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# TRUSTS-PARTICIPATION BY BANKS IN DIVERSION OF TRUST FUNDS

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TRUSTS—PARTICIPATION BY BANKS IN DIVERSION OF TRUST FUNDS—That fiduciaries who misappropriate or divert trust funds from their proper purpose are bound to make good is familiar doctrine. It is equally clear that those who guiltily participate in such diversions by faithless fiduciaries are also liable. The point of chief difficulty is the determination of what participations are properly classified as guilty, for innocent participators clearly are not bound to make good. For example, a fiduciary with power to sell things held in trust may wish to turn the subject matter into cash preliminary to a misappropriation. A bona fide purchaser who provides the cash no doubt stands in a far better position than does one who buys for cash knowing the seller's purpose.[1]

Fiduciaries' dealings with banks are often such that when trust funds are diverted or misappropriated the banks may truly be said to have been parties thereto, and since they normally are financially responsible and able to satisfy judgments against them, while faithless fiduciaries are not, many cases are to be found in the books growing out of efforts to fasten upon such institutions a charge that their participation was such as to impose liability.

While some types of negotiable paper—those representing investments, such as bonds—may be expected to be held by a fiduciary more or less indefinitely in carrying out the trust purposes, this cannot be true of checks the normal use of which is in place of cash. Indeed the holder of a check is under a duty, if the drawer's liability to make good is to be preserved, to make a pretty prompt presentment thereof to the

[1] It was settled long ago that a bona fide purchaser of the subject matter of the trust takes free of the trust, but it was not clear that such purchaser was free of liability if the fiduciary misappropriated the proceeds. Courts commonly cut down the area of liability by finding, whenever possible, a power in the fiduciary to give a valid receipt. This disposition of the courts has found expression in many statutes. For example, the Michigan statute, Comp. L. (1929), § 12988, declares that:

"No person who shall actually and in good faith make any payment to a trustee, which the trustee as such is authorized to receive, shall be responsible for the application thereof according to the trust; nor shall any right or title derived by such person from the trustee, in consideration of such payment, be impeached or called in question, in consequence of any misapplication of such payment by the trustee."

See the discussion by Scott, "Participation in a Breach of Trust," 34 HARV. L. REV. 454 at 463 (1921); "The Uniform Fiduciaries' Act," 81 UNIV. PA. L. REV., 863 (1933). See also the Uniform Fiduciaries' Act, found in 9 UNIFORM LAWS ANN. 301 (1942), a part of the statutory law of about one-third of the states.

TRUSTS RESTATEMENT, § 321 (1935) states:

"If a third person pays or conveys to the trustee money or other property which the trustee as such is authorized to receive, and the trustee misapplies the money or other property, the third person is liable for participation in the breach of trust, if but only if, when he made such payment or conveyance he had notice that the trustee was misapplying or intending to misapply the money or other property."

drawee.[2] Checks are supposed to be quickly converted into cash or its equivalent. When, therefore, a check payable to a person acting in a fiduciary capacity is turned into cash or its equivalent, perhaps in the shape of bank credit, by presentment to the drawee bank or by negotiation to another bank, the check has simply taken its normal course, and the bank with whom the payee-fiduciary dealt could be said to have guiltily participated in any subsequent misappropriation only on pretty clear showing that it knew or ought to have known of such intention. This would seem to be true no matter whether the check showed on its face that it represented trust funds or not.[3]

One may imagine a situation in which any such cashing or negotiation of the check is in direct disregard of some statutory provision[4] or a

[2] It is well known law that a payee in a check very quickly assumes the risk of loss due to a failure by the drawee. This leads to the rule that unless presentment is made within a reasonable time, the drawer is released from his drawer's liability to the extent of the loss he has suffered by the delay; and a "reasonable time" in this connection is pretty short. Prompt presentment is necessary not only to preserve the liability of the drawer but also that of endorsers.

[3] McIntosh v. Detroit Sav. Bank, 247 Mich. 10, 225 N.W. 628 (1929), is interesting in this connection. Defendant bank there was claimed to be liable for certain misappropriations of partnership funds by one of two partners. Checks payable to the partnership were endorsed by the dishonest partner in the partnership name. Some of these checks were then cashed by defendant, some were deposited in the dishonest partner's personal account, some were cashed by defendant and the proceeds immediately received as deposits in that partner's account, and some, finally, deposited to the firm's credit minus part payment in cash. It appeared that the untrustworthy partner used some of the cash derived directly from such checks for his personal use and some of the money later withdrawn from his personal account he used likewise. The bank was held not liable for any part of the cash paid out on the checks thus endorsed except as to that immediately deposited in the personal account. As to deposits in the personal account due to the checks payable to the firm either directly or by cash just received on such checks, the bank was held liable to the extent to which such proceeds were not shown to have gone to partnership purposes.

So far as authorities are concerned, the only doubtful feature of the decision is that part imposing liability with respect to the amounts deposited in the personal account. As supporting the conclusion in this respect see Underwood v. Bank, [1924] 1 K.B. 775, where the action was for conversion of checks payable to the order of a corporation endorsed by the managing director in the name of the corporation and received by the bank as deposits in the director's personal account. Cf. Corporation Agencies v. Bank, [1927] A.C. 318. See also Wagner Trading Co. v. Bank, 228 N.Y. 37, 126 N.E. 347 (1920) and the observations thereon by Cardozo, J., infra, note 6. The case is referred to further, infra, note 10. The Uniform Fiduciaries' Act, § 9, imposes liability on the bank in such situations only when the bank has "actual knowledge that the fiduciary is committing a breach in making such deposit or drawing such check." See also TRUSTS RESTATEMENT, § 324 (1935). In this connection interest may be found in a recent Illinois case, Kerner v. Kinsey, (Ill. 1943) 51 N.E. (2d) 126.

[4] A leading case is Board of Comm'rs. v. Strawn, (C.C.A. 6th, 1907) 157 F. 49. See also Reichert v. Bank, 255 Mich. 685, 239 N.W. 393 (1931); Attorney General v. Bank, 278 Mich. 225, 270 N.W. 276 (1937); Brogan v. Kreipe, 116 Kan. 506, 227

specific stipulation of the instrument creating the trust. Except for statutes prescribing courses of action for public officers, such situations as that just stated must be most unusual. Banks no doubt would be charged with knowledge of any such statutes; but if provisions of trust instruments were relied on, notice thereof would have to be brought home to the bank.[5] In either of these situations the bank might well be held liable if it turns out that trust funds thus made available to the fiduciary were misappropriated.

A common fiducial relationship is that between principal and agent or corporation, public or private, and its officers. The agent or officer, however, ordinarily has no legal title to any property of the principal, and is, therefore, not a fiduciary in the same sense that a trustee, for example, is. Dishonest agents and officers frequently utilize negotiable paper and bank accounts in accomplishing their peculations. If they have authority to draw checks in the name of the principal or to endorse negotiable paper, banks parting with money thereon may find that liability is ultimately sought to be cast upon them for claimed misappropriations accomplished in that way. In such situations the problem is much the same as that discussed above. If, however, the agent or officer had no authority to draw or endorse, the bank may find itself liable quite independently of the trust aspect.[6] A drawee bank that has honored checks executed by an unauthorized agent or officer must restore the credit to the depositor's account, as in the case of clear forgeries, and a bank, not the drawee, that has purchased paper payable to order, on an unauthorized endorsement, is liable as a converter to the

P. 261 (1921). The question often arises, as it did in these cases, upon insolvency of the bank and a claim is made for preferential payment of the deposit as a trust fund.

In New York a statute 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. Surrogate Court Act, § 231, found in New York Civil Practice (Cahill, 1937), p. 1058. The scope of this legislation is pointed out in Clarke v. Bank, 259 N.Y. 285, 181 N.E. 574 (1932).

[5] See Clarke v. Bank, supra, note 4. In that case R was appointed committee of the estate of his incompetent son, the order of appointment directing him to deposit all funds of the estate in the Empire Trust Company. Disregarding that direction, he indorsed and deposited in his personal account with defendant bank checks from the Veterans' Bureau payable to himself, "Committee of David Rosenhaus." It was held that defendant bank was not liable for misappropriations by R accomplished by withdrawals from his personal account.

[6] Wagner Trading Co. v. Bank, 228 N.Y. 37, 126 N.E. 347 (1920); Nat. Bank of Commerce v. Marr & Co., 254 Mich. 333, 237 N.W. 56 (1931). In those cases the instruments were payable to the order of a corporate payee. They were indorsed by an officer thereof and used for his personal benefit. It was concluded that the indorsee had not received good title because of lack of authority by the officer to make such indorsements. In Whiting v. Hudson Trust Co., 234 N.Y. 394 at 406, 138 N.E. 33 (1923), Cardozo, J., observed that "The cases imposing liability in such circumstances lay down, however, a strict and at times a harsh rule, and are not to be extended. They

owner.[7] These situations, though bearing a superficial resemblance to those dealt with above, must not be confused with them.

In determining whether the bank is to be charged in these cases involving no lack of authority it is, of course, of tremendous importance if it appears that the proceeds of the check or other instrument are devoted to personal purposes of the fiduciary as, for instance, in payment of an indebtedness to the bank.[8] Receipt by him of cash or bank credit is not of itself generally regarded as a personal advantage—the misappropriation, if any, in such situation comes upon later use of such cash or credit.

Overwhelmingly the cases hold that in depositing trust funds in a personal account, even mingling them with personal funds, a fiduciary commits no breach of trust unless such deposit is in violation of directions by statute or of provisions of the trust instrument,[9] and, of course, 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.[10] If the deposit is a

do not reach a case where the instrument has been collected according to its tenor for the account of the very person who is there named as payee. The transactions of banking in a great financial center are not to be clogged, and their pace slackened, by overburdensome restrictions."

[7] See Aigler, "Right of Holder of Bill of Exchange Against the Drawee," 38 HARV. L. REV. 857 at 881-883 (1925). It has been held, too, that the drawee bank may be liable as a converter. James v. Bank, 238 Ill. App. 159 (1925); Louisville & N.R. Co. v. Bank, 74 Fla. 385, 77 So. 104 (1917). When, however, the action is against the drawee bank § 189 of the N.I.L. may cause difficulty. See Elyria Sav. & Banking Co. v. Walker Bin Co., 92 Ohio St. 406, 111 N.E. 147 (1915). Why the framers of the N.I.L. provided in that section that until certification the drawee bank shall not be "liable to the holder," while in § 127, as to bills in general, it is declared that without acceptance the drawee is not liable "on the bill," is a mystery. The broad language regarding checks affords some basis for concluding that the drawee bank is not liable even in tort, as apparently is the view of the Ohio court.

[8] Hall v. Windsor Sav. Bank, 97 Vt. 125, 121 A. 582 (1923) and cases cited therein. See Uniform Fid. Act., § 4, found in 9 UNIFORM LAWS ANN. 305 (1942).

[9] See supra, notes 4 and 5.

[10] "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 a right to presume that the fiduciary will apply the funds to their proper purposes under the trust." Bischoff v. Bank, 218 N.Y. 106 at 111, 112 N.E. 759 (1916). This view is incorporated in TRUSTS RESTATEMENT, § 324 d. (1935) quoted approvingly in Columbia Land Co. v. Empson, 305 Mich. 220, 9 N.W. (2d) 452 (1943), a case in which it was held that the bank was free of liability, though the deposits in the personal account consisted of checks payable to a corporation of which the depositor was an officer. The McIntosh case, supra, note 3, is distinguished on the ground that a statute, Mich. Comp. L. (1929), § 9849, Stat. Ann. § 20.9, declaring that "An act of a partner which is not apparently for the carrying on of the business of the partnership in the usual way does not bind the partnership unless authorized by the other partners," was the basis of that decision. Another dissimilarity in the two cases is that while the corporation in the Land Co. case apparently had no bank account, in the McIntosh case

breach on the part of the fiduciary, the bank may or may not be treated as a guilty participant, depending upon whether it has notice, which it clearly would have if the deposit is in violation of a statute.[11]

> "Inasmuch as the defendant knew that the credits to Poggenburg created by the proceeds of the checks were of a fiduciary character and were equitably owned by the executor, it had not the right to participate in a diversion of them from the estate or the proper purposes under the will. Its participation in a diversion of them would result from 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."[12]

Against this background one may examine the recent decision by the Michigan Supreme Court in *Seaboard Surety Co. v. State Sav. Bank of Ann Arbor*,[13] arising out of the peculations of one Gibb while serving as county clerk in handling payments of welfare contributions to the county by county municipalities and townships. These payments were made by checks "from poor fund" payable to Gibb as county clerk. They were indorsed by him as county clerk and deposited in a personal checking account with defendant bank. From time to time amounts were withdrawn from this account by Gibb, about four-fifths of the withdrawals being devoted to county purposes, the remainder being misappropriated. The suit was by a surety company which had paid the county the amount of the defalcation. In the trial court judgment was for the plaintiff, and this was affirmed by a vote of five to three. The majority, however, was split, three to two, as to the ground for affirmance. It is thus difficult to tell what is decided by the court, other than that the lower court was right in holding the bank liable.[14]

Three of the five prevailing justices in an opinion by Wiest, J., thought the authorities relied on below were not in point, and they distinguished their recent decision in the *Columbia Land Co.* case[15] on the

the partnership had an account in the very bank where the personal account of the dishonest partner was kept. See also City of Helena v. Bank, 173 Ark. 197, 292 S.W. 140 (1927) where a city treasurer was allowed by a bank to deposit city funds in his personal account, the bank knowing the nature of the funds so received. The treasurer used some of the funds so deposited for city purposes and some for his own activities. The bank was held not liable. This decision was relied on in the Land Co. case.

[11] Supra, note 4.

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

[13] 11 N.W. (2d) 321 (October 11, 1943).

[14] Apparently the trial court decided the case on the authority of Fidelity and Casualty Co. v. Bank, 275 N.Y. 194, 9 N.E. (2d) 833 (1937) and McIntosh v. Bank, supra, notes 3 and 10.

[15] Supra, note 10.

ground that "here we have a public officer with his rights and duties specifically regulated by statute, with no trustee, fiduciary, or cestui que trust involved." [16] Their vote for affirmance was based upon one case [17] and the supposed effect of three sections of the statutes.[18]

The other two justices for affirmance, in an opinion by Boyles, J., were doubtful whether those statutory provisions had the effect attributed to them. They thought the case quite unlike the one on which the first three relied, but they agreed that the *Columbia Land Co.* case was not applicable. These two voted for affirmance on the ground that "the bank had sufficient notice to put it on inquiry, when it permitted Gibb to deposit these checks in his personal account." [19]

The three dissenting justices, in an opinion by North, J., disagreed flatly with the first three as to the effect of the three sections of the statutes. They disagreed with the other two in their imposition of liability on the bank because it was put "on inquiry" by the deposit in a personal account without more appearing to put it on notice that withdrawals were being misappropriated. They thought the case should follow the doctrine announced in the *Columbia Land Co.* case, that:

> "A bank's knowledge that moneys deposited with it have been acquired by a depositor in a fiduciary capacity does not impose on it the duty, or give it the right, to institute an inquiry into the conduct of its customer in order to protect those for whom he may

[16] It is difficult, if not impossible, to follow the justice when he says here that the facts involve "no trustee, fiduciary, or cestui que trust." Obviously there was no trust in the formal sense, but surely every public officer handling funds of the public is acting in a fiduciary capacity, and the public, represented by the public corporation, here the county, is a cestui.

[17] Employers' Liability Assur. Corp. v. Trust Co., 250 App. Div. 159, 294 N.Y.S. 698 (1937), affirmed in 276 N.Y. 542, 12 N.E. (2d) 567 (1938).

[18] Mich. Comp. L. (1929), § 1313, Stat. Ann. § 5.832; Comp. L. (1929), § 1266, Stat. Ann. § 5.686; Comp. L. (1929), § 1193, Stat. Ann. § 5.531. These will be referred to more fully, infra.

[19] Seaboard Surety Co. v. Ann Arbor Bank, 11 N.W. (2d) 321 at 323 (1934). "On inquiry" as to what? It may fairly be said that the bank was not only "on inquiry" as to the nature of the funds going into Gibb's account but that it actually had notice thereof. But does that, under the authorities, impose liability on the bank if it turns out later on that withdrawals are not put to their proper uses? In the outstanding Bischoff case, supra, note 10, generally criticized for having gone too far in part of its conclusion, the court said at page 112:

"A bank does not become privy to a misappropriation 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. The law does not require the bank, under such facts, to assume the hazard of correctly reading in each check the purpose of the drawer, or, being ignorant of the purpose, to dishonor the check. The presumption is, and after the deposits are made remains until annulled by adequate notice or knowledge, that the depositor would preserve or lawfully apply the trust funds."

> hold the fund, but between whom and the bank there is no privity, as the bank has a right to presume that the fiduciary will apply the funds to their proper purposes under the trust."[20]

In support of the position taken by Mr. Justice Boyles but little can be offered. The authorities are overwhelmingly against it,[21] and his summary rejection of the *Columbia Land Co.* case as "entirely different" leaves one intellectually groping.[22] The conclusion expressed by Mr. Justice Wiest is based on the effect of three sections of the statutes. If the act of the county clerk in making the deposit in his own account in defendant bank was in violation of the statute, then, as pointed out above, it is clear that the bank, taking with notice, as must be implied, became a trustee, *ex mal.* and was liable for what followed. The only question regarding the view of those three members of the court is whether those statutes fairly bear that construction. Three justices were positive they did not, and two others were at least doubtful.

Only one of the three sections relied on deals with county clerks.[23] Mr. Justice Wiest says that that section imposed "a duty on the clerk to pay over all moneys that may come to his hands as such clerk." The section, however, is one prescribing the form of bond required of county clerks; it provides that such bond shall be conditioned, among other things, upon his paying over "all moneys that may come into his hands as such clerk." As matters turned out, Gibb surely failed to pay over all such moneys, but one must strain the statutory language beyond the breaking point to say that the condition of the bond was breached when he deposited the checks in question in defendant bank. The next section[24] merely declares it to be the "duty of the *county treasurer to receive* all moneys belonging to the county, from whatever source they

[20] Seaboard Surety Co. v. Ann Arbor Bank, (Mich. 1943) 11 N.W. (2d) 321 at 325-326. TRUSTS RESTATEMENT, § 324 d, (1935) is here quoted as announcing the same doctrine.

[21] Two cases that might have been cited as sustaining the position are Bank of Hickory v. McPherson, 102 Miss. 852, 59 So. 934 (1912) and United States Fidelity & Guaranty Co. v. Bank, 127 Tenn. 720, 157 S.W. 414 (1913).

[22] A decision against the bank in the Columbia Land Co. case would, in truth, have had more to support it than does the view of Boyles, J. in the current case. See Underwood v. Bank, [1924] 1 K.B. 775, and Wagner Trading Co. v. Bank, 228 N.Y. 37 (1920), referred to in note 3, supra. In this connection might be cited also the McIntosh case, supra, notes 3 and 10, in which, though a statute was involved, its provisions would seem to be merely declaratory of what the law would be anyhow. See too, Nat. Bank of Commerce v. Marr & Co., supra, note 6.

[23] Mich. Comp. L. (1929), § 1313, Stat. Ann. § 5.832.

[24] Mich. Comp. L. (1929), § 1266, Stat. Ann. § 5.686. (Italics supplied).

may be derived," and, finally, section 1193[25] makes it the "duty of the county treasurer of any county to deposit daily all moneys, drafts or checks on hand received by him as such treasurer, in such bank or banks as may be designated by the board of supervisors or the board of county auditors." If it had been the county treasurer who had made deposits contrary to the provisions of this last section, the result would admit of no doubt. If the legislature intended to make it the duty of the county clerk to turn over all receipts of his office to the treasurer or to make it unlawful for him to make deposits in banks as Gibb did in this case, surely it would have been easy to find language that would have expressed that purpose. The county was amply protected against loss by the requirement of a bond conditioned that he shall "pay over" all receipts, and the position taken by Mr. Justice Wiest and his two associates merely shifted the loss from the insurance company to the bank.

Trial judges in trying cases and lawyers in advising clients will be puzzled as to just what is the effect of this decision upon the law of Michigan.[26] It cannot be said, in the first place, that the three sections of the statutes dealt with have been authoritatively construed. Certainly the meaning attached to them by Mr. Justice Wiest has not had the approval of the court. In the second place, the view expressed by Mr. Justice Boyles is shared by only one associate, so it cannot be said that fiduciaries are violating their duties when they deposit fiducial funds in personal accounts or that banks accepting such deposits with notice of their character are liable if the funds are thereafter misappropriated. In short, the decision in the current case upsets nothing in the way of established law of the state; at the same time it settles nothing that heretofore was in doubt.

*R. W. A.*

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[25] Mich. Comp. L. (1929), § 1193, Stat. Ann. § 5.531.

[26] It certainly is not a novel idea, but it is desirable occasionally to remind oneself that a decision for a plaintiff or defendant is not only a determination of the rights and duties of the parties in that litigation but also the furnishing of a guide for future conduct by courts, lawyers and the public. The desire of judges to reach a just result in a pending case is both understandable and laudable. But the justice they administer, generally speaking, should be according to the law, not according to some internal, subjective standard. Lower courts, the bar and the public can determine what their courses of action should be only on the assumption that in the last analysis the standard to be applied in deciding cases is something capable of reasonably definite ascertainment, and that is the justification for the fundamental principle that justice according to the law is what is to be expected. The chief value in legal periodicals, such as this Review, to its readers is to be found not only in their publicizing new and significant developments in the law but in helping them to interpret recent decisions.