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Following Trust Funds

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F O L L O W I N G T R U S T F U N D S

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CORNELL UNIVERSITY SCHOOL OF LAW.

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I N T R O D U C T I O N

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Trust estates and trust funds have ever been carefully gaurded and protected, both at law and equity. The law lays down the most stringent and arbitrary rules for the guidance of those, who are entrusted with the management of such property. The path of duty, when not pointed out by the trust instrument itself, is carefully mapped out by the law and he who assumes to discharge a trust duty must keep within the narrow path laid out. He steps without, under any circumstances, only at his peril.

The general theory of following trust funds seems to be:- That whenever the trust fund has been converted into another species of property, that if its identity can be traced it will be held in its new form liable to the rights of the cestui que trust; or as the product of it, equity will follow it, unless the greater equity of a bona fide holder for value without notice, should intervene. Thus through all the changes the trust may undergo if the article substituted can be identified as such substitute it will be impressed with the trust. The

right of following it only fails, when the power of identification is lost. And this, according to the views of those who follow what is known, in this country, as the general rule, is the case when the subject is turned into money andmixed and confounded in a mass of property of the same kind.

TRUST MONEY INVESTED WITH THAT OF THE TRUSTEE.

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Where it can be shown that the trust fund has gone to swell another fund, or has been used in the purchase of property, though the part purchased with trust funds, and the part not so purchased are entirely mixed, what in such a case are the rights of a cestui que trust? Is he relegated to the rights of a simple creditor, or, if not what are his rights?

This question usually arises when a trustee, after having used the trust funds contrary to his duty, becomes insolvent and the cestui que trust endeavors to enforce a claim to priority against the general creditors. If the trust fund were traceable to a separate piece of property therecould be no question, and there would be none, and still it is contrary to all sense of justice

and equity, if because the trustee has mingled the trust money with his own, the cestui que trust shall lose all rights against the property purchased with his money. Such a rule could only be defended on the supposition that when the trust fund is mixed with other money it is beyond the power of equity to grant the relief, which is granted when the trust fund is not so confused. This does not now appear to be the rule,(a) although years ago such was considered to be the rule.(b) Where the trust fund is traceable into a certain investment, and the part it bears to the whole sum so invested is capable of being proven, the cestui que trust should be allowed to treat the investments as made for his benefit in the same way that he could if all the money so invested had been his. That is to say, that he should be entitled to such a proportion of the whole as his trust money so invested, bore to the whole sum so invested.(c)

The fundamental reason in one case as in the other being that a trustee should not and cannot be allowed to make a profit out of a wrongful act. If the property

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(a) Knatchbull v. Hallett, L. R. 13 CH. Div. 696.
(b) Whitcomb v. Jacobs, 1 Salk. 160.
(c) Taylor v. Plummer, 3 Maule & S. 562.

which he wrongfully purchased were held to be subject only to a lien for the amount invested any increase in value would go to a wrong doer.

It will often happen, nevertheless, that the cestui que trust cannot identify any property as being purchased wholly or in any definite proportion with his money, and therefore equity cannot regard him as the owner of any property either individually or in common, and yet he can show that the trust fund has gone to swell the general assets of the trustee's estate, as where the money has been used in a business which afterwards becomes bankrupt. Here strictly speaking there can hardly be a trust, as it is as necessary for equitable as for legal ownership that there should be fixed property as the subject matter of it. In both cases the necessity rests rather on the nature of things than on any rule of law. It would , however, be in the highest degree unjust that the rights of the cestui que trust should be made to depend on whether his property is distinguishable from the general mass of the trustee's property, or indistinguishable. Though hoplesslyconfused with the trustee's , still his money or ~~his~~ its proceeds is there, and if equity c an by any means work it out he should be en-

abled to get at it. Equity accomplishes justice in such a case by giving the cestui que trust a lien upon the property,- a right to be paid from the estate in priority to the general creditors. This latter right the cestui que trust always has though he also may be able to follow his money into a certain investment.(a) In case the investment has turned out badly, it would be for his advantage not to regard the investment as being made for him, but assume that it had been wrongfully converted, and take alien on what was purchased with his money and co me in with the general creditors for any deficiency occasioned by the depreciation of the investment.(b)

If a trustee purchase real estate partly with his ~~or~~ own property and partly with trust funds, it is universal ly allowed that the cestui que trust has a claim in equity against the land, but the exact nature of the right allowed is not uniformly agreed upon. If the property purchased should increase in value, it is for his interest to obtain an undivided share of it rather than a lien

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(a) Monroe v. Collin, 95 Mo. 33; Cook v. Tullis, 18 Wall. 332; Bent v. Priest, 86 Mo. 476.

(b) Riehl v. The Foundry, 104 Ind. 70.

on the property for the bare amount of the trust money invested. If the proportion which the trust money bore to the purchase money is known or acertainable, the larger right should it seems be allowed, as the trustee's eatate otherwise benefits by the misappropriation. The question has not however, been very fully discussed and the decisions do not appear to be uniform. In England the point can hardly be considered settled, but in Knatchbull v. Hallett, Jessell, M. R., after speaking of the cestui que trust's right to elect either to take the property purchased, or to hold it as a security for the amount of the trust money laid out in the purchase, says: "But in the second case, where a trustee has mixed the money with his own there is this distinction, that the cestui que trust, or beneficial owner, can no longer elect to take the property, because it is no longer bought with the trust money purely and simply, but with a mixed fund. He is, however, still entitled to a charge on the property purchased for the amount of the trust money laid out in the purchase."

The general rule in this country allows the cestui que trust to recover a specific share of the property purchased with any portion of such trust funds.(a)

(a) Perry on Trusts, Sec. 427; Jones v. Dexter, 130 Mass. 380; Schlaefer v. Corson, 52 Barb. 510.

TRUST FUNDS MINGLED WITH THOSE OF THE TRUSTEE IN THE SAME BANK ACCOUNT.

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A question similar to that which has been considered, arises where trust money is paid into a bank to the private account of the trustee, funds of his own being paid to the same account. Here the question is not whether the cestui que trust is entitled to a lien or a proportionate part, for it is entirely immaterial in the case of money, but whether he has any rights at all against the bank account. There can be little doubt, that, according to the older English precedents, the question would have to be answered in the negative. Money, when mixed with other money, could not be followed because it had no "ear marks".(a)

A consideration of these old cases led Justice Fry, as late as 1879, to decide that the rights of the cestui que trust were lost.(b) In deciding as he did in this case Justice Fry took occasion to say that equity and justice was against the rule; but that nevertheless he considered the rule well settled. Thus the law remain-

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(a) Whitcomb v. Jacobs, 1 Salk. 160.
(b) Ex parte Dale, 11 CH. Div. 772.

ed until Sir George Jessell, M. R., in the famous case of Knatchbull v. Hallett, after thoroughly reviewing all the authorities frankly acknowledged that such was formerly the law, but that he was of the opinion that equity had advanced. He therefore over-ruled Justice Fry, and as the law now stands moneymaybe followed in the same manner as any other chattels, as long as it can be traced into a specific fund. Thus we escape the consequence of a trustee mingling a small sum of his own, with the trust funds, and thereby making of himself a debtor instead of a trustee, when in truth the trust fund is still in existence and in his charge.

In Knatchbull v. Hallett, Jessell, M. R., says:- "Supposing, instead of being invested in the purchase of land or goods, the monies were simply mixed with other monies of the trustee, using the term again in its full sense as including every person in a fiduciary relation, does it make any difference according to the modern doctrine of equity? I say none. It would be very remarkable if it were to do so. Supposing the trust money was 1000 sovereigns andthe trustee put them in a bag, andby mistake, accident or otherwise, dropped a sovereign of his own into the bag, could anybody suppose that

a judge in equity would find any difficulty in saying that the cestui que trust has a right to take a thousand sovereigns out of that bag? I do not like to call it a charge of 1000 sovereigns on the 1001 sovereigns, but that is the effect of it. I have no doubt of it. It would make no difference if, instead of one sovereign it was another 1000 sovereigns; but instead of putting it into his bag, or, after putting it into his bag, he carries the bag to his bankers, what then? According to law, the bankers are his debtors for the total amount; but if you lend the trust money to a third person, you can follow it. If in the case supposed the trustee had lent the 1000 sovereigns to a man without security, you could follow the debt and take it from the debtor. If he lent it on a promissory note, you could take the promissory note; or the bond, if it were a bond. If, instead of lending the whole amount in one sum simply, he had added a sovereign, or had added 5000 sovereigns of his own to the 1000 sovereigns, the only difference is this; that instead of taking the bond or the promissory note, the cestui que trust would have a charge for the amount of the trust money on the bond or promissory note. So it would be on the simple contract debt; that is, if

the debt were of such a nature as that, between the creditor and thedebtor, you could not sever the debt in two so as to show what part was trust money, then the cestui que trust would have a right to a charge on the whole."

RULE WHEN THE TRUSTEE HAS DRAWN AGAINST THE ACCOUNT

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In most of the cases which arise on this point there is a difficulty encountered not heretofore referred to; that is the trustee after mingling his own and the trust money in the private bank account draws on the account to a greater or less extent. Can the cestui que trust still claim to be reimbursed in full from the amount left on deposit, or should it rather be held that a portion of themoney withdrawn was his?

It is a general presumption of law, whenit becomes important to decide, to which of several deposits, drafts drawn on the general account should be charged, that the deposits shall be deemed to have been drawn out in the order in which they were put in, so that each draft when paid would be charged against the earliest deposit in the account. (a)

(a) Clayton's Case, 1 Mer. 572.

This is a general rule applied in all mercantile transactions; and was followed in Pennell v. Deffell, 4 DeJ. M. & G. 372, which was a case where trust funds were so deposited and drawn against as to indicate that a portion of the trust fund had been used. This rule was approved, and followed by a number of later English decisions ; but in the celebrated case of Knatchbull v. Hallett, the court after having disposed of the view that the cestui que trust had no claim at all, decided that the presumption did not arise, when the account is composed in part of trust funds and in part of the trustee's private funds, but that in such a case it should be presumed that the trustee drew out what he had a right to draw out, to wit, his own money. In deciding this latter point, Sir George Jessell, M. R., said:- "Now upon principle, nothing can be better settled, either in our law, or I suppose, the law of all civilized countries, than this, that where a man does an act which may rightfully be performed, he cannot say that the act was intentionally and in fact done wrongly. A man who has a right of entry can not say he committed a trespass in entering. A man who sells the goods of another as agent for the owner can not prevent the owner adopting the

sale, and deny that he acted for the owner. It runs throughout our law, and we are familiar with numerous instances in the law of real property. A man who grants a lease, believing he has sufficient estate to grant it, although it turns out that he has not, but has a power which enables him to grant it, he is not allowed to say that he did not grant it under the power. Whenever it can be done rightfully, he is not allowed to say, against a person entitled to the property or the right, that he has done it wrongfully. That is the universal law."

This thoroughly sound, just, and equitable doctrine has with but few exceptions, notably the courts of Maine and Pennsylvania, been the rule of the American courts.(a)

(a) Knatchbull v. Hallett, L. R. 13 CH. Div. 696.
National Bank v. Insurance Co., 104 U. S. 54.
VanAlen v. The Bank, 52 N. Y. 11.
Overseers v. Bank of Virginia, 2 Gratt. 544.
United States v. State Bank, 96 U. S. 30.
Hooley v. Gieve, 9 Abb. N. C. 8 Aff 82 N.Y.628.
Baker v. Bank, 100 N.Y. 31.

WHEN THE TRUST FUND HAS BEEN WITHDRAWN

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If in such a case as we have be n considering the balance in the bank to the credit of the trustee should fall below the amount of the trust fund; the conclusion that as to the difference between the two, the trust money has been drawn out is inevitable and must be adopted. Thus as to the difference the cestui que trust must take up the scent and endeavor to trace this difference into its present lodgment and there force his claim against it Failing to successfully trace and identify the specific fund or its proceeds, he must content himself with the position of an ordinary creditor.(a) Nor, following the reasoning of the above cases, will subsequent deposits of the trustee's own money give any larger rights, in the absence of special circumstances showing a purpose on the part of the trustee to make up the deficiency in the trust fund, and such a purpose will not be presumed as against general creditors of the trustee. Therefore, unless it be proven that the subsequent deposits were made

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(a) Continental Bank v. Weems,69 Tex. 489;
Cavin v. Gleasman, 105 N. Y. 254.
Philadelphia Bank v. Dowd, 2L. R. Ann. 480.
Neeley v. Rood, 54 Mich. 154.

for the purpose of restoring the trust fund, the equitable charge of the cestui que trust cannot exceed the smallest balance to the trustee's credit, since the deposit of the trust funds. Therefore, if the balance shpuld be wiped out, but for a day, the cestui que trust would be relegated to the position of a simple creditor.(a)

TRUST MONEY A PART OF THE TRUSTEE'S ESTATE.

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It is not necessary to trace the trust fund into some specific property in order to enforce the trust; if it can be traced into the estate of the agent or trustee it is sufficient.(b) Thus, where a bank receives money as agent whichit mixes with its own funds, the principal, on the failure of the bank, is not required to show into what particular assett of the bank this money went, but need only show that it went into such assetts in some form, thus increasing themin that amount. A case upon all fours with this statement is found in People v. Bank

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(a) Cavin v. Gleason, 105 N. Y. 254; Con. Bk. v. Weems, 69 Tex. 489.

(b)McLeod v. Evans, 28 N. W. 173; People v. Bank of Rochester, 96 N. Y. 32.

of Rochester.(a) The defendant bank having discounted certain notes for the firm of S. H. & F. , a depositor with it, and that firm, wishing to anticipate payment, gave to the bank its checks for the amount of the notes less rebate of interest; which checks the bank received and charged in the firm account, and entries were made in the bank books to the effect that the notes were paid. The firm at the time supposed that the bank held the notes, but they had in fact previously sold by it. Before the notes came due the bank failed. Held, that an order requiring the receiver to pay the notes out of the funds in his hands was properly granted; that the transaction between the bank and said firm was not in their relation of debtor and creditor, nor in that of bank and depositor but by it a trust was created, the violation of which constitues a fraud by which the bank could not profit, and to the benefit of which the receiver was not entitled.

This case has been warmly approved of in many of

(a) People v. Bank of Rochester, 96 N. Y. 32.

our sister states. Several cases in Kansas involving facts almost identical with those involved in this case, have been decided in the same way.(a)

The decided weight of authority is, I think, shown by these cases. True there are some cases to the contrary, but they are now in the minority. In the case of the Illinois Trust Bank v. The National Bank of Buffalo,(b) the circuit court for the N. D. of New York reached an opposite result, holding that though the defendant had collected a draft as agent for the plaintiff, and had kept instead of remitting the proceeds, and in a few days had suspended payment, the plaintiff had no priority over other creditors. Several years later our Supreme Court on almost the same statement of facts held contra; andfollowed the case of the People v. Bank of Rochester.(c)

(a) Elliott v. Barnes, 31 Kan. 170; Peak v. Elliot, 30 Kan. 156; Harrison v. Smith, 83 Mo. 210; Stoller v. Coates, 88 Mo. 514; Thompson v. The Gloucester Bank, 8 At. Rep. 97; Bowers v. Evans, 36 N. W. 629; McLeod v. Evans, 28 N. W. 173; Jones v. Kilbreth, 31 N. E. 346; People v. Bank of Dansville, 39 Hun 187.

(b) Trust Bank v. Nat. Bk. of Buffalo, 15 Fed. Rep. 858.

(c) People v. Bank of Dansville, 39 Hun, 187; McColl v. Frazer, 40 Hun 114.

LIMITATIONS ON THE TRUSTEE'S RIGHT TO ENFORCE A PREFERENCE

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While we might reasonably deduce, as a rule from what we have already demonstrated, that, where money has been used to swell the assetts or benefit the estate in any way, a trust may be enforced. This rule seems, at first glance, to be the only logical deduction from the authorities we have been examining, and it has been so declared by a number of courts in our Western states. Such seems not to be the case, according to the more closely reasoned cases. They holdit is not enough that the trust money should have been used to the benefit of the private estate. It must be shown that in some form or another the trust fund went into the property which is sought to be charged, and still forms a part of it, or the cestui que trust has no greater right s than any other creditor.(a) The leading sase on this point, although not the earliest, is Cavin v. Gleason.(b) Here a sum of money had been placed in the hands of one White to be in-

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(a) Continental Bank v. Weems, 69 Tex. 489;
Cavin v. Gleason, 105 N. Y. 254;
Philadelphia Bank v. Dowd, 2 L. R. Ann. 480.
(b) 105 N. Y. 254

vested by him on bond and mortgage. Instead of so doing he used the entire fund except $30, in paying his personal debts, and soon thereafter made an assignment, the $30 coming into the hands of the assignee. It was held by the court reversing the General Term, that the plaintiff could claim priority only to the extent of $30, the amount traced into the hands of the assignee. Andrews, J., in discussing the rule of law, as to tracing trust property, and its proper limitation says:— "If it appears that trust property has been wrongfully converted by the trustee, and constitutes, though in a changed form, a part of the assetts, it would seem to be equitable and in accordance with equitable prihciples that the things into which the trust property has been changed should, if required, be set apart for the trust, or, if separation is impossible, that priority of lien should be adjudged in faver of the trust estate for the value of the trust property or funds or proceeds of the trust property, entering into and constituting a part of the assets. This rule simply asserts the right of the true owner to his own property. But it is a general rule, as well in a court of equity as in a court of law, that, in order to follow trust funds and subject them to the operation of

the trust, they must be identified. A court of equity, in pursuing the inquiry and administering relief, is less hampered by technical difficulties than a court of law; and it may be sufficient to entitle a party to equitable preference in the distribution of a fund in insolvency, that it appears that the fund or property of the insolvent remaining for distribution includes the proceeds of the trust estate, although it may be impossible to point out the precise thing in which the trust fund has been invested, or the precise time when the conversion took place. The authorities require, at least this distinctness in the proof before preference can be awarded."

This case has been severely criticized by several courts holding the opposite theory, upon a cestui que trust's right to a preference in such a case. But with due respect for the opinions of those who criticize it, I think, it is based upon law and equity. At all events it is the law of New York upon the right of a cestui que trust to a preference over simple creditors, and will eventually mark the line beyond which preferences will not be allowed, in most jurisdictions.

CRITICISM OF THE RULE THAT THE RIGHT TO FOLLOW TRUST MONEY CEASES WHEN THE SAME IS MIXED WITH OTHER MONEY.

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The long line of decisions in the several state and Federal courts, which hold that the right to follow trust property ceases, when the means of ascertainment and identification fail, as where the subject matter is turned into money, and mixed and confounded in a general mass of property of the same description, are not based upon law or precedent.

In the case of the Illinois Trust and Savings Bank v. First Nat. Bank of Buffalo,(a) the defendant bank had collected a draft as agent for the Illinois bank, and had kept and mingled the proceeds with its own funds instead of remitting the same, and in a few days suspended payment, and upon a suit by the Illinois bank for the fund so held, it was decided that the plaintiffhad no priority over general creditors.

Wallace, J., saying:- "The cases hold that if a trustee has converted a trust fund into money and mingled the proceeds with his other moneys, so that they

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(a) Ill. Trust and Sav. Bank v. 1st Nat. Bk. of Buffalo, 15 Fed. 858.

were indistinguishable, the cestui que trust cannot follow his fund into the hands of an assignee in bankruptcy, or of an executor of such trustee, but must occupy the position of a general creditor of the estate." The court then cites as authority for its statement the case of Whitcomb v. Jacobs,[a] and Story on Equity Jurisprudence.

Now upon an investigation of the authorities cited in Story as sustaining this proposition I find three cases,[b] and strange to say not one of them is an authority for the proposition laid down in Story. Indeed one of the cases is first class authority for the converse proposition. This case is Copeman v. Gallant, which I here reproduce in full:—

"A. made a bill of sale of some leases and personal estate to B. and C. in trust to pay A's debts; at first B. acted in the trust but afterwards C. took the whole into his possession, and acted alone, and became a bankrupt. Upon which A. brought a bill against C. and others under the commission of bankruptcy to account touch-

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(a)Whitcomb v. Jacobs, 1 Salk. 160; Story on Eq. Juris. Sec. 1259;

(b) Copeman v. Gallant, 1 P. Wms. 319-20; Ryall v. Roole, 1 Atk. 172; Leigh v. Macauley, 1 Younge & Coll. 260-5.

ing the personal estate of A. so assigned in trust for the payment of his debts, as aforesaid. Therefore the assignees under the commision sued out against C. were ordered to account for all the estate of A. which the court declared per Lord Couper, should not be liable to the bankruptcy of C. "

Upon the case of Whitcomb v. Jacobs and Ryall v. Rolle[a] as authority for Story's proposition, Jessell, M. R, speaking particularly of the latter case has this to say; "It is the same as Whitcomb v. Jacobs(1 Salk. 160). You may follow the goods, but you cannot follow the money. That is no longer law." Without taking up more space, it is sufficient to say, that a reading of Leigh v. Macauley, will show it to be an authority, if one at all, sustaining the opposite to what Story cites it to sustain.

My slight investigation leads me to the conclusion, that text book writers, even of the conceded ability of the great Story, are responsible for a great many of the mistakes of our courts, relying, as they apparently do,

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(a) Whitcomb v. Jacobs, 1 Salk. 160;
Ryall v. Rolle, 1 Atk. 172.
Knatchbull v. Hallett, L. R. 13 Ch. Div. 696.

upon the unsupported dicta of text book writers.

In Pennsylvania the first case involving the facts I have been considering is decided upon the authority of Story's Equity Jurisprudence, Sec. 1259. Again in Maine and Indiana (a) I find the same state of affairs exist. All the later cases arising in these states follow the same rule. Thus it is seen how one great text-book writer has led the courts of a number of our most prominent states astray from the course of authority and justice.

(a) Thompson's Appeal, 22 Pa. St. 16;
Hopkin's Appeal, 8 Cen. Rep. 860;
McComas v. Long 85 Ind. 549;
Goodell v. Buck, 67 Me. 514