

THE AMERICAN LAW REGISTER.

SEPTEMBER, 1891.

"THE LIABILITIES ARISING OUT OF THE EMPLOYMENT OF TRUST FUNDS IN PART- NERSHIPS."

I.

It is a well known principle of Equity that a trustee shall not be allowed to derive a profit from the subject matter of his trust. If an improper disposition of trust money is made by a trustee, the right devolves upon the *cestui-que-trust* either to compel the repayment of the sum so invested with interest, or to follow the fund itself into the specific piece of property into which it has been converted. "The rule is," said Mr. Justice Story in *Oliver v. Piatt*, "that all the gains made by the trustee, by a wrongful appropriation of the trust fund, shall go to the *cestui-que-trust*, and all the losses shall be borne by the trustee himself:" 3 How. 401. This principle has been applied to speculation in loans, stocks, commercial paper, and real estate, to the employment of trust money in business firms and trading companies, and to all other classes of investments which the Courts regard as inappropriate to the proper execution of a trust. *Perry on Trusts*, Ed. of 1889, §§ 456, 464, and cases cited. A case involving unusual difficulty is that of a trustee who invests trust money in a business conducted by himself, especially if there are associated with him one or more persons who are not trustees. In the case of a partnership, rights and liabilities spring into existence between the trustee, his co-partners and the *cestui-que-trust* which are most complex in their character, and which present many important modifica-

tions of the general doctrine. The equitable principles by which these rights and liabilities are defined and adjusted will be the subject of consideration in these pages.

The theory upon which a trustee is held accountable for profits that accrue to trust property has been the subject of much judicial discussion. It is clear that such profits, when exacted from a trustee, cannot be construed as a penalty for misconduct, since it is not within the province of a Court of Equity to impose penalties. To quote the words of Lord Justice James in *Vyse v. Foster*, "A Court of Equity is not a court of penal jurisdiction. It compels restitution of property unconscientiously withheld; it gives full compensation for any loss or damage through failure of some equitable duty; but it has no power of punishing anyone." L. R., 8 Ch. Ap. 333; see also *Atty. Gen. v. Alford*, 4 D. M. & G. 851. Further, if profits were exacted as a penalty for bad faith or misconduct, it would follow that a trustee might rebut the presumption of liability by setting up the defence that he had acted in good faith, and that the investment had proved to be a safe one for the estate, whereas it has frequently been held that the motive which prompted the trustee to make the investment is entirely immaterial. *Heathcoate v. Hulme*, 1 J. & W. 129. Nor can the liability of a trustee to account for profits be explained by the opposite theory that Equity will presume that he acted with a good intent and in the interest of the trust estate. *Laird v. Chisholm*, 30 Scot. Jur. 584; *Parsons on Partnership*, § 39. Such a presumption would be inconsistent with the well established principle that the investment of trust funds in trade is *ipso facto* a breach of trust. The law condemns such an investment without regard to the motives which prompted it or the results which it may secure. Consequently the presumed good intention of the trustee can no more be regarded as the basis of his responsibility than his presumed bad intention, and we have seen that the latter theory is untenable. A more logical explanation of the trustee's liability to account for profits has been suggested by Lord Cranworth in the case of *Robinson v. Robinson*, 9 Eng. L. & Eq. R. 75, viz.: that the *cestui-que-trust* has a valid claim to profits because they are the

natural increment of his estate. Hence, his title to such profits, if he chooses to exert it, takes precedence over the title of the trustee, and the latter may be compelled to account for them in the same manner and upon the same ground as he is liable to account for the principal of the estate. On the other hand, if the investment has been unsuccessful and no profits have accrued, the trustee may be charged with interest. Since, in violation of his trust, he has neglected to invest the estate in appropriate interest-bearing securities, a Court of Equity will compensate the *cestui-que-trust* for the resulting loss by charging him with the interest which he might and ought to have obtained. The *cestui-que-trust* has the right to elect, in all cases, either to hold the trustee liable for the profits which have actually been realized, or for interest at whatever rate the Court may deem appropriate in view of the circumstances of the case. To restate the doctrine thus elaborated in another form; the employment of trust funds in trade constitutes a breach of trust by which the trustee renders himself primarily liable for the principal sum invested with interest. If the profits accruing to the trustee exceed the amount of interest due, the *cestui-que-trust* is entitled to claim them in lieu of interest by virtue of his beneficial ownership in the property from which they are derived.

The equitable doctrine that a trustee is liable for the profits of trust money can be traced back through a period of nearly two hundred years. In its present form it is the outgrowth of a series of Chancery decisions which date from the reign of Queen Anne. The case of *Brown v. Litton*, 10 Modern, 20; 1 P. W. 140; decided in 1711, is the oldest authority upon this subject which is to be found in the reports. The important facts of that case were that the master of a ship died while at sea, leaving among his effects the sum of 200 pounds. During the remainder of the voyage his successor employed the money in a series of trading operations which yielded a net gain of three hundred per cent. Upon the return of the vessel to England, the widow of the deceased master filed a bill in the Court of Chancery, praying that an account of the profits of the voyage might be decreed. Lord Keeper Harcourt sus-

tained the bill upon the ground that the master had by his conduct constituted himself a trustee both as to the principal sum and the resulting profits. The Lord Keeper, having no authority to cite in support of this conclusion, based his opinion upon the curious ground that since England was an island, it was the policy of the law to give the greatest possible encouragement to commerce, and that this end would be furthered by the adoption of the principle in question, since it would be "a comfort to a man to know that if he should die, the improvement of his effects in the way of trade should be for the advantage of his family." 10 Mod. 21. The case of *Brown v Litton*, is the foundation stone of the general equitable doctrine governing the accountability of trustees who trade with trust funds; and it is worthy of note that in the same case occurs the earliest statement of the supplementary doctrine, which, as we shall see, is still in a very crude state of development, that a trustee who has expended time and labor upon the trade or pursuit in which the trust funds are embarked, is entitled to receive a fair proportion of the resulting profits as compensation.

During the last century the equitable doctrines established by *Brown v. Litton* underwent no appreciable development. Early in the present century, however, a custom became general in the Court of Chancery to charge an executor or trustee who negligently permitted trust funds to remain uninvested, with interest at the rate of four per cent., and a trustee who invested such funds in an improper manner with interest at five per cent.: *Tew v. Earl of Winterton*, 1 Ves. 452; *Piety v. Stace*, 4 Ves. 619; *Pocock v. Redington*, 5 Ves. 799; *Roche v. Hart*, 11 Ves. 58; *Bates v. Scales*, 12 Ves. 402; *Forbes v. Ross*, 2 Cox 113; *Tebbs v. Carpenter*, 1 Madd. 290. Thus the latter rate was regularly imposed upon all trustees who mingled trust money with their private capital, whether it was actually employed in commercial operations, or merely allowed to remain on deposit as part of the trustee's private account. The higher rate of interest was charged in the latter case upon the ground that a large balance in the bank has a tendency to give a trader additional credit: *Sutton v. Sharp*, 1 Russ. 146;

Treves v. Townshend, 1 Cox, 50. At first, interest at five per cent. was the largest amount ever allowed by the Court, but in the case of *Raphael v. Boehm*, 11 Ves. 92, in which a very gross breach of trust had been committed, Lord Eldon introduced the practice of charging a delinquent trustee, in certain cases, with compound interest. Although the decree in that case was at the time regarded by other judges as very severe, it has been followed as a precedent in numerous instances where a great breach of trust has been committed, and other methods of compensating the injured party have been adjudged inadequate: *Stacpoole v. Stacpoole*, 4 Dow. 209; *Walker v. Woodward*, 1 Russ. 107; *Jones v. Foxall*, 15 Beav. 388; *Williams v. Powell*, 15 Ibid. 461; *Townend v. Townend*, 1 Giff. 201. *Seguin's Appeal*, 103 Pa. 139; *Perry on Trusts*, edit. of 1889, §§ 468, 471, and cases cited. It would appear from the decisions, especially the opinion of the Master of the Rolls in *Jones v. Foxall*, that the Court will be influenced in determining whether compound interest shall be charged by such considerations as the strictness of the terms employed in the trust instrument and the extent to which the trustee has departed from them, the risks to which the trust property has been exposed, the length of time during which the misconduct of the trustee has continued, and the advantage which he has personally derived from the breach of trust.

At the same time, however, that the interest rule was being generally applied to the class of cases just described, a series of decisions was being rendered by the Court of Chancery requiring an account of profits in another class of cases very closely analogous. In *Palmer v. Mitchell*, 2 M. & K. 672, decided in 1809, and quoted from the Register's Book in a later case, an account of profits was decreed against one of the executors of a decedent who had continued the business of his testator in partnership with certain other persons. In the case of *Heathcote v. Hulme*, 1 J. & W. 122, decided in 1819, the administratrix of a deceased merchant continued the business for a period of several years, and the Court held that the next of kin of the decedent were entitled to the profits. It appears also from numerous cases reported

in the Register's Books, that very early in this century the principle had become well established that the surviving partners of a decedent as such, might be held accountable to his personal representatives for the profits realized in the business after his death: *Crawshay v. Collins*, 15 Ves. 218, and cases cited. In the great case of *Crawshay v. Collins*, which was in Chancery for eighteen years, and which came before Lord Eldon five times for adjudication, this principle was extended further. In that case A, B, and C, were members of a partnership. C, having become bankrupt, his co-partners continued the business without him for several years and made large profits. D, the assignee of C, filed a bill against the other two partners claiming the proportion of profits to which C would have been entitled if the bankruptcy had not occurred. A decree was rendered in D's favor upon the ground that by trading with the bankrupt's assets, A and B had constituted themselves trustees, and had become subject to a trustee's liability.

It will be observed that in all of these early cases the profits awarded by the Court were the result of *the continuation* of a trade or business which had previously belonged in whole or in part to the person from whom the trust estate was derived. The interest rule was still applied to the case of a trustee who mingled trust money with funds of his own in a separate business conducted by himself. In the case of *Docker v. Somes*, 2 M. & K. 655, decided in 1833, in which two executors were shown to have employed funds belonging to their testator's estate in their private business, Lord Chancellor Brougham refused to follow the interest rule, and held them both liable for a share of the accruing profits. It was the opinion of the Lord Chancellor that profits ought to be charged against a trustee who mingled trust money with his capital in a private venture of his own just as much as in the case of a trustee who continued a business established by another person. The interest rule was objectionable because it had "a tendency to cripple the just power of the court in the most wholesome of its functions," and because of the encouragement thus held out to fraud and breaches of trust. The five per cent. rule, said the Lord Chancellor, virtually proclaimed to executors

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and trustees that they had only to mix trust money with their private capital, and they could then keep all that remained over five per cent.

The case of *Docker v. Somes*, not only decided that a trustee cannot escape from the liability to account for profits by mixing the funds, but the Court declared further that it would not be deterred in that or in any other case from directing such an account either by reason of the large expense involved or the obstacles which would have to be overcome. The case of *Heathcote v. Hulme*, as we have seen, established the principle that a trustee will not be relieved from liability merely because he has acted in good faith. Neither is it any defence that the trust fund bears only a very small proportion to the total capital employed, nor that the trustee was ignorant of the liability which he incurred, nor that the money could have been borrowed elsewhere by the trustee's firm at the same or at lower rates of interest, nor that the firm was able and willing to repay the money whenever it was called for. It has been decided also that no peculiarity in the organization of the business, whether it is in the form of an ordinary partnership or of a chartered corporation, will affect the right of the *cestui-que-trust* to claim profits. Nor can the investment of trust funds in a firm be disguised under the form of a loan secured by a bond or a promissory note. In that and all similar cases, a Court of Equity will disregard the form of the transaction and look only at the substance: *Parsons on Partnership*, § 40; *Townend v. Townend*, 1 Giff. 201; *Small's Estate*, 24 W. N. C. 92; *Kyle v. Barnett*, 17 Ala. 306; *Bush v. Bush*, 33 Kan. 556.

II.

It is now time to notice certain limitations which Courts of Equity have imposed upon the right of a *cestui-que-trust* to demand an account of profits from his trustee. A careful examination of the authorities will disclose four distinct lines of defence of which a trustee can avail himself in a suit of this character. They are as follows :

(1.) That the investment producing the profits claimed was authorized by the instrument creating the trust, and that the terms imposed by it have been strictly complied with.

(2.) That the profits claimed have never come into the trustee's possession.

(3.) That the fund producing the profits was not trust property at the time they accrued.

(4.) That the profits are attributable either wholly or partially to productive factors other than the trust estate.

(1.) A good illustration of the first of these different lines of defence is the case of a testator who authorizes his executor to loan the assets of his estate to a certain business establishment at a specified rate of interest. The executor could not be held responsible for the profits accruing to the capital loaned, even though he derived a personal advantage from the transaction: *Parker v. Bloxam*, 20 Beav. 295; *Travis v. Milne*, 9 Hare 141.

(2.) It has already been stated that the liability of a trustee to account for profits is based upon the theory of restitution and not upon the theory that it is imposed as a penalty. Now there can be no such thing as a restitution of property which has never been in the possession of the person from whom restitution is sought. Hence, a trustee cannot be held liable for profits which he has not individually received. Profits which have accrued to third persons can be recovered, if at all, only from those in possession of them. A distinction must therefore be drawn, with reference to the question of liability for profits, between the case of a trustee who is, and one who is not, a member of the partnership in which the fund producing the profits is invested. It is a well established rule that in the latter case a trustee is *not* responsible for profits, but only for the principal of the trust estate with interest: *Stroud v. Gwyer*, 28 Beaven, 130. He cannot be charged with profits for the simple reason that he has never received any.

Nor is the position of a trustee at all modified in this respect by the fact that the partners who employ the funds in trade are his co-trustees. The latter may, of course, be held responsible by the *cestui-que-trust* for the profits which accrue, but the liability of the trustee who is not a member of the firm, is

limited, as in the preceding case, to the repayment of the principal sum with interest: *Booth v. Booth*, 1 Beaven 125; *Townend v. Townend*, 1 Giff. 210; *Laird v. Chisholm*, 30 Scot. Jur. 589; *Vyse v. Foster*, 7 E. & I. Ap. 318. This question received a very full discussion in the Scotch case of *Laird v. Chisholm*, 30 Scot. Jur. 589, and the principle there laid down has been adopted in later English cases. The Lord Ordinary having taken the opposite view that a trustee might be charged with profits, although not a member of the firm, a majority of the judges in the Court of Sessions overruled the decision of the lower court and held that a trustee could under no circumstances be charged with profits which he did not actually receive. A trustee occupying this position, might, in the opinion of the Court, be held responsible for funds lost through his neglect, but he could not be held "penally liable for allowing others to make profits." We shall have occasion hereafter to note the application of the same principle to the case of a trustee who shares the profits of trust property with his co-partners in a firm. In the meantime it can be laid down as an invariable rule, that in order to charge a trustee with profits, it is an essential requisite to prove that at some time he has had either actual or constructive possession of the profits which the *cestui-que-trust* seeks to recover.

(3.) A trustee may in the third place defend against a suit for profits upon the ground that the fund producing them was not trust property at the time the profits accrued. This is a defence very commonly set up by the surviving partners of deceased persons in suits brought by their personal representatives to obtain profits resulting from a continuation of the business. We have seen that the liability to account for profits attaches not only to an executor who assumes the place of his testator in a firm, but also to the surviving partners as such, upon the ground, as stated by Lord Chancellor Hart in *Booth v. Parks*, 1 Moll, 465, that a surviving partner cannot be said to continue the partnership, since that is dissolved by the death of the decedent, but he rather deals with the effects "*ex necessitate*, and in the character of a trustee:" See also *Skidmore v. Collier*, 8 Hun. (N. Y.) 54; *Forrester v.*

Olliver, 1 Brad. (Ill.) 264. Consequently it has been held that a surviving partner who continues to trade with the firm assets, thereby becomes liable to the estate of the deceased for a proportionate share of the profits earned, and as in the case of an express trustee, he can be compelled to replace with interest all sums which are lost: *Crawshay v. Collins*, 15 Ves. 223, 226, and cases cited from the Register's Books; *Hammond v. Douglas*, 5 Ves. 539; *Featherstonaugh v. Fenwick*, 17 Ves. 298; *Brown's Appeal*, 89 Pa. 139; *Story on Partnership*, §§ 341, 343. If, however, the share of the decedent in the firm is sold, either to his co-partners or to a stranger, his estate loses all claim to profits which may subsequently accrue: *Ogden v. Astor*, 4 Sand. (N. Y.) 349. It is true that his co-partners are not permitted to take the share of the decedent at a valuation fixed by themselves: *Crawshay v. Collins*, 15 Ves. 218, 227; *Sigourney v. Munn*, 7 Conn. 11; *Heath v. Waters*, 40 Mich. 466, but his personal representatives may sell the share, provided the terms of the sale are fair and reasonable, just as they have the power to sell any other kind of personal property: *Chambers v. Howell*, 11 Beav. 6. If one or more of the personal representatives are also co-partners, then the transaction is subject to the well known rule of Equity, that a trustee cannot purchase at his own sale without the permission of the Court, and such a sale, if made, will be set aside: *Cook v. Collingridge*, Jac. 607. But under ordinary circumstances the sale of a deceased partner's interest in a firm is a perfectly valid transaction, and those interested in his estate lose all claim to profits from that date, whether they receive the purchase money in cash, or the consideration consists of a stipulation by those purchasing the share to pay for it upon some future condition or at some future time. In the latter case the obligation of the surviving partners assumes the character of a debt, and they acquire in exchange for it an immediate title to the share of the deceased with all the profits which may subsequently accrue to it.

The same defence becomes available in behalf of the surviving partners of a decedent when there is a stipulation in the partnership articles, that upon the death or retirement of any

member, his associates shall have the privilege of acquiring his interest upon certain specified terms. This privilege may also be conferred by the will of a deceased partner. In such a case, if the terms prescribed are complied with, there is a complete transfer of the partner's share to his successors, with the right to receive the subsequent profits as in the last case. If the terms imposed are not complied with, the personal representatives of the decedent are entitled to the profits, but only under certain circumstances. The question depends largely upon whether the consideration for the sale of the deceased partner's share constitutes a condition precedent or a condition subsequent. If the sale is to take effect upon the fulfilment of certain stipulated conditions, and these are not fulfilled, then the title to the share remains in the decedent's estate, and his representatives have a right to the profits. If on the other hand, there is an immediate transfer of the interest to the surviving partners absolutely, or for a definite period, and the consideration consists of something which is subsequently to be done by the purchasers, then the title to the profits passes to them at once and the beneficiaries of the deceased partner's estate can only demand the fulfilment of the stipulated conditions. Although the consideration is executory the transfer of title is immediate. If the partnership articles or the deceased partner's will provide for the retention of his interest for a certain period, at the end of which it is to be paid to his estate, his representatives are not entitled to claim profits during the continuance of the period. If, however, the partnership is not wound up at the designated time, and, in the absence of any reasonable ground of excuse, the share is retained longer than the articles or the will permit, then the surviving partners can be held accountable for a proportionate share of the profits subsequent to that date, and there will exist a two-fold reason for so charging them if they occupy a fiduciary position under the will of the deceased: *Laird v. Chisholm*, 30 Scot. Jur. 582; *Townend v. Townend*, 1 Giff. 201; *Willetts v. Blanford*, 1 Hare, 253. A claim to profits may also be asserted against the surviving partners, if through failure to perform the consideration, their rights have at any time become

forfeited, and ground afforded for the rescission of the contract by a Court of Equity. Exactly what constitutes such a forfeiture is still a doubtful question. It seems to be clear however, that where an option to purchase a deceased partner's share in a firm has been conferred upon the surviving partners either by the articles or by will, and they neglect to comply with the prescribed conditions of the sale, even though they are conditions subsequent, they ought not to be excused from accounting to the estate for profits on the ground that there has been a formal acceptance of the option: see opinion of Lord Cairns, 7 E. & I. Ap. 329. It has been held, however, by the House of Lords, that where the partnership articles contain a contract of immediate sale, and the surviving partners conform to the terms of the agreement in all their substantial features, a departure from these terms which is of such a nature as not to affect the essence of the contract will not constitute a valid ground for its rescission by a Court of Equity, and hence no right will devolve upon the deceased partner's representatives to claim profits. It is altogether immaterial in such a case that one or more of the surviving partners are also executors of the decedent's estate. If by virtue of the terms in the partnership articles, they become the immediate proprietors of their testator's share in the firm, then, with respect to that share they must necessarily stand, not in the position of trustees, but of debtors to the estate: see *Vyse v. Foster*, 7 E. & I. Ap. 332. Their rights will be controlled by the terms of the contract so long as it is in force. It was the opinion of the Court in *Vyse v. Foster*, that mere delay in paying to the estate of the deceased partner the purchase money for his share, was not, in the absence of any circumstance making time of the essence of the contract, such a departure from the terms of the partnership agreement as would justify a rescission of the contract. Hence, in this case and in all cases of the same general character an account of profits will *not* be decreed against either the surviving partners or the executors of a decedent as trustees of his interest in the partnership.

The case of *Vyse v. Foster* is also valuable as an authority in that it contains many important suggestions as to the class of considerations which will influence a Court of Equity in its interpretation of contracts relating to the disposition of a deceased partner's interest in a firm. We have seen that neither good faith nor the fact that the investment of trust money in trade has been productive of good results, will excuse a trustee from the obligation of accounting for profits. On the other hand, the question whether an executed contract of sale, like that in *Vyse v. Foster* will be upheld or rescinded by the Court, is largely dependent upon the motive which has actuated the partners in departing from the strict terms prescribed for the transaction. In *Vyse v. Foster* both Lord Cairns and Lord Hatherley, in rendering their opinions in the House of Lords, *Vyse v. Foster*, 7 Eng. & Ir. Ap. 336, 342, declared that they were largely influenced, in deciding the case for the defendants, by the fact that the latter had been prompted in their actions by the best intentions, that they had every reason to believe that they were acting for the benefit of the plaintiff, and that as a matter of fact, the plaintiff's interests had been protected and advanced in every respect. Had there been any bad faith, or had the results of the defendants' conduct been harmful to the plaintiff, they distinctly stated that good ground would have been afforded to rescind the contract, and to declare the partnership in an unliquidated condition, with the attendant liability for profits to the deceased partner's estate.

4. The fourth case, in which the courts have imposed a limitation upon a trustee's liability for profits, proceeds upon the assumption that the profits sought are not derived from the trust estate but from other sources. It is clear that a *cestui-que-trust* cannot claim profits upon any other ground than beneficial ownership of the fund which produces them. If they are wholly or largely attributable to the skill and sagacity of the partners, or their acquired reputation, or to their credit, or to the established good-will of the business in a case in which the plaintiff has no title to the good-will, then the claim of the *cestui-que-trust* is rebutted in a corresponding degree.

The two cases which best illustrate this principle are *Wedderburn v. Wedderburn*, 2 Keen 722, 4 M & C. 41, 22 Beav. 84; and *Simpson v. Chapman*, 4 D. M. & G. 154. In the former case A, B, and C were in partnership as merchants, and A died, leaving B and C his executors. The assets of the firm were found to exceed its liabilities to the extent of 86,000 pounds, of which balance A's estate was entitled to 55,000 pounds, but the good-will of the firm survived entirely to B and C under the partnership articles. A's share of the capital was retained in the firm by the surviving partners, and as A's children reached full age they were paid their respective shares with interest. During the period of thirty years which elapsed before the final payment was made, profits accrued to the firm amounting to over 300,000 pounds, and a bill was filed by A's next of kin, claiming 55-86 of this sum. A decree of the lower court directing an account of profits was reversed on appeal by the Master of the Rolls, who held that A's surviving partners and executors, B and C, were *not* liable for profits upon the following grounds:

1. That B and C were entirely excusable for not paying out A's interest immediately upon his death, according to the usual rule, since the assets of the firm consisted principally of debts which could not be collected at once except at a great sacrifice and with the probable result of producing a disastrous insolvency.
2. That A's share would have proved worthless, if a sale had been effected at his death, since in the opinion of the Court, not a single merchant in London would have given a farthing for it in view of the large accompanying liability.
3. That the profits subsequently realized by the firm were attributable entirely to the exertions of B and C, and to the good-will of the firm, in which the estate of A had no share: 22 Beav. 107, 109.

In the case of *Simpson v. Chapman*, 4 D. M. & G. 154, in which three partners conducted an extensive business as bankers, a share of the subsequent profits was refused to the representatives of a partner who died, upon the ground that the decedent, at the time of his death, owed the firm upon his private account a larger sum than his fractional share of the difference between the assets and liabilities. It does not ap-

pear, however, that the surviving partners possessed an exclusive right to the good-will of the business. In fact, the Court asserted its inability to adjudicate this question because all of the surviving partners were not joined as defendants in the suit, and consequently the claim of the deceased partner's representatives to a share of profits did not receive adequate consideration. Although no money was actually due from the firm on account of the deceased partner's capital, a share of profits might justly have been awarded upon the ground that, at his death, he was possessed of a certain fractional interest in the business. For this reason it is the opinion of the writer that the case of *Simpson v. Chapman* was wrongly decided, but the general theory upon which the Court proceeded is a sound one. According to that theory, the claim of a *cestui-que-trust* to profits may be rebutted in all cases in which it is possible for the trustee to prove that the profits claimed, although accruing to a business in which the trust estate is invested, are attributable exclusively to other productive agents.

To illustrate this principle further by an extreme case, if a trustee is a member of two separate firms, and invests trust money in one of them, the *cestui-que-trust* would obviously have no right to any portion of the profits realized by the other firm. Or again, if a firm is conducting two separate lines of business, or if the same business consists of two distinct series of operations, one of which requires capital and the other does not, the trustee ought not to be made liable for the profits of the latter series upon the ground that he has invested trust money in the former, since the profits realized in no sense constitute the *product* of the trust capital. Nor, on the other hand, as appears from the decree of the Master of the Rolls in *Wedderburn v. Wedderburn*, does the liability for profits attach in a case where trust funds are either invested or retained in a business, which, although producing profits, does so under circumstances in which it may reasonably be presumed that equally large profits would have been produced if the firm had had *no capital at all*, using the word "capital" in the sense which it always has in connection with this subject, viz., the

preponderance of assets over liabilities. In such a case the entire profits *earned* may rightly be claimed by those whose exertions, skill, credit, or reputation have produced them, and it is altogether immaterial that such persons occupy toward the plaintiff a fiduciary relation.

Lastly, a trustee is entitled to claim a *partial* exemption from the liability to account for profits, in almost all cases, upon the ground that he deserves a reward for the labor and skill expended by him in superintending the business in which the trust funds are embarked. It seldom happens that the profits of a productive enterprise can be attributed solely to the capital employed. As a rule, they are the joint result of capital and business skill. Consequently it has been the practice of the Courts, even since the case of *Brown v. Litton*, see also *Yates v. Finn*, 13 C. D. 839, to deduct first a portion of the profits, as a reward for the labor and skill of the trustee and other persons in the same position, and then to divide the remainder in rateable proportions between the trust estate and the owners of the capital stock. The fraction of the total profits which should be deducted for this purpose varies with each individual case. It depends upon the character of the business involved and the relative importance of capital and skill to its successful operation: *Willett v. Blanford*, 1 Ha. 253, 268. In some instances the skill exerted deserves to be rewarded by a very large fraction of the profits; in other instances it deserves no compensation at all. For instance, if a deceased partner in a firm had in his life-time been possessed of a share in valuable patent rights, and these were to be exercised by the surviving partners, his estate would be entitled to his full fractional share of the resulting profits: 1 Hare, 270. An instance of the opposite kind was cited by Lord Brougham in the case of *Docker v. Somes*, 2 M. & K. 667. He discussed the case of an apothecary who should invest 100 pounds of trust money in the purchase of drugs, and carry on a business yielding 1000 pounds a year. In such a case the fraction of profits attributable to skill would far exceed the portion which should be allotted to capital. A similar illustration was suggested by Judge Penrose, of the Orphans' Court,

of Philadelphia, in a recent Pennsylvania case: *Seguin's Appeal*, 103 Pa. 145. A carpenter purchases with trust money some rough boards, and out of the material so obtained makes an elaborately carved set of furniture. Obviously the *cestui-que-trust* would be entitled to an exceedingly small fraction of the profits realized from its sale. It rarely happens, however, that an actual case approaches either of these two extremes. The majority of cases lie midway between them, and so different are the circumstances in each that it is impossible to fix upon any definite fraction which would hold good for all or even for a large proportion of them. It should be the aim of the Court in every instance to allot to the trust estate a fraction of the total profits exactly corresponding to its value as a productive factor. This fraction will approach, more or less, nearly to the ratio between the total capital of the firm and the amount of trust money invested in it according as the labor and skill of the partners are allotted a small or a large compensation. But every case should be decided on its own merits. Accordingly the English Courts have taken the ground that the determination of the proper fraction in a particular case is a matter to be left entirely to the master, subject, of course, to the review of the Court: Opinion of Lord Eldon in *Cook v. Collingridge*, Jac. 623; see also *Crawshaw v. Collins*, 2 Russ. 347. On the other hand, in several Pennsylvania cases, a definite rule has been followed, according to which profits are to be divided in the proportion of one-third as compensation for skill, two-thirds as the return upon trust capital. This ratio was first adopted by our Supreme Court in *Robinett's Appeal*, 36 Pa. 174, because it appeared to meet the requirements of that case, and the precedent thus established has been followed in two more recent cases of a very different character, *Seguin's Appeal*, 103 Pa. 139; *Small's Estate*, 24 W. N. C. 92, in spite of the fact that it was not the intention of the Court in deciding *Robinett's Appeal* to lay down any general rule: See opinion of Court in 103 Pa. 145. That such a precedent should have been followed at all is doubly unfortunate. It is an attempt, in the first place, to establish a general principle with reference to a subject about which it is impossible

to generalize. It is illogical to regard as fixed that which is essentially a variable quantity. The convenience of a fixed standard of measurement in dealing with questions of this kind is undoubtedly very great, but on the other hand, such a standard tends to deprive the law of its elasticity and to render it more difficult for the Courts to frame just decrees in particular instances. It is impossible to make a fair allotment of profits, in any case, between capital and skill, without taking into consideration all the circumstances peculiar to it. Hence, the enforcement of any definite rule in the decision of all cases upon the ground that it has been found appropriate in some one particular instance, would operate to produce great injustice.

The one-third rule is objectionable in the second place, because it awards to the trustee a fraction of profits, which is, in many instances, too large a compensation for his labor and skill. In lines of business in which skill is of unusual importance, and capital plays a subordinate part, one-third of the profits, or even a much larger fraction, might fairly be allotted; but in manufacturing and mercantile pursuits, in which the possession of an abundant capital is absolutely necessary, it is submitted that the proportion of one-third is too large. The true criterion by which to determine what is due to a capitalist for the exercise of his skill has been suggested by Judge Penrose in *Seguin's Appeal*, 103 Pa. 146. The suggestion is that a reasonable allowance for services should not exceed the sum which such a capitalist would have to pay a competent manager to perform his work for him. To see how this rule would work, let us take the ordinary case of a manufacturing corporation, with a capital stock of \$1,000,000, and earning ten per cent. annually upon the investment, and let us suppose that a salary of \$10,000 is paid to the general manager, which, as such things go, would be a liberal compensation in a case of this kind. Now, according to our supposition, the profits of the enterprise for one year added to the salary of the manager would amount to the sum of \$110,000; or, to put the case differently, if we include the salary of the manager in the statement of the net profits, the proportion of those profits to which he is entitled, instead of amounting to one-third of the whole

sum, amounts only to *one-eleventh*. Now, let us go one step farther and assume that the factory has a single owner who is himself the manager, and that he invests \$500,000 of trust funds in the enterprise in addition to the \$1,000,000 of capital owned by himself. What proportion of the resulting profits should be awarded to the trust estate? According to the Pennsylvania rule, it would be $500,000-1,500,000 \times 2-3 = 2-9$. According to the more accurate principle suggested by Judge Penrose, the trust estate is entitled to more. By capitalizing the \$10,000 which the owner of the factory would have to pay to a competent manager, employing the same rate per cent. as before, we get \$100,000. The productive forces which cooperate to create profits may then be arranged as follows:

Capital of owner, . . .	\$1,000,000	
Capital of trust estate, . .	500,000	
Skill of manager, . . .	100,000	
		<hr style="width: 10%; margin: 0 auto;"/>
		\$1,600,000

Five-sixteenths of the profits should therefore be awarded to the trust estate, instead of the much smaller fraction of two-ninths, obtained by the former method.

To sum up, the "one-third" rule is open to criticism upon two grounds: first, that it is an attempt to establish a hard and fast rule with reference to a commercial relation, which is essentially variable and uncertain; second, that, in a large class of cases, the application of the rule works injustice to *cestui-que-trustent*. By permitting the trustee to retain too large a proportion of the profits as compensation for his services as a business manager, the Court in reality awards to him a sum of money which belongs to the trust estate.

III.

Having reviewed the circumstances which determine the proportion of profits to which a *cestui-que-trust* is entitled, when property belonging to him has been invested in a partnership, two questions remain to be considered: First, who may be held liable for those profits? Second, by what procedure can this liability be enforced? The first question may be

subdivided into an examination of the respective liabilities of the trustee and his co-partners. The liability of the trustee will be considered first.

The case of a trustee who invests trust-money in a business conducted solely by himself, presents few difficulties. By applying the principles explained in the last section, the exact proportion of profits attributable to the use of the trust fund can easily be determined. This sum will be the measure of the trustee's liability, and it has been already stated that it is immaterial whether the money has been embarked in a separate speculation or has become mingled with the trustee's private capital. If, however, the trust fund has been invested in a business conducted by the trustee jointly with other persons who are not trustees, the liability of the former is subject to some variation. Under certain circumstances the trustee can be held responsible for *all* of the profits accruing to the trust estate, under other circumstances only for *a portion* of such profits.

In an article published in the *Law Quarterly Review* for the month of April, 1887, by a certain G. T. Hamilton, "On the Doctrine of *Vyse v. Foster*," *Law Quarterly Review*, Vol. III, p. 211, may be found a most elaborate discussion of this branch of the general subject. The article in question has received favorable notice from at least two recent text books, and this fact will furnish an excuse for the amount of space devoted to it in the present discussion.

Apparently it is the aim of the writer to prove that in every case in which trust money has been contributed to a partnership by a trustee, he should be held personally responsible for *all* of the resulting profits, without regard to the question whether such profits have been received by him or not. The article begins by stating in a general way that the profits realized in a partnership are the increment not of the capital of any one partner, but of the combined capitals of all the partners. Hence the profits which any one partner receives from the business are the product of the capital of the firm as a whole, and not of his individual share of that capital. For example, if A and B are partners, having an equal interest in the firm

stock, the profits accruing to A's interest do not all go to him, but are divided equally between A and B, and the same thing is true of the profits accruing to B's interest. Now let us assume that A is a trustee, and that his moiety of the firm capital consists exclusively of trust funds, and further, that profits accrue to the firm which we will represent by the number four. A and B will each receive one-half of these profits, or two units, but of A's two units one unit is the product of the trust estate, and the other unit is the product of B's capital. Hence, A's liability to his *cestui-que-trust*, in the present state of the law as Mr. Hamilton interprets it, is to account not for two units of profits, but only for one unit, since the other unit has gone to B and A is accountable only for the fraction of the trust profits which he has actually received. This state of things, Mr. Hamilton thinks, is very unjust. A should be compelled to account to the trust estate for *all* of the profits which have accrued to it, and not merely for a part of them. It is true that the other half of the trust profits have gone to B, but at the same time A has received an exact equivalent from the product of B's capital, which he would not have received had he not invested the trust funds in the firm. Hence, argues Mr. Hamilton, a trustee who deals with the trust estate in that manner, should be held accountable for *all* of the resulting profits.

The line of argument, of which a sketch has just been given, appears to the writer to be open to serious criticism. Mr. Hamilton is undoubtedly right in saying that it is the capital of the firm as a whole which produces profits, and not the separate capitals of one or more of the partners. To revert to our former illustration, the four units of profits which result from the firm's operations are all clearly the product of the entire capital. No one of these four units, for instance, is the product of A's capital any more than B's capital. But when we come to consider the nature of the profits with reference, not to their production, but their distribution, in other words, when the time comes to divide the profits, a different relation is established. The claim of each of the partners to one-half of the four units is given effect by dividing the product into

two equal halves. Two units are assigned to A and B respectively, because that is what their respective capitals have produced, and each group of two units not only represents, but, in both an actual and a legal sense, constitutes the product of the individual capital of the recipient. It is like the partition of real estate between former tenants-in-common. In the eye of the law, at a given moment of time, the undivided interest of each tenant in the whole piece of realty is replaced by an entire and individual ownership in a certain fraction of it. So in the above illustration the two units of profits which A receives are clearly the product of the trust estate, and there can be no objection, either legal or metaphysical, to their being so regarded. But in that event it would follow that, even on established legal principles, the *cestui-que-trust* could claim the *entire profits* from the trustee, making of course a proper deduction as a compensation for skill. There can be but little doubt that such is the case. Although Mr. Hamilton has assumed throughout his entire argument that in the existing state of the law, the *cestui-que-trust* can recover only one unit, there is good ground for believing that this is a mistaken assumption. It is inconceivable that any Court of Equity, in passing upon the accounts of a trustee whose interest in a firm consisted solely of funds belonging to another, would permit him to retain any portion of the resulting profits as a perquisite of his office. The cases which Mr. Hamilton cites in support of the view that such is the law, are clearly distinguishable from the fictitious case to which his line of argument relates. For example, he quotes at length from the opinion of the Court in *Jones v. Foxall*, 15 Beav. 395. The Master of the Rolls in adjudicating that case, said, "I cannot charge the trustee with a greater amount of profits than he has actually received, and according to the evidence before me, the trustee, Foxall, received only one-third part of the profits produced by this sum," by which was meant the trust money with reference to which the action was brought. Now the important facts of *Jones v. Foxall* were that certain trust funds had been deposited in a bank owned and conducted by three individuals associated as partners of whom the defendant was one. Consequently

any profit attributable to this particular deposit, as in the case of any other deposit, must have been divided equally between the partners, in consequence of which, as the Court said, the trustee derived only one-third of the resulting benefit. The benefit conferred upon the trustee in Mr. Hamilton's fictitious case consists of the *entire* product of the fund. His deductions from the case of *Vyse v. Foster*, are open to the same criticism. It is, true that Lord Cairns, in his opinion, asserted that a trustee partner could not be made answerable for the share of the *cestui-que-trust's* profits which had been received by others, but in laying down this principle, Lord Cairns had in contemplation, not a case like that suggested by Mr. Hamilton in which the trustee really receives the entire product of the fund, but the particular case of *Vyse v. Foster*, in which the trust money constituted a debt of the firm, with the result of increasing the profits of all the partners equally. In the fictitious case only the profits of the trustee himself were increased. A fundamental distinction can therefore be drawn between two classes of cases, which Mr. Hamilton has overlooked, nor has it ever, within the knowledge of the writer, been clearly presented in any text book or judicial decision. The distinction referred to by Mr. Hamilton as well as by Lord Justice Wood, 8 Ch. Ap. 326, and others, between the case of trust money which is contributed to a firm, and trust money which is loaned, approaches it in some degree, yet this is not exactly the same distinction. The real distinction lies between that class of cases in which trust money is invested in a firm upon terms which permit the trustee to take *the whole* of the resulting profits, and that other class of cases in which he receives *something less* than the resulting profits; and it is altogether immaterial in the latter case, whether the investment is in the form of a loan, or whether it is a contribution to the firm by the trustee without an accompanying stipulation that he shall receive an additional share of the total profits proportioned to the value of the trust funds as a productive factor. Of these two classes of cases, Mr. Hamilton's imaginary case is a good illustration of the first class. A and B invest the same sum in a partnership, and share the profits equally, A's

contribution consisting exclusively of trust money, and B's contribution of his own private capital. In accordance with Mr. Hamilton's contention, although on other grounds, the trust estate is entitled to all that A receives from the business as profits, leaving out of consideration for the sake of convenience the question of compensation for skill. Or we may vary the illustration by assuming that A invests x units of his own money in the firm, and x units of trust money, and that B invests x units, making three x units in all, and let us assume further that A stipulates for a proportionate share of the profits, that is to say two-thirds. In this case also A should be held liable for the *entire profits* accruing to the trust estate, which would be one-third of the profits accruing to the firm as a whole. The remaining two-thirds would of course be divided equally between A and B as the return upon their respective capitals. But let us again vary the last illustration by assuming that A, instead of investing the trust money in the firm with the stipulation that he shall receive a proportionate increase of profits, contributes it without such a stipulation, or loans it to the firm upon a promissory note, and continues to receive one-half of the total profits as before. If we estimate the total profits at six units, the share attributable to the trust fund will be two units, and the same sum will be attributable to A's and B's private capitals respectively. But A and B each receive one-half of the total profits, or three units. Hence, of the two units of profits produced by the trust fund, A receives one unit and B one unit. It has been frequently held that, under these circumstances, A, the trustee is responsible to the estate only for *one* unit of profits: *Laird v. Chisholm*, 30 Scot. Jur. 582; *Macdonald v. Richardson*, 1 Giff. 81; *Freeman v. Fairlee*, 3 Mer. 43; *Jones v. Foxall*, 15 Beav. 395; *Vyse v. Foster*, 7 E. & I. Ap. 318; *Seguin's Appeal*, 103 Pa. 139; *Small's Estate*, 24 W. N. C. 92. He can be compelled to account, not for the total profits earned by the trust fund, but only for the share of such profits which he has himself received. To determine, therefore, the extent of a trustee's liability for profits in any case whatever, it is only necessary to examine the terms of the agreement governing

the investment of the funds, and to ascertain the proportion of the trust profits to which the trustee is individually entitled. A Court of Equity will never permit a trustee to retain profits which are the increment of trust funds, nor on the other hand, will a trustee be compelled to account for profits which have come into the possession of third persons.

That the liability of trustees should be limited in this manner appears entirely reasonable. Very able arguments in support of the opposite view were made by the counsel for the plaintiffs in *Laird v. Chisholm*, and in *Seguin's Appeal*, 30 Scot. Jur. 582; 103 Pa. 139; but in both of these cases, as well as in many others, the Court declined to charge the trustee with a larger share of profits than he had actually received. Reference has already been made to the statement of Lord Justice James in *Vyse v. Foster*, that the proper function of a Court of Equity is to compel restitution of property wrongfully withheld, not to impose penalties upon those guilty of offences. Elsewhere, in the same opinion, he calls attention to the "absurdity" of contending that, while a dishonest squanderer can be charged only four per cent. upon funds which he has lost, a trustee who invests trust funds in a firm which he knows to be solvent, should be charged not only for the share of profits which he has individually received, but for all the profits received by his co-partners as well. In deciding the case of *Laird v. Chisholm*, the Lord President of the Scotch Court of Session, expressed the opinion that a trustee could be made to account for the gains derived by his associates from the trust funds only upon the theory that he is individually responsible for the profits made by every debtor to the estate; 30 Scot. Jur. 587. We have already seen that a trustee cannot be held responsible for profits made by an independent firm to which the trust funds have been lent, or for profits made by his co-trustees. Upon the same ground, a trustee is entitled to claim exoneration from all liability to account for profits which have accrued to his associates in a partnership. The courts have very justly held that the mere fact that the enrichment of his co-partners

is the indirect result of a breach of trust committed by himself, is not a sufficient reason for imposing that liability upon him.

IV.

Having discussed the character and extent of the rights which a *cestui-que-trust* is privileged to enforce against his trustee, when money belonging to the trust has been employed in trade, it is now time to inquire into the liability which is incurred by the trustee's co-partners. It is a well-established rule that trust property, which has come into the possession of any person who is not a *bona fide* holder for value, can be followed and recovered by the beneficial owner: 1 Cruise Dig. Tit. II, Ch. 4, §§ 12, 15, 16; *Hill on Trustees*, pp. 164, 172; *Perry on Trusts*, §§ 217, 238, Ed. of 1889, and cases; *Oliver v. Piatt*, 3 How. 401. The rights of the latter are enforced in such a case through the medium of a constructive trust which implies the same measure of responsibility as an express trust: *Lindley on Partnership*, p. 524; *Perry on Trusts*, § 245, Ed. of 1889; *Bennett v. Austin*, 81 N. Y. 308; *Ryan v. Morrill*, 83 Ky. 352. In accordance with this principle, the co-partners of a trustee who have united with him in employing trust funds in their common business, either with knowledge of the true character of the funds, or having the means of knowledge at command: *Sadler v. Lee*, 6 Beav. 324, 330; *Marsh v. Keating*, 2 Cl. & Fin. 250, thereby become jointly and severally liable for the breach of trust so committed: *Lindley on Partnership*, x pp. 161, 524; *Ex parte Woodin*, 3 M. D. & D. 399; *Ex parte Poulson*, De. Gex. 79; *Wharton v. Clements*, 3 Del. Ch. 209. It is the privilege of the *cestui-que-trust* in such a case, not only to follow his property into the joint assets of the firm and the separate estates of the various partners, but also to treat the sum misappropriated as a debt, and to recover it by proceeding against the firm in an action of assumpsit: *Smith v. Jamson*, 5 T. R. 601; *Ex parte Watson*, 2 V. & B. 414; *Ex parte Heaton*, Buck 386; *Davis v. Gelhans*, 44 O. 69; *Bush v. Bush*, 33 Kan. 556. If the trust funds can be distinctly traced into some definite piece of firm property or even into a mixed account in a bank,

the right of the *cestui-que-trust* to reclaim his property will take precedence over all other claims against the partnership: *Perry on Trusts*, Edit. of 1889, §§ 128, 828; *Taylor v. Plumer*, 3 M. & S. 562; In re *Hallett's Estate*, L. R. 13 C. D. 713. If, on the other hand, the identity of the trust money has been lost, and the claim of the *cestui-que-trust* has been merged into the form of an ordinary debt, he will be allowed to come in *pai passu* with the other creditors of the firm and to enforce the claim against both the joint assets of the firm, and the separate estates of the partners: *Guillou v. Peterson*, 89 Pa. 163; *Carter v. Lipsey*, 70 Geo. 417. The *cestui-que-trust* has also the full rights of a firm creditor in all cases in which money belonging to him has been borrowed by the firm upon a bond or a promissory note, issued either by the firm itself, or by one of the partners in the firm name, either with or without the knowledge of his co-partners. Although money borrowed by a partner in his own name cannot be recovered from the firm merely on the ground that it has been used in the course of its business: *Story on Partnership*, § 134; *Parsons on Partnership*, p. 91; *Bevan v. Lewis*, 1 Sim. 376; *Hutchinson v. Smith*, 7 Paige 26; *Donally v. Ryan*, 41 Pa. 306; *Tallmadge v. Penoyer*, 35 Barb. 120; *Logan v. Bond*, 13 Ga. 196; it is within the implied power of any partner to borrow money by the use of the firm name, and thus to create the relation of debtor and creditor between the firm and the lender of the money: *Richardson v. French*, 4 Metc. 577; *Palmer v. Scott*, 68 Ala. 380. Consequently, if a partner has in his hands funds belonging to another under circumstances which would constitute him a trustee of such funds, and gives the note of the firm to the owner, or as a partner makes an admission of the firm's liability to account for the money, the *cestui-que-trust* acquires the right to recover the amount from the firm as a creditor, even though the money was borrowed without the knowledge of the other partners: *Welker v. Wallace*, 31 Ga. 362. In such a case, however, the liability of the firm to repay the money would rest, not upon the theory that a constructive trust had arisen, but upon the basis of the contractual relation established.

It has been stated that a firm is liable to account for trust funds employed in conducting its operations in all cases in which the partners are aware of the fact that a breach of trust is being committed. It should be remarked in this connection, that the knowledge of the partner investing the trust money as to the character of the transaction, does not of itself constitute notice to the firm, since the fact to be known does not directly relate to the subject of the firm business: *Collyer on Partnership*, § 414, p. 672; *Lindley on Partnership*, p. 312. On the other hand, it is not necessary, in order to charge the firm and the various partners with the liability to repay the money, that every member should be informed of the fact that trust funds are being dealt with. The knowledge and acquiescence of any single partner, other than the trustee partner, is sufficient to create a firm obligation: *Guillou v. Peterson*, 89 Pa. 172.

Let us suppose, however, that a trustee invests trust money in his firm without the knowledge of his co-partners, and without adopting any of the means necessary to create a contract obligation between the firm and the *cestui-que-trust*, what are the rights of the latter in such a case? On principle it would seem just to allow the *cestui-que-trust* to follow and reclaim his money, even if it was invested by the trustee without the knowledge of his co-partners. But see contra, *Hollembaek v. More*, 44 S. C., N. Y. 107. We have seen that a person who has acquired possession of trust property can defend against the title of the beneficial owner only by proving two facts: first, that he is a purchaser without notice; second, that he is a purchaser for value. To constitute a valid defence, both of these points must be established. It is not sufficient to establish only one of them. Now if the firm of which the trustee is a member has dealt with funds in ignorance of their true character, the firm may indeed be said to be without notice, but is it correct to say that it is a purchaser for value? It would seem not. Mr. Parsons has reasoned out this conclusion in the following manner: *Parsons on Partnership*, § 40. "The firm is not a person existing apart from its members," says Mr. Parsons, "but an aggregate of the partners. . . . The *cestui-que-trust* in reclaiming it from the firm, takes it back from the trustee, and

from his co-partners, who have paid nothing for it out of the joint estate, but simply added something to it in the joint stock. The firm therefore is a volunteer, and by the doctrines of equity, the trust fund may be followed into the hands of a volunteer."

It must be observed, however, that the rights of the *cestui-que-trust* in a case where his money has been used without the knowledge of the trustee's co-partners, are limited to the privilege of actually tracing his property into the hands of the firm and reclaiming it by virtue of his superior equitable title: *Lindley on Partnership*, p. 313. He has not the right in this case to treat the sum used in the partnership as a debt due to him as a firm creditor: *Lindley on Partnership*, p. 160; *Jacques v. Marquand*, 6 Cow. 497. Consequently if the trust money has been so employed by the trustee as entirely to lose its identity, and it is impossible to trace it into some definite piece of partnership property (see rule laid down in *In re Hallett's Estate*, L. R. 13, C. D. 713), the firm is entirely free from liability and the *cestui-que-trust* can have recourse only to the private estate of the trustee himself for compensation and redress: *Ex parte Apsey*, 3 Brown C. C. 265; *Ex parte Heaton*, Buck 386; *Willett v. Stringer*, 17 Abb. P. p. R. (N. Y.) 155.

In view of the fact that the firm incurs a certain responsibility to the *cestui-que-trust* as a constructive trustee when the co-partners are ignorant of the breach of trust as well as when they have knowledge of it, it might at first seem illogical to hold them to a greater degree of liability in the latter case than in the former. It must be remembered, however, that the constructive trust rests upon a different basis in the two cases. There is a well-known distinction between a constructive trust arising from the existence of fraud and one arising in the absence of fraud. A purchaser of trust property with notice is an example of the first; a good example of the second is a person who honestly acquires possession of trust property without paying a valuable consideration: *Perry on Trusts*, § 241, Ed. of 1889.

A somewhat similar classification of constructive trustees was made by Lord Selborne in the case of *Barnes v. Addey*,

L. R. 9 Ch. Ap. C. 251, in which he pointed out that a stranger to a trust might incur the responsibility of a constructive trustee in either of two ways, by "receiving and becoming chargeable with some portion of the trust property," or by "assisting with knowledge in a dishonest and fraudulent design on the part of the trustee." As a purchaser of trust property with notice is necessarily guilty of a certain degree of moral culpability, while this is not always the case with a purchaser without consideration, it is certainly reasonable to attach a greater degree of liability to the constructive trust in the former case than in the latter; hence, the authorities cannot justly be deemed inconsistent in permitting a *cestui-que-trust* to recover his money as a firm debt when the partners are aware of the breach of trust, while he is allowed only to follow his property in specie in a case where they are ignorant of it.

It has been stated that when the co-partners of a trustee are aware of the fact that the firm is using trust money, their liability to account for it as a debt is both joint and several, and also that the partners incur a similar liability whenever the loan of trust funds to the firm is evidenced by a bond or promissory note bearing the firm name. The *cestui-que-trust* is further entitled to follow his property into the hands of the individual partners, if its identity can be traced, and to recover it, in all cases in which the defence cannot be set up that the holder has paid value and is without notice. It should be remarked, however, that there is one very important case in which an individual partner might justly be allowed to defend upon this ground when such a course would not be open to the firm as a whole. It is the case of the investment of trust funds in a firm by a trustee partner as his private contribution, without the knowledge of his co-partners: See *Parsons on Partnership*, § 41.

Let us revert to our former illustration and assume that A and B have formed a partnership, in which A has contributed the proceeds of trust money to the capital of the firm, and B an equivalent amount of his own property. Now we have seen that if the *cestui-que-trust* is able to trace his money into

the firm assets, he is allowed to do so, for the reason that the firm is not "a purchaser for value." But let us assume that in the course of the firm business, either through the distribution of profits or otherwise, a portion of the trust property contributed by A to the firm has become part of B's private estate. In such a case, it may fairly be argued as a reason for exempting B from personal liability, that he has become a purchaser of the trust funds for value and without notice: See opinion of the Court in *Hollenbaek v. More*, 44 N. Y., S. C. 114, where the court goes so far as to apply this principle to the pursuit of trust funds into the firm assets also. By entering into a partnership with A, B has acquired all the privileges with respect to his co-partner's contribution which the status of partnership confers. He may lawfully expend it for the purposes of the firm business, he may contract debts which will bind it equally with the capital which he has himself supplied, he may pledge it as collateral to secure the performance of contracts for which he has stipulated in behalf of the partnership, in short, he can exert the same rights with respect to his co-partners' contribution as if he had furnished it himself. In return for the privileges so acquired, B has given "value," by contributing property of his own to the uses of the firm in such a manner as to render it subject to the exercise of the same rights by his co-partner, A, and as the result of B's contribution, it has become possible to conduct operations in the interest of both parties, which, without it, would be impracticable. Consequently, if, in the course of exercising those rights, certain specific property of the trust estate, which A has invested as his contribution, comes into B's exclusive possession, he is entitled to retain it as a *bona fide* purchaser for value. Of course, if B is aware of the real character of the property with which he has been dealing, the *cestui-que-trust* is clearly entitled to reclaim it, since B could not in that case defend against the claim as a purchaser without notice; but if he is ignorant of A's breach of trust, it would be unjust to charge him with liability. The law does not impose upon a partner the duty of ascertaining the source from which a co-partner's contribution is derived. Hence, it cannot be said

that B has constructive notice that trust funds are being used by the firm, and in the absence of positive information to that effect, or the existence of such a state of facts as should suffice to put B upon his inquiry, it cannot be said that he has either actual or presumptive notice: *Ex parte Geaves*, 8 D. M. & G. 291.

Against the proposition that in certain cases trust funds can be followed into the possession of the firm, but not into the hands of the individual partners, the point might be raised that a firm liability invariably carries with it the right to proceed against the separate estates of the different members. It is a sufficient answer to this objection that we are not now dealing with an ordinary debt of the firm, recoverable in a suit at common law, but with an equitable principle governing the right to follow trust funds, and that it is quite possible that an equitable right might be enforced against either the joint estate of the firm, or the separate estates of the partners, as the case might be, without being enforceable against both estates. For example, it is by virtue of a well known equitable principle that the private debt of a partner is made a primary charge upon his separate estate, but not such a charge upon the joint estate: *Parsons on Partnership*, § 102. Hence, it is entirely reasonable that another equitable principle, viz., that of following trust funds, should operate to charge the firm with a liability which is not shared by the co-partners individually. The responsibility of the firm to a *cestui-que-trust* who seeks to follow and reclaim his property, is not based upon the nature of the partnership relation, or upon any theory of the common law. It is solely by virtue of an equitable doctrine that the *cestui-que-trust* can enforce his rights. Hence, the fact that the law of the partnership relation makes firm debts a charge on every partner's separate estate, does not furnish any adequate reason for a similar extension of the firm's liability in a case in which that liability proceeds, not from the legal structure of the partnership relation, but from an equitable principle relating to trust property.

Having examined the various cases in which the firm and the individual co-partners of a trustee may be held responsible

for the principal of the trust estate, it is now time to inquire into their liability to account for profits. It is quite evident, at the outset, that no valid claim to profits can exist in any case in which there is not a corresponding right on the part of the *cestui-que-trust* to recover the principal sum. It may also be taken for granted that a co-partner of a trustee is never liable, under any circumstances, for a larger share of the profits than he has individually received, since it cannot be presumed that the responsibility of a constructive trustee ever exceeds that of an actual trustee. Bearing in mind these two important qualifications, the question next arises in what cases, if any, the right of the *cestui-que-trust* to recover the principal of his estate from the trustee's co-partners is supplemented by the right to claim the profits which have accrued through its employment in trade.

As a preliminary to the determination of this question, it is necessary to inquire into the character of the liability which is incident to a constructive trust. This purpose can be accomplished most effectually by a study of particular examples. Let us examine the respective liabilities of (1) a vendor of real estate who has received the purchase money, but has not yet parted with the legal title; (2) a trustee who buys at his own sale; (3) a person who speculates with money belonging to another; (4) a surviving partner of a decedent who continues to trade with assets of the estate. It will be observed that in each of these instances, the property of one person has come into the possession of another under circumstances which give rise to a constructive trust. In every instance there is the obligation to account to the real owner for the value of the property acquired. But the obligation does not stop there. The real owner may not only hold the constructive trustee liable for the value of his property, but he is entitled to demand the property itself, and if it has risen in value in the trustee's hands, the benefit will accrue to him and not to the trustee. Thus, in the first case cited in illustration, if the land purchased by the vendee increases in value while the legal title is still in the vendor, the entire benefit will result to the vendee, since the latter by virtue of the constructive trust established, can demand

a conveyance of the land itself. So in the second case, if a trustee buys trust property at his own sale, a constructive trust immediately arises in favor of the former beneficial owner, which will enable him not only to demand a restoration of his property in specie, which would give him the advantage of an increase in value, but an account of the income of the property during the intervening time: *Perry on Trusts*, § 196, Ed. of 1889; *Ex parte Reynolds*, 5 Ves. 707, and cases cited in note; *Fox v. Macreath*, 2 Brown Ch. C. 400; *Moody v. Vandyke*, 4 Bin. 43. The constructive trustee is under a similar obligation to account for profits in the third case: *Brown v. Litton*, 10 Mod. 20; *Robinett's Appeal*, 36 Pa. 174; and we have already seen that the surviving partners of a decedent who deal with the latter's property in the manner stated in the fourth case, not only incur a liability to account for the interest of the decedent in the partnership, but the additional liability to account for all the profits which are attributable to the use of his assets in the business: see opinion of Lord Cairns in *Vyse v. Foster*, 7 E. & I. Ap. 318. It appears, therefore, to be the general rule that whenever there exists a liability in Equity to account for a principal sum, upon the ground that a constructive trust has been created, there exists also a liability to account for the resulting profits in the same manner as in the case of an express trust. Hence, it follows that in that class of cases in which the beneficial owner of trust funds is permitted to recover his property either from the firm as a whole or from the individual partners, upon the ground that the latter have constituted themselves constructive trustees, the right to recover the principal sum invested is supplemented by the right to recover accrued profits.

The conclusion which has just been reasoned out purely as a matter of principle is in strict accord with the only direct authority bearing upon this question, which is to be found in the reports. The case of *Flocton v. Bunning*, 8 Ch. Ap. 323, note, was decided by the English Court of Chancery in 1864. The facts of that case were that A, the sole proprietor of a business establishment died, leaving B, his widow, the executrix of his estate, which was devised upon certain trusts with

the direction to convert. B wound up the business, and then recommenced it in partnership with C and D, employing for the purpose assets of the estate in plain violation of the terms of the will. A second partnership succeeded the first one, which like the latter was conducted largely with the testator's money, and after the lapse of several years, B, the executrix of the deceased became bankrupt. A bill was filed by the six children of A, as beneficiaries of his will, against B, and the various persons who had been her co-partners during the time that the breach of trust had continued. Sir John Stuart, V. C., directed an account of the firm's affairs, and decreed a restoration by *all the defendants* of the testator's property *with profits*, or with five per cent. interest, at the will of the plaintiffs. On appeal the decree was affirmed, L. J. Selwyn remarking that in order to charge all the defendants both for principal and profits, but two things need be proved: first, "That some portion of the fund was employed in trade in breach of the trusts of the will; second, that the breach of trust was known to the respective partners upon their entrance into the firm. As it plainly appeared in the case of *Flocton v. Bunning* that the partners all had this knowledge, their liability to account both for principal and profits was treated by the Court as not admitting of the slightest doubt."

It will be observed that in the case of *Flocton v. Bunning*, the Court adopted "knowledge of the breach of trust" as the test of a co-partner's liability to account for the principal and increment of the trust estate. It has already been explained that such knowledge *impo facto* gives rise to a constructive trust since it renders impossible the defence of "no notice." But it has also been stated that there are other cases in which there exists a similar liability to account for the principal of the trust estate upon other grounds than knowledge of the breach of trust. An examination of these cases will show that in some instances there is, and in others there is not, a concurrent liability to account for profits.

We have seen that the firm incurs a certain responsibility to the *cestui-que-trust* with respect to the principal of the trust estate in four instances, and the individual partners in three

instances. The firm assets are liable, first (1) for a loan to the firm by a partner with the knowledge of his co-partners that the money is trust property; second (2) for a loan made without such knowledge; third (3) for trust funds invested by a partner, as his contribution or otherwise, with the knowledge of his co-partners; and fourth (4) for such a contribution made without their knowledge, provided the property can be traced. Fifth (5) the individually partners are responsible for trust money invested by one of their number as a loan, when they have knowledge of the fact; and sixth (6) when they do not have this knowledge; and lastly (7) they are individually responsible for trust money invested as a contribution when they have knowledge of its character. In what would otherwise constitute the eighth (8) case, viz., where a partner contributes the trust money *without* the knowledge of his co-partners, we have seen that they incur no individual responsibility whatever. Now it will be observed that in the first four cases the firm is liable to the *cestui-que-trust* in the character of a constructive trustee, for the reason that it is not "a purchaser for value." In the fifth and seventh cases the individual partners are responsible since they are affected with notice. It will also be observed that in the first, second, fifth and sixth cases the firm assets and the separate estates of the partners are liable to the *cestui-que-trust* for the principal sum invested with interest, upon the ground of contract, just as they are liable for any other debt of the firm. Now we have seen that the responsibility of a constructive trustee includes not only the liability to restore the principal sum invested, but also a liability of the same kind to account for profits. On the other hand, the claim of the *cestui-que-trust* when it rests exclusively upon the ground of contract, cannot include profits, but only such interest or other return upon the sum loaned as the terms of the contract require. Hence, it follows, that the trust estate is entitled to profits in all those cases in which the right to recover the principal proceeds upon the theory that the firm or the individual partners are liable as constructive trustees, or upon that theory and upon the ground of contract obligation combined; but that there can be no liability to ac-

count for profits when the responsibility for the principal sum rests solely upon the ground of contract. Consequently, of the seven cases in which there is a responsibility devolving upon the firm or the individual partners to restore the principal of the trust estate, profits can be recovered in the first, second, third, fourth, fifth and seventh cases. In the sixth case profits cannot be recovered.

A minor point deserves to be noticed in passing. It has been said that profits can be recovered in the seventh case, which would render the separate estate of a co-partner liable for the profits upon money invested by a trustee, when the former is aware of the nature of the contribution. The co-partner is indeed responsible as constructive trustee for the share of trust profits received, but it must be observed that in such a case it would seldom happen that he would receive any profits. Except in very rare instances, a trustee, upon investing trust money as part of his contribution, would stipulate for a proportionate increase in his own share of the profits. In such a case, as we have seen, the trustee himself can be compelled to restore the whole of the profits accruing to the trust estate, and no liability would attach to his co-partners for any portion of them, simply because they did not receive them; although, as we have seen, they become liable in such a case as constructive trustees to restore the principal sum.

A strong argument in favor of the view of a co-partner's liability here presented, is the fact that the opposite view would render it impossible in most cases for a Court of Equity to protect the rights of a *cestui-que-trust*. We have seen that a trustee partner cannot, consistently with equitable principles, be held responsible for a larger share of profits than he has personally received. Consequently, whenever it happens that the trust profits have been divided around equally between all the partners, as in the case of a loan to the firm, only a small fraction can be recovered from the trustee himself. In a firm of five partners, he would be responsible only for one-fifth of the trust profits, in a firm of ten, only for one-tenth, and so on. Hence, great injustice would result if the *cestui-que-trust* should

be denied the privilege of proceeding against his trustee's co-partners, and of recovering from them the profits which rightfully belong to him. It is the aim of a Court of Equity to do complete justice wherever that is possible. In the case under discussion, it is admitted that the profits sought from the co-partners are due entirely to the employment of trust money, and to the employment of it under circumstances which would render the co-partners liable, as constructive trustees, to replace it in the event of its being lost. Consequently, it is entirely in accord, both with the general spirit which actuates a Court of Equity, as well as with definite equitable principles, to accord the relief to which it is claimed that the *cestui-que-trust* is entitled. Such relief would be given against a constructive trustee, as in the case of an express trustee, upon the theory of compensation and restitution, not upon the theory that the defendants were in any way to be subjected to a penalty for misconduct. The co-partners should restore the profits to the *cestui-que-trust* because they are his property, and upon no other ground. In this way, the liability of the co-partners would become the exact complement of the liability of the trustee, and an equitable degree enforcing the two liabilities would result in doing complete and substantial justice between the parties.

V.

Having ascertained what the principles are which determine the extent of the *cestui-que-trust's* claim against a partnership in which his funds have been invested, a brief review will now be made of the different modes of procedure by which he can enforce his rights, and of certain general rules which govern the statement of the profit account. We have seen that the *cestui-que-trust* has rights which he can enforce in all cases against his trustee, and, in the majority of cases, against the firm and the trustee's co-partners. It is, therefore, optional with him whether he will enforce these rights by a single bill against all the members of the firm as defendants, or by separate bills directed against the trustee, and against his co-partners. The former method would have the advantage of

bringing all the liabilities arising in the case before the review of the Court at the same time, and except in very complicated cases, complete justice could be administered in a single decree. If, on the other hand, the *cestui-que-trust* should prefer to file a bill against the trustee alone, he could recover, as we have seen, the principal sum invested with the share of the profits received by the trustee himself; and he would, of course, have the further privilege of filing a separate bill against the co-partners for the purpose of obtaining from them the balance of profits due.

It has been said that the difficulties in the way of computing the profits due to a *cestui-que-trust* do not constitute any reason why a decree awarding such profits should not be made. Many of these difficulties are, of course, peculiar to individual cases, and no general discussion of them is possible. Certain rules, however, can be laid down with respect to the proper statement of the account, which are likely to prove serviceable.

It is essential in every case to begin the calculation by ascertaining the value in money of the *cestui-que-trust's* interest in the firm business. If this interest consists exclusively of a share of the capital stock, or of money loaned to the firm, then the balance due the trust estate at any given time will constitute the proper basis for computing profits: *Townend v. Townend*, 1 Giff. 201. If the funds remain in the business for a series of years, and no intermediate payments are made to the estate, the interest of the *cestui-que-trust* will increase every year to the extent of his share in the profits earned. The proportion of profits which the *cestui-que-trust* is entitled to claim in any particular year will correspond to the ratio which the value of his interest bears to the total capital of the firm (*Laird v. Chisholm*, 30 Scot. Jur. 583; *Brown v. DeTastet*, Jac. 284, 288; *Seguin's Appeal*, 103 Pa. 139), with an allowance for skill, and also a further allowance in exceptional cases like *Wedderburn v. Wedderburn*, 22 Beav. 84, for the part which the good-will of the business, or the credit employed, or the patents and franchises owned by the partners have played in producing the profits realized. For the purposes of this calcu-

lation, the capital of the firm at any given time is to be ascertained by subtracting its liabilities from its assets, since the difference between these two sums represents the amount of money which the trustee and his co-partners have at stake in the business. Of course, this capital is liable to increase year by year, if any portion of the profits of the business remain undisturbed, just as it has been shown that the trust funds will increase, under the same circumstances, and consequently the share of profits due to the estate is never likely to remain the same for two successive years: *Wedderburn v. Wedderburn*, 22 Beav. 84; *Simpson v. Chapman*, 4 De G. M. & G. 174; *Small's Estate*, 24 W. N. C. 92.

A very interesting question arises as to the character of the *cestui-que-trust's* rights, if during a portion of the period in which his money has been invested in the firm, there have occurred losses instead of profits. Is the *cestui-que-trust* privileged in such a case to divide the period, and to elect to take profits for a portion of the time, and interest for the remainder? This question arose under somewhat peculiar circumstances in the case of *Heathcote v. Hulme*, 1. J. & W. 122. In that case trust funds were invested in a firm, and for several years large profits were realized. A change of partners then occurred, an old partner retiring and a new one assuming his place, and for the balance of the time the funds remained in the firm, the business was much less successful. The plaintiffs in their bill, claimed profits for the first period interest during the second, but the justice of the claim was denied by the Court. The substitution of one partner for another could not properly be regarded as a sufficient reason for dividing the investment into fractions. "In fact," said the Master of the Rolls, "nothing short of the embarkation of funds in a new trade, or at a new place, would make it just to break the period."

The same conclusion was reached in a Massachusetts case (*Washburn v. Goodman*, 17 Pick. 526, 579; see also *Goodburn v. Stevens*, 1 Md. Ch. 420, 437), in which a firm continued business after the death of one of the partners, and a share in the subsequent profits was claimed by those interested in his estate. The Court held that in estimating the amount of pro-