a personal account in defendant bank and, on a form furnished by the bank, had given his wife a limited

[11] 5 U.L.A., § 52 (1943).

[12] Id., § 56.

[13] Goodman v. Simonds, 20 How. (61 U.S.) 343 (1857).

[14] Rochester & Charlotte Turnpike Road Co. v. Paviour, 164 N.Y. 281, 58 N.E. 114 (1900); 52 L.R.A. 790 (1900).

[15] See Professor Aigler's Comment, 42 MICH. L. REV. 694 (1944); 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).

[16] 52 N.Y.S. (2d) 246 (1944), appeal 58 N.Y.S. (2d) 290 (1945).

power of attorney to draw checks on this account. Some four years later, Johnson opened, in the same branch of defendant bank, an account in the name of "Estate of Joseph A. Lee, Dec'd, Arthur S. Johnson, Executor." Within a few days Johnson started the process of drawing checks as trustee on the trust account to his own order and depositing them in his personal account. Before the first of such deposits, his personal balance was $53.55 and one of the first checks drawn at that time was one by his wife for $55.03 payable to a department store. When the trust funds had been completely dissipated and the faithlessness of Johnson discovered, the widow of Lee sought, in an action for an accounting, to recoup the losses by seeking to hold the bank a guilty participant in the misappropriation of the trust funds.

In a leading case in the field, *Bischoff v. Yorkville Bank*,[17] it was stated that a bank's liability for participation in a diversion could be predicated upon "either (a) acquiring an advantage or benefit directly through or from the diversion, or (b) joining in a diversion, in which it was not interested, with actual notice or knowledge that the diversion was intended or was being executed, and thereby becoming privy to it."[18] The former basis is that used in the remedial device of the constructive trust and leaves wide open the illusive question of what constitutes the necessary advantage or benefit. Wisely, it seems, the courts have centered their attention on the latter (for some courts in equitable actions have intimated that sufficient benefit is derived by a bank acting as a mere agent in the collection chain to support a quasi-contractual recovery)[19] and even in the specific instances where the bank itself received payment for a personal obligation owed to it by the trustee out of the trust funds diverted to his personal account, the courts have approached the problem, not from the benefit angle, but from one of notice.[20] This is logical in view of the fact that if the benefit approach were utilized, one could recover, on the basis of quasi-contract or constructive trust, the amount the bank realized from the diversion;

[17] 218 N.Y. 106 at 112, 112 N.E. 759 (1916); L.R.A. 1916F, 1059 (1916).

[18] To the same effect in Allen v. Puritan Trust Co., 211 Mass. 409, 97 N.E. 916 (1912); L.R.A. 1915C, 518; Blanton v. First Nat. Bank, 136 Ark. 441, 206 S.W. 745 (1918).

[19] Cases collected in 31 A.L.R. 1068 (1924) and 67 A.L.R. 1535 (1930).

[20] Bischoff v. Yorkville Bank, 218 N.Y. 106, 112 N.E. 759 (1916); Grace v. Corn Exchange Bank Trust Co., 287 N.Y. 94, 38 N.E. (2d) 449 (1941); 145 A.L.R. 436 (1941), here the court scrupulously avoided the benefit angle by saying the receipt by the bank of diverted monies in payment of overdrafts in the personal account and interest on a personal loan did not make the bank a guilty participant—not until the trustee's personal loan from the bank (about $15,000) was paid from trust funds diverted to his personal account, was the bank charged with knowledge. In 287 N.Y. 94 at 106, "The bank becomes liable as a joint wrongdoer from the date when it *knowingly* assists the trustee in withdrawing the trust moneys from the personal account in order to pay a personal debt of the trustee to the bank."

whereas if one can hold the bank a guilty participant in the diversion through notice (the notice arising out of its direct benefit), then the entire embezzled fund can be regained.

Viewing the facts of the *Lee* case (and the other cases in this category) in regard to this latter basis announced in the *Bischoff* case, the misappropriating activities divide into two distinct processes—the deposit of trust funds to the personal account and the withdrawal for personal use. Before the bank can be said to have guiltily joined, the act in which it has joined must be determined wrongful.[21] Is the commingling of trust and personal funds in a personal account wrongful? Although trust funds should be deposited in a separate account (and the depositor incurs certain liabilities upon insolvency of the bank if this is not done)[22] and some few cases seem to hold to the contrary,[23] the great majority of the cases hold that commingling of trust and personal funds is not a breach of trust,[24] at least in the sense of incurring liability for diversion, most courts also stating that the bank can presume a proper use of the trust funds by the trustee.[25] Even where by statute[26] such commingling is made unlawful, the courts have held that even with notice of such illegal conduct, the bank's liability is not enlarged, such notice in itself not being enough to make the bank a guilty participant in a subsequent conversion.[27]

[21] 42 MICH. L. REV. 694 at 697, ". . . if the fiduciary is not guilty of a breach of trust on such facts, surely the bank is not to be charged with any participation."

[22] Trustee is personally liable if commingled [AMES, CASES ON TRUSTS, 2d ed., 484n (1893)], and even if no commingling, he is liable if account is not labelled to show its fiduciary character [Chancellor v. Chancellor, 177 Ala. 44, 58 S. 423 (1912)]; see 34 HARV. L. REV. 454 at 467, notes 40, 41 (1921).

[23] U.S. Fidelity & Guaranty Co. v. Peoples Bank, 127 Tenn. 720, 157 S.W. 414 (1913); Bank of Hickory v. McPherson, 102 Miss. 852, 59 S. 934 (1912).

[24] 42 MICH. L. REV. 694 at 697 (1944); Helena v. First Nat. Bank, 173 Ark. 197 at 202, 292 S.W. 140 (1927), "the deposit by a trustee of funds belonging to the trust estate in his individual name and account at the bank is not a conversion of the trust fund."

[25] "A fiduciary may legally deposit the trust funds in a bank to his individual account and credit. Knowledge on the part of the bank of the nature of the funds received and credited does not affect the character of the act. The bank has the right to presume that the fiduciary will apply the funds to their proper purposes under the trust." Bischoff v. Yorkville Bank, 218 N.Y. 106 at 111, 112 N.E. 759 (1916); incorporated into the 2 TRUSTS RESTATEMENT, § 324d (1935) and quoted approvingly in many cases; Columbia Land Co. v. Empson, 305 Mich. 220, 9 N.W. (2d) 452 (1943).

[26] Surrogate Court Act, § 231, New York Civil Practice Act (Cahill, 1937) 1059, which prohibits "Every executor, administrator, guardian or testamentary trustee" from depositing in his own name the funds or property received from the estate of a deceased person.

[27] Mfgs. Trust Co. v. U. S. Mtge. and Trust Co., 244 N.Y. 550, 155 N.E. 893 (1926); Clarke v. Public Nat. Bank & Trust Co., 259 N.Y. 285, 181 N.E. 574 (1926); criticized, 42 MICH. L. REV. 694 at 697 (1944).

As is aptly stated by the New York court in *Grace v. Corn Exchange Bank,*[28] if the knowledge of all the employees of a bank in regard to the ramified procedures involved in banking transactions of this kind, "could be combined in the consciousness of a single officer of the bank, that officer might have such clear notice that a transaction apparently innocent was fraudulent that the officer could not ignore the notice without becoming a party to the fraud." At least the bank, as principal, is deemed to have knowledge of the transfer of trust funds to the personal account in cases of this type. Whether this knowledge, coupled with a subsequent conversion, is enough in itself to render the bank liable the courts are not agreed.[29] The numerical majority holds for non-liability, but a sizeable minority stands to the contrary. Where pertinent legislation has been enacted, the rule of non-liability has been adopted.[30]

The second step in the process is the withdrawal of the trust funds from the personal account for personal use. Whether the bank is deemed to have notice of such wrongful withdrawal determines the bank's liability. In those jurisdictions in which the mere deposit is enough, the question is answered. Where the deposit does not constitute notice, the bank can presume that the withdrawals are for a lawful purpose and some additional factor must be present to constitute the necessary notice.[31] "A bank does not become privy to a misappropriation by

[28] 287 N.Y. 94 at 104, 38 N.E. (2d) 449 (1941), supra, note 20.

[29] Merrill, "Bankers' Liability for Deposits of a Fiduciary to his Personal Account," 40 HARV. L. REV. 1077 (1927), supra, note 15, very amply documented and citing which course is followed in most of the jurisdictions. In Boston Note Brokerage Co. v. Pilgrim Trust Co., (Mass. 1945) 61 N.E. (2d) 113, a fiduciary, having authority to indorse and cash his principal's checks, was paid $10,000 in cash by drawee bank on a check payable to the principal. The fiduciary then bought a bank check from the same bank payable to himself, deposited it in his personal account in another bank, and embezzled the funds. In an action by the fiduciary's principal, the drawee bank was held not liable as a participant in this diversion, the court stating, id. at 115; "In this Commonwealth, and by the weight of authority elsewhere, a bank upon which a check is drawn is not liable for the embezzlement of the proceeds by a payee who is a fiduciary, or by an agent of the payee authorized to collect the check, merely because the fiduciary or agent causes the check or its proceeds to be deposited in his personal account, much less because he collects the check in cash."

[30] Uniform Fiduciaries Act, § 9 (1922) as urged by the American Bankers' Association [2 PATON'S DIGEST 1421 (1926)]; Ga. Ann. Code (Park, Supp. 1922) § 2280.

[31] Grace v. Corn Exchange Bank, 287 N. Y. 94 at 102, 38 N.E. (2d) 449 (1941), "There can be no doubt that when the bank, pursuant to the directions of the trustee, debited the trust account and credited the trustee's personal account with the amount of the checks, which the trustee drew to his own order upon the trust account *and then deposited in his personal account*, and when the bank thereafter honored the personal checks of the trustee by means of which the theft was consumated, it, in fact, was assisting the trustee in stealing the trust moneys. Even so, unless in addition it appears that the bank knew that the trustee was engaged in embezzling trust funds by

merely paying or honoring the checks of a depositor drawn upon his individual account in which there are, in the knowledge of the bank, credits created by deposits of trust funds."[82] But such requisite notice creating privity occurs when the bank receives a benefit from the misappropriation. The presumption of regularity is destroyed when the bank is a recipient, as in the situation where a personal loan to the trustee is paid by personal check drawn on the trust funds deposited in the personal account, and the bank becomes a guilty participant in the diversion.[83]

The Supreme Court of Queens County, New York, upon the trial of the *Lee* case, applied the foregoing views and held the bank not liable as a guilty participant; but on appeal, it was held that the bank was liable. Although the commingling was unlawful under the Surrogate Court Act,[84] that did not render the participation by the bank guilty; the critical point was the wife's power of attorney. The lower court said, "there is no essential difference between a situation where the checks were drawn by the executor to the order of his wife and a case where the executor gave to such wife a power of attorney to withdraw such funds."[85] The appellate court stated that the assumption that the trustee would properly apply the trust funds standing in his personal account was made untenable when access to the personal account was afforded to a complete stranger to the estate. When the bank paid the wife's check of $55.03, the account then containing only $53.55 of personal funds—thus dipping into trust funds, the bank became a guilty participant and was liable for all subsequent misappropriations.

In contrast to this more frequent situation, a recent Maine case[86] presents the bank in the principal's position trying to hold customers of the bank liable as guilty participants in the diversions by the bank's manager, a fiduciary who owed personal obligations to these bank customers. The manager paid his personal debts to his creditors by checks drawn on his personal account in the bank. These checks were in turn

withdrawal of the trust money in the personal account *in order to apply them to his own use*, the bank was justified in following the directions of the trustee."

[82] Bischoff v. Yorkville Bank, 218 N.Y. 106 at 112, 112 N.E. 759 (1916).

[83] Bischoff v. Yorkville Bank, ibid.; Gilliland v. Lincoln-Alliance Bank & Trust Co., 264 N.Y. 517, 191 N.E. 543 (1934); Grace v. Corn Exchange Bank Trust Co., 287 N.Y. 94, 38 N.E. (2d) 449 (1941), in which the bank's benefit from the payment of small overdrafts in the personal account and interest on the personal loan out of the trust funds was not enough, but was given the requisite notice by payment of the loan out of the trust funds.

[84] Surrogate Court Act, § 231, New York Civil Practice Act (Cahill, 1937) p. 1059.

[85] Lee v. Corn Exchange Bank Trust Co., (Queen's Co. S. Ct. 1944) 52 N.Y. S. (2d) 246 at 250.

[86] Haynes v. Lincoln Trust Co., (Me. 1944) 39 A. (2d) 657.

presented by the payee-creditors to be deposited to their accounts in the bank. The diversions were accomplished by the manager crediting the deposits in the customers' passbooks, and substantiating their beliefs as to their bank credit by altering their periodic bank statements. However, the transactions were never cleared through the bank's bookkeeping system, the amounts neither being deducted from the manager's account nor credited to the depositors', and before withdrawal was made, the bank discovered the fraud. The action was brought by the depositors in an attempt to gain these amounts withheld by the bank. The court held that the creditors' recovery was barred by a guilty participation in the bank manager's breach of trust, their participation made guilty by the failure in their duty to ascertain that the manager was using his own funds and not misappropriating bank funds.

The depositors, as plaintiffs, presented their case on the basis of innocence or good faith in their dealings with the faithless fiduciary. The court decided the case on the basis of a duty owed by the depositors to the bank to ascertain that the fiduciary was acting in accordance with the trust, the duty arising when it was known that the fiduciary had interests adverse to those of his principal. Here then is a clear example of a court approaching the problem from the now discredited duty angle.

The court fixed the diversion at the time of the manipulations with the entries when it said: "In the latter capacity [as agent of the bank], he committed fraudulent acts without the knowledge of his employer, to make it appear by false entries that he had paid his debts."[87]

In the exercise of his permission to maintain a personal account in the bank, there was obviously nothing wrong in his drawing these checks. Thus the participation of the creditors must have occurred somewhere between their receipt of the checks and the fraudulent entries of the manager, and since a drawee incurs no liability until he accepts or pays the check, attention must be centered on that part of the transaction when the customers tendered their checks for deposit. In the analogous situation exemplified by the collection of cases in the field of the banker's liability for deposits of a fiduciary to his personal account,[88] the minority view has held the bank liable because the transfer of trust funds into a personal account is virtually a declaration of intent to devote the funds to personal use. Applying the same line of reasoning here, the presumed knowledge on the part of the customers as to the usual and ordinary authority of a bank officer,[89] coupled with the direct knowledge of the manager's adverse interest would constitute

[87] 39 A. (2d) 657 at 659 (1944).

[88] Merrill, "Bankers' Liability for Deposits of a Fiduciary to his Personal Account," 40 HARV. L. REV. 1077 (1927).

[89] State v. Thedford Bank, 114 Neb. 534, 208 N.W. 627 (1926); Schwenker v. Parry, 204 Wis. 590, 236 N.W. 652 (1931).

notice that would make guilty such participation without further inquiry.[40] The majority of the bank cases base non-liability on the presumption of proper conduct on the part of the fiduciary. Applied here, the liability of the customers would seem to be in error unless the benefit or advantage derived by them through the misappropriation would render their participation guilty as that factor did in certain bank cases.[41]

Robert O. Hancox

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[40] STORY, AGENCY, 9th ed., § 210 (1882); 2 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., § 435 (1931); 7 AM. JUR., Banks, § 227; 1 PATON'S DIGEST OF LEGAL OPINIONS, Bank Personnel, § 7A:4 (1940).

[41] Bischoff v. Yorkville Bank, 218 N.Y. 106, 112 N.E. 759 (1916); Grace v. Corn Exchange Bank, 287 N.Y. 94, 38 N.E. (2d) 449 (1941).