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CONFLICT OF INTEREST WHEN A TRUSTEE INVESTS TRUST FUNDS

JOHN M. HADSALL*

The trustee has come to occupy a position in the modern world that is of vastly wider scope than was his status when the law of trusts was first being nurtured by equity. That law has been amazingly permanent and consistent in its fundamental concepts of duties. On this stable foundation the trust function has spread until it is omnipresent, and has grown to represent a sizeable fraction of the total of invested capital. The new importance of the corporate trustee is one of the most obvious manifestations of this development. Still, no matter how large the trustee, or how involved his financial dealings, the relation remains a fiduciary one, and, moreover, the fiduciary element is more intense than with other fiduciaries. What the law will say when any interest other than the beneficiary's enters into an investment transaction must be constantly kept in mind. A review of decisions on this subject impresses one that the trustee's path is narrow at best; sometimes he seems to be unduly restrained or the course approved for him appears excessively cumbersome compared with modern business conduct. It is proposed to observe in what situations the courts have decided that the interjection of the trustee's individual interest into the making of a trust investment results in a breach of trust; then to review the remedies available to the cestui if such is the case; and finally to consider some attempts to improve this situation by statutory provisions and the arguments for and against the principal schemes.

WHAT CONSTITUTES A BREACH OF TRUST

This subject is clearly a division of the trustee's duty of loyalty. The exclusion of all selfish interest is one of

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the most fundamental characteristics of a trust. The
commonly accepted inability of any person to serve two
masters would be expected to be applied to him whom
the law places on a much higher level of integrity than is
demanded of the crowd. The United States Supreme
Court in the early case of Michoud v. Girod\(^1\) expressed
this attitude of equity in language which has become
classic, including:

In this conflict of interest the law wisely interposes. . . . It
. . . provides against the probability in many cases, and the
danger in all cases, that the dictates of self-interest will ex-
ercise a predominant influence, and supersede that of duty.
It therefore prohibits a party from purchasing on his own
account that which his duty or trust requires him to sell on
account of another, and from purchasing on account of another
that which he sells on his own account. In effect, he is not allowed
to unite the two opposite characters of buyer and seller, be-
cause his interests, when he is the seller or buyer on his own
account, are directly conflicting with those of the person on
whose account he buys or sells.

The trustee's first obligation to an income producing
trust is obviously to make proper investments. He is
definitely under a duty to make the trust property pro-
ductive, but in doing so he is required to manifest the
care, skill, prudence, and diligence of an ordinarily pru-
dent person engaged in similar affairs who is investing
for the benefit of others for whom he feels morally bound
to provide. No amount of good faith will excuse him
from this, nor will the taking of advice. To these are
added the limitations applied by the settlor, the court,
and statutes. There is also a tendency toward holding
professional trustees to a still higher degree of skill and
prudence, apparently because they profess to be capable
of it.\(^2\) So it appears that the modern corporate trustee
has much reason for exercising caution in making invest-

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1 4 How. (U. S.) 503, 11 L. Ed. 1076 (1846).
2 In re Clark's Will, 242 N. Y. S. 210 (1930); In re Allis' Estate, 191
Wis. 23, 209 N. W. 945 (1926). But see In re Linnard's Estate, 299 Pa. 32,
148 A. 912 (1930).
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ments and for using all the facilities it has at its disposal.

Under such restrictions, the exclusion of all possible individual interest of the trustee from investment transactions is not a negligible problem. An imposing line of cases has uniformly held that it is improper for the trustee to purchase its own securities, regardless of fairness and good faith. It is likewise a breach of trust to invest trust funds in the individual name of the trustee, as the Illinois case of White v. Sherman\(^3\) decided. Although the situation seldom arises, a trustee who buys an incumbrance upon any trust property is chargeable with any profit made thereby.

The unyielding rigidity with which the courts have clung to this doctrine is well illustrated by decisions from Minnesota. In *St. Paul Trust Company v. Strong et al.*,\(^4\) the beneficiaries of a trust fund objected to certain notes secured by real estate mortgages when the trustee brought action to have its first account settled and adjusted. The facts were that the trustee had at different times owned these notes in its corporate capacity. The court struck out the amounts thereof and so surcharged the account. The Supreme Court, in affirming, found it to be settled that in such a case no fraud in fact need be shown, and no excuse can be offered by the trustee to justify such transactions. The appellant did not dispute the rule but contended that it did not apply here because, under the statute under which it was organized and was acting, the interest of beneficiaries and that of trustees could not conflict. The court remarked that the statute threw around such organizations rigorous regulations and had imposed liabilities of a very stringent character, but it found therein no expression of an intention to make a radical departure from this established doctrine. The opinion states that if such had been the legislature’s in-

\(^3\) 168 Ill. 589, 48 N. E. 128 (1897).
\(^4\) 85 Minn. 1, 88 N. W. 256 (1901).
tention, "it would have expressly provided that investments might be made by trust companies in securities held and owned by such companies." The restrictions and obligations were introduced to safeguard their patrons and were not designed for the benefit or advantage of the organizations therein provided for. The court suggested that if an obligor became reduced in circumstances or a defense against the trustee in particular was threatened, the inducement would be strong to transfer such securities to the trust, although their actual money value might still remain unquestioned and answer in every way to the statutory requirements.

Several years later the court disposed of a similar controversy in the same way in the case of In re Security Bank & Trust Company. The former opinion was handed down in 1901. Knowing of that decision, the legislature failed to follow the language quoted above when it amended that statute in 1903, but provided that any amount not less than one hundred dollars received by a trustee, "it shall invest so soon as practicable in authorized securities, either then held by it or specially procured by it." This court, in 1929, said the failure to follow the language of the earlier case, "held and owned," showed a contrary intent, and decided that the word "held" should be construed in the sense in which it is found elsewhere in the trust company laws, i.e. "hold property in trust," meaning having in possession and under control property (not its own) for others. Thus, the conclusion was reached that the only effect of the amendment was to furnish grounds for an inference that a trustee can now sell securities from one of its trusts to another. However, permitting even this practice would seem to be an equally radical departure from established principles, and the language is hardly adequate for the purpose if construction is to be so strict.

5 178 Minn. 209, 224 N. W. 235 (1929).
This situation illustrates that when a legislature wishes to modify the obligations of trustees to conform to the practical business world, it must leave nothing to the imagination of the courts; but Minnesota appears to be satisfied, as that language still remains unaltered.\(^6\)

New York has furnished some relief to trust companies, at least, from the burden of this restriction by the amendment of 1917 to the Banking Law. The Appellate Division pointed out in the case of *In re Flint's Will*\(^7\) that the former phrase, "no trustee shall purchase securities hereunder from himself," was thereby deleted, and a corporate trustee was authorized to deal with itself in a limited way in good faith. However, the court noted that that language had been retained in amendments enacted the same day to the Personal Property Law\(^8\) and the Decedent Estate Law,\(^9\) so the prohibition continues to apply to an individual trustee. The important language of the Banking Law is,

Investments in bond and mortgage by any such corporation as ... trustee, ... may be made by apportioning to any estate or fund held by such corporation in any of such capacities a part interest in a bond and mortgage held by or in the name of such corporation, individually or in any representative capacity ... and such corporation shall promptly notify each person of full age and sound mind entitled to the income therefrom of the fact that such investment has been made.\(^10\)

A trust company, however, found to its sorrow, in the case of *In re Roche's Will*,\(^11\) that this language authorizes investment of trust funds in mortgage participations only, and its account was surcharged with the amounts of certain entire bonds and mortgages which it had sold to the trust estate.

\(^{6}\) Minn. St., sec. 7738.
\(^{7}\) 269 N. Y. S. 470 (1934).
\(^{8}\) Consol. Laws, c. 41, sec. 21.
\(^{9}\) Consol. Laws, c. 13, sec. 111.
\(^{10}\) Consol. Laws, c. 2, sec. 188, subd. 7.
\(^{11}\) 281 N. Y. S. 77 (1935).
The statutes of the District of Columbia and Ohio also contain express prohibitions against a trustee selling investments to trusts. The Indiana statute does not expressly forbid such transactions, but on the other hand expressly prohibits the bank or trust company from making a profit on a sale to or purchase from the trust, and gives such profit, if made, to the trust. Wyoming, on the other hand, has completely swept away the fiduciary doctrine with the language,

Any such corporation may transfer to trust estates without incurring any other legal liability than as if such transfer were made by a third person, any mortgages or other securities owned by it which comply with the requirements of legal investments for trust funds under the statutes.

The traditional doctrine is no less severe against a trustee using trust property for his own purposes or taking for himself any profit, bonus or commission from a trust transaction other than his stipulated compensation. He is always chargeable with any separate benefit so realized. The leading case on this subject is *Magruder v. Drury*. There a trustee purchased notes from the firm of real estate brokers of which he was a partner. The Supreme Court reversed the decision of the Court of Appeals of the District of Columbia for allowing him the commission, saying,

It makes no difference that the estate was not a loser in the transaction, or that the commission was no more than the services were reasonably worth. It is the relation of the trustee to the estate which prevents his dealing in such a way as to make a personal profit for himself. . . . While no wrong was intended, and none was in fact done to the estate, we think nevertheless that upon the principles governing the duty of a trustee, the contention that this profit could not be taken by Mr. Drury, owing to his relation to the estate, should have been sustained.

12 Laws of 1933, c. 40, sec. 189.
13 Rev. St. 1931, sec. 10-403, subd. 12.
In the case of *White v. Sherman*, mentioned above, the trustee, holding trust property to be insured, joined an underwriters' association and thus secured a commission on the premiums paid. The Illinois court required him to account for it, even though the trust estate suffered no loss by the transaction. The reason for the forbidding of separate profits seems too obvious for much discussion. Much more than the prohibition against the trustee's being both buyer and seller does the rule against separate profits shield estates from the mercies of over-astute business men. However, as with other long-condemned practices, some still attempt to succeed in it. As recently as 1935, in *Bold v. Mid-City Trust and Savings Bank*, a trust company acted as trustee under mortgage loans sold to a trust and charged the owners of the properties fees for certifying the bonds and also received commissions; it placed insurance on the properties, charging the owners the full premiums, and received rebates from the insurance companies; it also retained discounts on guarantee policies, and placed all these sums in its general funds. Needless to say, such dealings came under the condemnation of the Illinois Appellate Court.

Not every conflict of interest, however, is so clear cut. If a trustee may not, say, lend money to himself, the courts would be quick to recognize such an artifice as a trustee's organizing a dummy corporation and making a loan to it from the trust property. But it does not follow that trust investments may not concern any corporation in which he has an interest however slight. And the fact that his interest is considerable is not conclusive that a court will not approve the transaction, if it finds that the trust is adequately protected. In *Cornet v. Cornet*, the trustee owned one-half of the stock of a real estate company. Loans were made to this firm, but

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16 269 Mo. 298, 190 S. W. 333 (1916).
no commissions were paid. The Missouri court said that the personal credit of the trustee had nothing to do with the security. The law surrounded the corporate entity with a credit founded upon its own capital, and the landed security was all that would be exacted from a stranger. It was remarked that the situation did not differ intrinsically from the purchase of a bond of a railway company in which the trustee was a stockholder. The court refused to assess compound interest in the absence of a showing of what the trustee's profits were, and concluded from every fair test that these particular investments were beyond reproach. On the other hand, in *Birmingham v. Wilcox*, the California court held that a trustee investing funds of a trust estate in bonds of a corporation, of which he was an organizer, stockholder, and director, dealt with the funds to his own advantage within the express prohibition of the Civil Code.

Not many of the states have dealt with this particular matter by statutory enactment. Tennessee, however, attempts to be really "practical" with it. Her statute provides that no fiduciary shall purchase for investment of trust funds securities from any corporation in which he or it (or its stockholders, if a corporation) owns twenty-five per cent or more of the stock unless such security was purchased or acquired by such affiliated corporation within sixty days prior to the sale to the trust, and the gross profit or commission realized by such corporation from the sale shall not exceed one and one-half per centum of the price paid.

A closely parallel question is whether a corporate trustee can properly deposit in its banking department funds which it holds as trustee. As for an individual fiduciary, *Genesee Wesleyan Seminary v. United States Fidelity & Guaranty Company* held that one such was

17 120 Cal. 467, 52 P. 822 (1898).
19 247 N. Y. 52, 159 N. E. 720 (1928).
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guilty of embezzlement when he deposited trust money in a private bank owned by him. The case of a corporate trustee is definitely distinct, and it is undoubtedly a common practice. Still, one line of cases holds that it is using funds to the trustee's advantage and so it is liable either for full legal interest\(^2\) or for a proportionate share of the profit made by it on its loans.\(^{21}\) Several cases, on the other hand, have refused to impose such liability and require only such interest as the trust company ordinarily pays on deposits.\(^{22}\)

In Pennsylvania a regulation of the state banking department requires that uninvested trust funds shall be deposited in some other institution properly earmarked as trust funds. Expressive of the other theory, the California statute provides that the trust department of any bank doing a departmental business, holding funds awaiting investment or distribution, may deposit such with the savings department or the commercial department of the same corporation or association, on condition that the latter first set aside, as security for such deposit, securities, legal for savings banks, to a value not less than the funds so deposited.\(^{23}\) The New York Banking Law has a still different effect, in that it requires a trust company to pay interest at not less than 2 per cent on all sums of money not less than one hundred dollars collected and received by it as trustee.\(^{24}\)

The better reasoning appears to be that which concludes that the corporate trustee's deposit of trust funds in its own banking department is not really a use of the trust funds in the trust company's own business for which it should answer with all its profits. Independent

\(^{21}\) St. Paul Trust Co. v. Kittson, 62 Minn. 408, 65 N. W. 74 (1895).
\(^{22}\) Hayward v. Plant, 98 Conn. 374, 119 A. 341 (1923).
\(^{24}\) Banking Law, sec. 188 (11).
of the persuasive pragmatic considerations, the latter view may be justified on the theory that the trustee purchased the trust funds, that is the trust res, and has given the estate in exchange a legal claim against itself for the amount of the funds and for interest accruable. It will be remembered that a purchase of the trust res by the trustee is only presumptively voidable when the cestui has knowledge of it, and the transaction will be sustained if there is no possibility that it could prejudice the interest of the cestui. As a practical matter there obviously could be no more convenient depositary for all concerned, and it is as much subject to state law and supervision as any other. It would not seem unreasonable to hold that the settlor who appoints a corporate trustee impliedly authorizes it to deposit temporary funds with itself. Furthermore, in one material respect the practice adds to the protection given to the estate. That is, assuming that the depositary becomes insolvent, is not the situation in which it is the trustee more advantageous than that in which it is a third party? Knowledge of its own condition certainly may be imputed to it, and long before its impending insolvency it will be under a duty to withdraw the deposit. If it fails to do so, its case is not dissimilar to that of a bank which receives deposits after it knows itself to be insolvent, and then equity will enforce a constructive trust upon the funds if they can be identified. Almost all of the statutes take care of the latter element. The advantages as well as the efficiency of this practice certainly seem to outweigh the intangible benefits of an unyielding application of an abstract principle of law.

Consent

In these as well as other breaches of trust it is possible that the conduct of the beneficiary has been such as to prevent him from holding the trustee liable, because it
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would be unfair to do so. The first requisite of this defense is that the beneficiary who has so induced or approved the action be competent to act at the time; that is, that he be of full age and sound mind. Of course one cestui cannot affect another’s right in this regard.

Having the necessary capacity, the beneficiary must be shown to have had at the time full knowledge of both the facts and the law. The principle has never been better expressed than by the Supreme Court of Illinois in *White v. Sherman*, where the court said:

In order to bind a cestui que trust by acquiescence in a breach of trust by the trustee, it must appear that the cestui que trust knew all the facts, and was apprised of his legal rights, and was under no disability to assert them. Such proof must be full and satisfactory. The cestui que trust must be shown, in such case, to have acted freely, deliberately and advisedly, with the intention of confirming a transaction which he knew, or might or ought, with reasonable or proper diligence, to have known to be impeachable. . . . The trustee is bound to know what his own duty is, and cannot throw upon the cestui que trust the obligation of telling him what such duty is.

To be protected in this way, the trustee must see that the beneficiary has knowledge of the facts, and in giving notice that the trust is being exposed to an independent interest of the trustee’s, he must set forth all the details of the transaction completely. It will be noted that the section of the New York Banking Law quoted above includes this requirement, and the courts of that state have held that it is one of the essential elements intended and imposed by the statute. The accounts of trust companies have been surcharged for failure to give notice that was adequate and prompt.26

Consent that is binding may of course come from another source, that is, it may be expressed in the instrument creating the trust. It is quite common to find pro-

25 168 Ill. 589, 48 N. E. 128(1897).
26 In re Roche’s Will, 281 N. Y. S. 77 (1935); In re Peene’s Will, 279 N. Y. S. 131 (1935).
visions in trust instruments that the trustee is to be held to standards of care and skill lower than regularly set by equity. Likewise, by the terms of the trust, the trustee may be permitted to sell trust property to himself individually, or as trustee to purchase property from himself, or to lend to himself money held by him in trust, or otherwise to deal with the trust property on his own account. Such stipulations have been held valid on the ground that it is within the powers of the settlor to impose terms and conditions upon his gift as well as select the agency to execute it. However, dictated by considerations of public policy, the law fixes limits beyond which the parties cannot agree to relieve a trustee from liability for breach of trust duties. He will still be deemed to have violated his duty to the beneficiary if his conduct amounts to gross negligence or indicates bad faith, no matter how broad may be the provisions conferring power upon him to deal on his own account. The limits so fixed on express consent were not deemed by the legislature of Ohio to be sufficiently restrictive. It was consequently provided by statute that “fiduciaries shall not buy from or sell to themselves nor shall they in their individual capacities have any dealings with the estate, any power in the instrument creating the trust to the contrary notwithstanding.”

Regardless of express waiver in the trust agreement, a trustee, realizing the limitations imposed by the courts, may be placed in the difficult position of being required at its peril to forecast the court’s opinion of the course it pursues when faced with a conflict of interests. This is especially true when one course might result in a substantial loss to the trustee, which, as the court might subsequently decide, need not have been incurred. The recent case of In re Balfe’s Will is one good illustration.

27 1931 Probate Code, sec. 10506-49.
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The testator's will read:

I furthermore authorize and direct that my said Executor and Trustee may freely act under all or any of the powers by this Will given in all matters concerning my estate and trusts herein created without the necessity of obtaining the consent or permission of any person interested therein or the consent or approval of any court, notwithstanding that such Executor and Trustee may also be acting or interested either individually or as trustee of other trusts or as agent for other persons or corporations interested in the same matters.

The majority of the New York court held that the Title Guarantee & Trust Company was not liable for the loss sustained through its holding thereunder stock in itself and an affiliated company against a constantly falling market, as it had been honest and acted in good faith. These judges were convinced that that clause had deprived the estate of the benefit of the doctrine forbidding trustees from acting under circumstances involving "divided loyalty," but that it was not against public policy, nor did it involve doing anything malum in se or malum prohibitum. It had simply made case law and statutory safeguards inapplicable, the only protection left to the estate being the trustee's honesty and good faith.

There was, however, a very strong dissenting opinion, expressing the view of two of the five judges, which held that there was nothing in the foregoing grant of power which conveyed the idea that "divided loyalty" was authorized. The trustee was here buying for its own benefit during a falling market and therefore could give no consideration to the advisability of selling. If it had sold the stocks in these trust estates, even if such sales were gradually made, the inevitable result would be to decrease the market prices of the stocks of the companies and in all likelihood impair their business, which in the larger measure depended upon public confidence. Although not charging the trustee with bad faith as a mat-
ter of fact, the purchase of these stocks was a breach of trust duty as a matter of law, and so, the dissenting opinion concludes, it should have been surcharged from the time when it deprived itself of free and unhampered action. Of course, no speculation as to which result the testator would have chosen can be conclusive; his language was certainly broad enough to cover this situation. But should that breadth be binding upon the courts? The consideration of such a case and the conflicting dilemma in which the trustee found itself impels one to the conclusion that some such statutory provision as that of Ohio quoted above, although perhaps not so all-inclusive in terms, would be the best policy.

**Remedies**

There are various remedies available to cestuis que trust for breaches of the duties we are considering. They are not unique, as they may be available in breaches of trust of totally different sorts. Of course these remedies are almost exclusively equitable. It is entirely possible that equity will use its injunctive powers, as, where the trustee threatens to violate the trust with respect to his duties as to investments, the cestui may procure a court order that he live up to his obligations. Specific performance of a duty may also be granted in a proper case, such as where the trustee should convert investments but insists on holding them. The discretion of the court may prompt it to remove the trustee as well where it is convinced that the interests of the estate will then be more surely safeguarded.29

Equity will also exert its unique powers where the interests of any one under an incapacity render them appropriate. If trust funds are used to purchase property which it is the trustee's duty to refrain from pur-

29 Joliet Trust & Savings Bank v. Ingalls, 276 Ill. App. 445 (1934); Smith v. Howlett, 51 N. Y. S. 910 (1898).
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chasing, and the beneficiary lacks capacity to make an
effective election to reject or affirm the transaction,
the court will enforce the remedy which in its opinion is
most advantageous to the beneficiary and most effective
to accomplish the purposes of the trust. If the property
has fallen in value, the court will probably reject the
purchase and charge the trustee with the amount ex-
pired with interest, while if the value has increased,
the court will ordinarily affirm. If the court decides to
affirm the purchase, it will usually require the trustee to
sell the property, as it is not a proper trust investment,
and make other investments with the proceeds.30

Any competent cestui que trust has a similar election
to reject the purchase or affirm it. The former is in
effect simply voiding the transaction, and the trustee is
compelled to replace the amount of the purchase price
with interest thereon. This was the relief granted by the
Iowa court in In re Riordan’s Trusteeship31 and in the
Federal court case of First National Bank of St. Peters-
burg v. Solomon.32 However, as the Illinois court di-
rected in White v. Sherman, already referred to, the
trustee must be credited with any income from the non-
legal investment which has been applied to trust pur-
poses. He can only be held for the original principal in-
vested together with loss of income; an anticipated gain
in principal is too speculative, unless there was a duty to
invest in a specific security. In so charging him with the
funds expended, the beneficiary is entitled to enforce an
equitable lien upon the property wrongfully purchased as
security for his claim. If the trustee purchased his own
individual property, he is chargeable with any deprecia-
tion in its value, even though he sold it at a fair value and

30 See Restatement of the Law of Trusts, sec. 205; International Trust
Co. v. Preston, 24 Wyo. 163, 156 P. 1128 (1916); Hunt v. Gontrum, 80 Md.
64, 30 A. 620 (1894).
31 216 Iowa 1138, 248 N. W. 21 (1933).
32 63 F. (2d) 900 (1933).
if it had been purchased from a third person it would have been a proper trust investment.

Another type of remedy is the general scheme of accounting for profits. The trustee is of course chargeable generally with anything he earns or realizes through the administration of the trust beyond his agreed compensation. This obviously must be limited to what he actually realizes; that is, he cannot be accountable for what he would have realized if he had continued longer in a violation of his duty. So if he purchased securities from a third person and resold them to himself as trustee, he is chargeable with the additional amount received, if any. In the early case of *Campbell v. Campbell*[^33] a Federal circuit court applied this principle, saying the investment must be regarded as the estate’s from the time of the purchase. This rule applies not only to such profits but also to any bonus, commission, or rebate received by the trustee, as was noted in the *Magruder v. Drury*[^34] decision quoted above and in many others. In *Cornet v. Cornet*,[^35] the trustee, who loaned trust funds through his own brokerage firm, was charged by the Missouri court not only with his own share but also with his partner’s share, of the commission received from the borrower.

As with all breaches of trust, trustees are jointly and severally liable for breaches of duty with regard to trust investments, although one who committed only a technical breach may claim indemnity from the active violator or co-trustee who received the benefit of the breach. A trustee cannot escape or reduce a liability incurred by proving that through another violation of his trust a profit has been earned for the estate. So, if he wrongfully purchases property, subsequently sells it at a profit, and later uses the proceeds in another improper invest-

[^33]: 8 F. 460 (1881).
[^34]: 235 U. S. 106, 59 L. Ed. 151 (1914).
[^35]: 269 Mo. 298, 190 S. W. 333 (1916).
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ment which results in a loss, he cannot deduct the previous profit therefrom. He is both accountable for the profit and chargeable with the loss if they were distinct breaches of trust. The latter qualification is a source of considerable difficulty, however. It is sometimes by no means easy to decide whether distinct breaches have occurred, and no positive rules can be laid down as to the relative weight to be given the various factors involved.

The claim of the cestui against the trustee for damages for breach of trust is that of a general creditor, except to the extent that he is entitled to enforce a constructive trust, to place a lien upon the trustee’s property, or to hold him as a guarantor of the safety of the principal. His claim, however, is augmented to compensate for loss of income. For failure to invest in legal trust securities the court may, in its sound discretion, choose to award either simple interest, compound interest, or the average trust investment yield in the community, but in any event the trustee is chargeable with the interest actually received by him. If it was his duty to make investments which pay a certain rate of interest, he will be charged that rate, even though it is higher than the legal or current rates of return. Ordinarily a failure simply to invest renders him liable for interest at the current rate of return on trust investments rather than the legal rate of interest. There are three general situations which are held to warrant charging compound interest: where the trustee himself has received compound interest, where he has received a profit which cannot be ascertained but is presumably at least equal to compound interest, and where it was his duty to accumulate the income. The decisions of courts of different jurisdictions are in irreconcilable conflict on this matter, both because of the difference in their fundamental attitudes and the almost imperceptible shades of distinction which may be drawn
between the conduct of different trustees. In an early case, *Barney v. Saunders et al.*, the United States Supreme Court remarked that "interest is compounded as a punishment, or as a measure of damages for undisclosed profits and in place of them." However, the theory behind most recent decisions is simply to make the plaintiff whole, rather than to penalize or punish the defendant for a reprehensible act. In the Minnesota case, *St. Paul Trust Company v. Strong et al.*, mentioned above, the decision of the lower court was modified to award simple interest, instead of compound, the court being of opinion that a trustee who mingles trust funds with his own money or uses them in his private business should be charged simple interest at the legal rate where there has been no fraud or flagrant breach of trust. Illinois, however, considers such practices sufficiently "flagrant" in themselves, judging from the cases of *Asay v. Allen et al.* and *Hough v. Harvey et al.* The statutes of some states expressly limit the allowance of compound interest to cases in which the trustee is guilty of a willful breach of trust. However, a rigid rule seems less salutary than a consistent holding to the theory that no remedy should be adopted which gives the wrongdoing trustee any advantage from his own breach of trust.

**Authorization of Participating Investments**

One of the most striking features brought to mind by a casual review of this subject is that the ten thousand commandments for trustees, like their prototypes, are all negative. In the more or less theoretical realm of the controlling legal principles, which place their limitations on the administration of trusts, it is not often that the question arises, "What can the trustee do?" To one not

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36 See discussion of this situation in 14 *Chicago-Kent Rev.* 59.
37 57 U. S. 535, 14 L. Ed. 1047 (1853).
38 124 Ill. 391, 16 N. E. 865 (1888).
39 71 Ill. 72 (1873).
in actual contact with the workaday world of this business, the occasion for such an inquiry may not appear manifest. However, the facts are that a technically precise application of those principles creates restraints on conduct which make for inconvenience, waste, loss of profits, and inefficiency which affect all concerned. The reported decisions deal only with cases where the trustee is charged with having left his prescribed path. The loss to trust estates caused by an over-rigorous adherence to that narrow route does not receive such publicity. Remedies for this condition have been suggested and adopted in several states in the form of "participating" or "contributory" investments. Sometimes the suggestion comes from the courts in the form of language which may be construed as a plea for some such reform. The Supreme Court of Michigan, where, as in Illinois, there is no such statutory innovation, in a recent case held a purchase of a bond from another trust estate of which the defendant was trustee to be an improper investment, as it was not called to the attention of all the interested parties. The court said:

We can readily see how a large trust company may find it necessary to sell a high-grade security for one of its trusts, and it may have funds for investment in another trust. Securities such as mortgage bonds, etc., as a rule are unlisted and there is no market price for them. Sometimes good securities are scarce. The trust company, acting in good faith, may deem it advisable to make the sale and purchase. It nevertheless is acting for both buyer and seller, and the transaction, if attacked, will be set aside on failure of the trustee to show absence of any irregularity or of any personal benefit to itself. It must also show that, at the time of the transfer, the sale, purchase, and price were advantageous and fair to the various interested trusts.  

Participating mortgages, used for many years in financing loans, may consist simply of a single mortgage

in which investors purchase interests and receive certificates of participation. They have been authorized by statute as investments for trust funds in California, Hawaii, New Jersey, New York, Ohio, Oregon, and Pennsylvania. In those jurisdictions a trust company may have on hand for investment $500 of the funds of one trust, $17,500 of another, and $130,000 of a third; it could then purchase a $200,000 mortgage, allocate its proportionate interest to each trust, and treat itself on its books as the owner of the remaining $52,000 interest. The same general scheme may be achieved in a more complex fashion if the trust company has a group of mortgages against which it issues participation certificates to several trusts held by it. Another variation is for the particular trustee to purchase the certificates from another trustee who is handling the distribution for the mortgage loan company, and so obtain, rather than a lien on realty, a right in equity to compel another trustee to enforce various mortgages. The case of *In re Peene's Will*\(^{41}\) gives an interesting history of the New York case and statutory law on this subject.

It is urged in behalf of this practice that the participation certificates can be of small denominations, and so furnish ready investment for odd amounts of trust income or principal which may be on hand. The advantage over requiring the trustee to search for a single small mortgage suited to his trust is obvious. Besides the convenience, it increases diversification and spreading of the risk. The plan is hardly distinguishable in theory from purchasing bonds of public utility corporations which are secured by a single mortgage to a trustee, and such have been validated as trust investments in many states.

On the other hand arguments are advanced against such investments. In the first place the cardinal rule that trust funds must be earmarked and kept separate from

\(^{41}\) 279 N. Y. S. 131 (1935).
other trust and non-trust property is violated, and the investments of each individual trust cannot be supervised for the sole benefit of that estate. It is also pointed out that it is considerably more difficult for the trustee to make sure that there is the proper margin of security for the mortgages in which he holds an interest and to be sure that it is maintained. The truth of these objections cannot be disputed; it is simply a question of whether the arguments of convenience and necessity are sufficiently strong to overcome them. Moreover, there are other objections that can be guarded against in statutory enactments. Certainly there should be a provision against the trustee for the mortgage company having power to substitute mortgages, make extensions, or grant releases without consultation with the holders, as such would be a highly objectionable delegation of discretionary powers. It would also seem desirable to require the investing trustee to purchase such investments from third parties to remove such a conflict with its individual interest. They hardly seem to be adapted to use by natural persons as trustees because of the complications involved when such a sole trustee dies. Also corporate trustees are subject to governmental regulation, and may be expected to have greater financial responsibility. Furthermore, it would certainly be advisable to provide expressly that the certificates which are allotted to trusts shall not be junior to any others, and that the value of the issue shall not exceed the face of the mortgage.

Another plan which has considerable support is the so-called “capital accumulation trust.” The practice in its fundamentals is commonplace everywhere. Savings bank deposits, building and loan participations, mortgages held by a trustee for the common security of bond holders, and life insurance policies are familiar applications of the principle. As applied to trusts the trustee holds all its trust investments as a block and issues cer-
tificates of interest in that common fund. The practice is to measure the participation therein by units instead of in money. The units are usually revalued every month by the trustee in accordance with a formula contained in the trust instrument with a view of facilitating additions and withdrawals. The trustee is forbidden to invest the common fund otherwise than through the units of participation, and thus can have no interest adverse to the beneficiaries.

All investments, no matter how conservative, fluctuate in value, and the principal virtue claimed for this type of trust is that it avoids this effect. The continual revaluation of the units would prevent the fund from failing through withdrawals, and so those cestuis who permit their funds to remain in times of stress are not injured by the withdrawals of others. It is clear that measurement in units makes liquidation, as well as management, much simpler. It is claimed that this feature is a stabilizing influence in times of heavy liquidation of securities. It is also pointed out that an equitable distribution of earned surplus is achieved which is never the case in other types of deposits. There is a definite tendency toward authorizing trust companies to create such funds. They have been provided for in the statutes of Hawaii, Massachusetts, Ohio, Oregon, Pennsylvania, Tennessee, and Vermont. This also indicates an attempt to protect trust estates against over-protection. This scheme or something similar can probably be expected to become quite prevalent in the future. It is one of the recognized virtues of our legal system that it is able to overcome inflexibility and adapt itself to new needs and growing conditions. Perhaps before another major depression occurs we shall see the practice of employing a trustee become more universal than that of securing an investment banking house to sell at a profit to itself.