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RESCISSION - CONSTRUCTIVE TRUSTS - TRACING MISAPPROPRIATED FUNDS

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RESCISSION — CONSTRUCTIVE TRUSTS — TRACING MISAPPROPRIATED FUNDS — Defendant, president of plaintiff corporation, misappropriated over $1,000,000 in corporate funds, investing $79,000 thereof in government bonds. With the proceeds from these bonds, defendant set up two corporations, all the capital stock of which was owned by defendant's son and was purchased with plaintiff's money. One Greenslade was hired by defendant, and paid with a part of the misappropriated funds, to experiment with locomotive staybolt testing devices. As a result of the experimentation, Greenslade invented and patented several devices, transferring ownership thereof to one of the two corporations. In a prior action, brought without knowledge of the disposition of the funds, plaintiff recovered a personal judgment against defendant for the amount of the misappropriation.[1] After satisfaction of this judgment to the extent of $4,500 only and a discovery of the above investments, plaintiff brought an action to impose a constructive trust on the patents and inventions. *Held*, plaintiff was entitled to the patents and inventions on the ground that defendant was a trustee *ex maleficio* of the misappropriated funds and all the assets of the two corporations were "but the fruit of the proceeds of the trust funds." *Flannery v. Flannery Bolt Co.*, (C. C. A. 3d, 1939) 108 F. (2d) 531.

Courts have long recognized the right of a person whose property has been misappropriated by another to follow it through its various mutations and recover it in its final form.[2] This result is achieved by applying the tracing principles of the constructive trust doctrine. No matter what species of property the original fund is exchanged for or invested in,[3] nor how intricate the transactions through

[1] Flannery Bolt Co. v. Flannery, (C. C. A. 3d, 1936) 86 F. (2d) 43.

[2] See generally, 3 SCOTT, TRUSTS, § 507 (1939); RESTITUTION RESTATEMENT, § 202 (1937); 4 BOGERT, TRUSTS AND TRUSTEES, § 921 (1935).

[3] Pioneer Mining Co. v. Tyberg, (C. C. A. 9th, 1914) 215 F. 501, bank draft; Elmer Co. v. Kemp, (C. C. A. 9th, 1933) 67 F. (2d) 948, corporate assets; Indian Land & Trust Co. v. Owen, 63 Okla. 127, 162 P. 818 (1916), land; Sparks v. McCraw, 112 S. C. 519, 100 S. E. 161 (1919), notes and mortgages; Primeau v. Granfield, (C. C. N. Y. 1911) 184 F. 480, ore deposits; Shaler v. Trowbridge, 28 N. J. Eq.

which it has gone,[4] the original owner is entitled to the final product, provided the rights of innocent third parties have not intervened. Furthermore, the party wronged is entitled to any increases in the value of his property or any profits therefrom, not by virtue of any merit on his part, but solely because the policy of the law is to impose a deterrent to wrongdoing.[5] The principal case presents an unusual situation for the application of tracing principles, due to the fact that plaintiff's funds have not been "exchanged" for other property in the usual manner.[6] Plaintiff's money did, however, (1) pay for the materials used in the experimentation, and (2) hire the inventor to do the experimenting, which in effect amounted to a purchase of any product of his labor. Since there were no factors contributing to the final product other than those purchased with plaintiff's money,[7] the patents and inventions can be said to be plaintiff's property in another form. This logical result is further justified since the inventor is claiming

595 (1877), proceeds of life insurance policy; Smith v. Lynch, (C. C. A. 5th, 1923) 288 F. 552, proceeds of shares of stock; Millard v. Green, 94 Conn. 597, 110 A. 177 (1920), shares of stock.

[4] Third Nat. Bank of St. Paul v. Stillwater Gas Co., 36 Minn. 75, 30 N. W. 440 (1886), through several bank accounts; Elliott v. Landis Machine Co., 236 Mo. 546, 139 S. W. 356 (1911), patents into corporate stock into other stock; Smith v. Lynch, (C. C. A. 5th, 1923) 288 F. 552, money into bonds into substituted stock into money; Primeau v. Granfield, (C. C. N. Y. 1911) 184 F. 480, money into machinery and services which made available ore deposits; Fant v. Dunbar, 71 Miss. 576, 15 So. 30 (1893), money into a promissory note into a house which burned down and was rebuilt by insurance proceeds.

[5] See generally, 3 SCOTT, TRUSTS, § 508 (1939); Ames, "Following Misappropriated Property Into Its Product," 19 HARV. L. REV. 511 (1906). Also Stokes v. Burlington County Trust Co., 91 N. J. Eq. 39, 108 A. 863 (1919), profits from land; City of Lincoln v. Morrison, 64 Neb. 822, 90 N. W. 905 (1902), profits from warrants; Farmers' & Traders' Bank v. Kimball Milling Co., 1 S. D. 388, 47 N. W. 402 (1890), corporate profits; Greene & Co. v. Haskell, 5 R. I. 447 (1858), profits from ivory tusks; Shaler v. Trowbridge, 28 N. J. Eq. 595 (1877), proceeds of life insurance policies, all of whose premiums were paid by plaintiff's funds. For a discussion of the problems raised by the insurance cases, see 4 ST. JOHN'S L. REV. 239 (1930); 4 BOGERT, TRUSTS AND TRUSTEES, § 924 (1935); 35 YALE L. J. 220 (1925).

[6] The only case discovered which approximates the situation in the principal case is Primeau v. Granfield, (C. C. N. Y. 1911) 184 F. 480, where plaintiff's money was wrongfully employed by defendant to pay for machinery and expenses used in opening a mine which he had leased. Plaintiff was allowed that portion of the ore-in-place which his money bore to the total expenses of obtaining the ore (i.e., the expenses of labor and machinery plus the rents and royalties paid the lessor). The Primeau case is factually similar to the principal case in that defendant put plaintiff's money to an extremely profitable use, but differed in that plaintiff's money was but one of the factors contributing to the final product.

[7] It might be argued that plaintiff's money paid only for the inventor's labor and not for his ingenuity, so that there would be an independent factor to be accounted for in the final product, and plaintiff would therefore be entitled only to a portion thereof. Even if this reasoning is followed, however, the impossibility of apportioning the final product as the result of plaintiff's money and the inventor's ingenuity would still enable plaintiff to obtain the patents and inventions as a whole. Cf. Hamilton-Brown Shoe Co. v. Wolf Bros. & Co., 240 U. S. 251, 36 S. Ct. 269 (1916), profits derived from infringement of plaintiff's trademark.

no right to the patents and inventions, no innocent third party has contributed to the final product, and plaintiff has been able to recover only a small fraction of the total funds misappropriated. Under such circumstances, courts should be free to effectuate their policy of deterring wrongdoing by refusing to allow the tortfeasor to profit by his wrong, and of restoring the plaintiff to the economic position he occupied before the wrongful disposition of his property.

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