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Banks and Banking -- Insolvency -- Recovery of Funds Held by Insolvent Bank as Trustee Ex Maleficio

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assuming the equitable viewpoint in "regarding as done that which ought to be done."

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Banks and Banking—Insolvency—Recovery of Funds Held by Insolvent Bank as Trustee Ex Maleficio.

The trust department of the *C.* Bank had approximately two hundred small trust accounts, whose uninvested funds had been included in a general deposit maintained by it in the commercial department. To facilitate investment the trust department consolidated these small accounts into what it termed a "Mortgage Pool Account," with itself as trustee, and each estate was credited with a participation certificate to the extent of its contribution. A consolidated account totaling $155,940 was thereby built up out of which the bank purchased from its own departments, affiliated investment companies, and elsewhere securities aggregating $151,867.34, leaving a cash credit in the pool account of $4,072.66. Subsequently the bank closed its doors, and the plaintiffs were appointed to succeed it as trustees for the "Mortgage Pool Account." In this action it was alleged and to some extent proved that the securities sold to the pool account then had a market value of $60,746.93 less than the sums actually paid therefor. On this basis plaintiffs sought to impress the bank's cash in the hands of the Commissioner of Banks with a constructive trust in favor of the estates represented by them. *Held,* that the judgment of nonsuit be affirmed.[1]

It is well settled that a fiduciary may be declared a trustee *ex maleficio* of any profits which he may have acquired through his dealings with the funds committed to his care,[2] and, since creditors are not *bona fide* purchasers, the rule is applicable to the receiver[3] of an insolvent trustee. Such a proceeding, however, is not, as is so often stated, one to establish a preference, but, rather, an action brought to restore to the *cestui* that which equity considers his own.[4] Success will depend upon the proof of two facts: (a) that the alleged trustee, whether express or *ex delicto,* has at the outset acquired something of value the beneficial ownership of which remains, either by express or implied provisions of the parties, or in the contemplation of law, in another; and (b) that

[1] Cocke v. Hood, 207 N. C. 14, 175 S. E. 841 (1934).

[2] 3 POMEROY, EQUITY JURISPRUDENCE (4th ed. 1918) §§1052, 1058; Notes (1931) 44 HARV. L. REV. 1281; (1927) 43 L. Q. REV. 438.

[3] The same principles would, of course, be applicable to an assignee for benefit of creditors or trustee in bankruptcy.

[4] Powesheik County v. Merchants' Nat. Bank, 220 N. W. 63, 209 Iowa 467, 228 N. W. 32 (1928); *cf.* Capital Nat. Bank v. First Nat. Bank, 172 U. S. 425, 19 Sup. Ct. 202, 43 L. ed. 502 (1898) (Such an action against the receiver of a national bank raises no federal question.)

the original trustee has so retained this property that in some form it has passed with his estate into the hands of the receiver.[5] These principles, though easily stated, are so general in their scope that their delimitation by various rules of application has been found necessary.

At common law it was required that the *cestui* trace and identify his specific property, or its product, in the hands of the trustee.[6] Thus, if the *res* was money, and this money had been mingled with that of the trustee, the *cestui* was reduced to the status of a mere creditor, since his money had no "ear mark" and could no longer be traced. With the advent of modern commercial practices this rule, though simple to apply, as often as not proved conducive to gross injustice, and it was discarded by the famous English case of *In Re Hallett's Estate,*[7] decided in 1879. It was there held that, where the trustee has mingled trust money with his own, the trust was not thereby terminated, but that the *cestui* was entitled to the proportion of the fund which his money had contributed,[8] and moreover, that, should the trustee withdraw his money from this fund, it would be presumed that he intended first to withdraw his own money before dissipating the trust.[9] Thus the *cestui* was entitled to recover the amount of the trust, not to exceed the lowest amount which the fund had contained between the time of the commingling and the commencement of the action.[10] This case has been accorded the almost unanimous approval of the American courts.[11] However, there

[5] Note (1928) 13 MINN. L. REV. 39.

[6] *Ex Parte* Dale & Co., 11 Ch. Div. 772 (1879); Mills v. Post, 76 Mo. 426 (1882); Thompson's Appeal, 22 Pa. 16 (1853).

[7] 13 Ch. Div. 696 (1879).

[8] It would seem that the *cestui* is given a choice between two remedies: (a) an equitable lien not to exceed the lowest point which the fund has reached between the wrongful commingling and the receivership, or (b) under the constructive trust theory, he may be considered as beneficial part-owner of the fund, his interest to be proportionate to the contribution which his property has made thereto. Williston, *The Right to Follow Trust Property when Confused with Other Property* (1888) 2 HARV. L. REV. 28; Ames, *Following Misappropriated Property into Its Product* (1906) 19 HARV. L. REV. 511; Scott, *The Right to Follow Money Wrongfully Mingled with Other Money* (1913) 27 HARV. L. REV. 125.

[9] It was ruled at one time that the "first money in first money out" doctrine was applicable in this situation. Pennell v. Duffell, 4 De G., M. & G. 372 (Ch. 1853).

[10] It is to be remembered, however, that the presumption is one, not of law, but of fact, and consequently may be rebutted. Thus, where the trustee has withdrawn more than his own credit, the presumption is rebutted to the extent of his inroads upon the trust fund. Likewise, there are other circumstances which have been held to successfully rebut the presumption. Where the first withdrawals from the commingled fund were preserved and subsequent withdrawals dissipated, it was held that the trust attached to the proceeds of the first withdrawals. Brennan v. Tillinghast, 201 Fed. 609 (C. C. A. 6th, 1913). Also a showing that the trust money was obtained by the bank through the willful and criminal acts of its agents has been held sufficient to rebut the presumption. *In re* First State Bank, 152 Iowa 724, 133 N. W. 354 (1911).

[11] Central Nat. Bank v. Connecticut Mut. Life Ins. Co., 104 U. S. 54, 26 L. ed. 693 (1881); BOGERT, TRUSTS (1921) pp. 521-535; Note (1929) 16 VA. L. REV. 392.

are some courts which have extended the ruling to a rather illogical conclusion, namely, that the trust will attach to the entire estate so long as it may be shown that the estate was, at the outset, augmented by the commingling, and that the trust fund has not been dissipated, in this latter regard the *cestui* being aided by the presumption mentioned above.[12] But the majority have more conservatively required that the trust money be traced into some particular fund or asset before equity will lend its aid.[13]

The North Carolina law on the subject is not entirely clear. In the earlier cases our Court definitely espoused the old "ear mark" precept, and the commingling of trust funds dissipated the trust.[14] However, it was subsequently decided that a special deposit, or a deposit for a specific purpose,[15] was entitled to a "preference" in the distribution of the assets of an insolvent bank.[16] It would seem that, since the reason for this holding was that these types of deposits were impressed with a trust, the same rule would apply where the bank received the money in pursuance of a strict trusteeship, but that apparently has not been the situation. Reasonable distinctions in this regard are not readily discern-

[12] Meyers v. Board of Education of City of Clay Center, 51 Kan. 87, 32 Pac. 658 (1893); Eastman v. Farmers' State Bank, 175 Minn. 336, 221 N. W. 236 (1928); State v. Page Bank, 322 Mo. 29, 14 S. W. (2d) 597 (1929).

[13] Schuyler v. Littlefield, 232 U. S. 707, 34 Sup. Ct. 466, 58 L. ed. 806 (1913); Board of Com'rs of Crawford County v. Strawn, 157 Fed. 49 (C. C. A. 6th, 1907); Myers v. Matusek, 98 Fla. 1126, 125 So. 360 (1929); Leach v. Iowa State Sav. Bank, 204 Iowa 497, 215 N. W. 728 (1927); *In re* State Bank of Portland, 110 Ore. 61, 222 Pac. 740 (1924); *cf.* Peurifoy v. Boswell, 162 S. C. 107, 160 S. E. 156 (1931). Townsend, *Tracing Technique in Bank Preference Cases* (1933) 7 U. OF CIN. L. REV. 201.

[14] First Nat. Bank v. Davis, 114 N. C. 344, 19 S. E. 280 (1894); Commercial & Farmers' Nat. Bank v. Davis, 115 N. C. 226, 20 S. E. 370 (1894); Corporation Commission v. Bank, 137 N. C. 697, 50 S. E. 308 (1905); Virginia-Carolina Chemical Co. v. Rogers, 172 N. C. 154, 90 S. E. 129 (1916); *cf.* Commercial Nat. Bank v. Armstrong, 148 U. S. 50, 13 Sup. Ct. 533, 37 L. ed. 363 (1892); Whitley v. Foy, 59 N. C. 34, 78 Am. Dec. 236 (1860).

Accord: J. Allen Smith & Co. v. Montgomery, 209 Ala. 100, 95 So. 291 (1923); Acuntius v. Steneck Trust Co., 111 N. J. Eq. 81, 161 Atl. 349 (1932).

[15] A special deposit is created when money, or other property, is placed with the bank for safe keeping merely, and not with the intention that it is to be mingled with the other money in the bank. Thus a type of bailment exists. While a deposit for a specific purpose is, as the name implies, one made under an agreement that it is to be put to some designated use, as the payment of interest on some obligation of the depositor, the purchase of certain securities, etc. See Notes (1923) 12 CALIF. L. REV. 214; (1928) 13 CORN. L. Q. 603.

[16] Corporation Commission v. Merchants' Bank & Trust Co., 194 N. C. 125, 138 S. E. 530 (1927); Parker v. Central Bank & Trust Co., 202 N. C. 230, 162 S. E. 564 (1932) commented upon (1932) 10 N. C. L. REV. 381, (1932) 38 W. VA. L. Q. 365; Heckstall v. Citizens Bank, 202 N. C. 350, 163 S. E. 107 (1932); Flack v. Hood, 204 N. C. 337, 168 S. E. 520 (1933); Smith v. Hood, 204 N. C. 343, 168 S. E. 527 (1933); Asheville Safe Deposit Co. v. Hood, 204 N. C. 346, 168 S. E. 524 (1933); Real Estate Trust Co. v. Hood, 204 N. C. 778, 168 S. E. 530 (1933); Lawrence v. Hood, 205 N. C. 268, 170 S. E. 926 (1933); Brunswick County v. North Carolina Bank & Trust Co., 206 N. C. 127, 173 S. E. 327 (1934).

ible, yet the cases in which recovery has been allowed have usually, but not always,[17] dealt with special deposits or deposits for a specific purpose,[18] while those in which recovery has been denied have been held to involve unidentifiable trust funds.[19]

The inconsistencies of the North Carolina cases are clearly indicated by a contrast with the instant case. In the *Lauerhass Case,*[20] decided last year, suit was brought by the holder of participation certificates in this same "Mortgage Pool Account." The bank, after administration, had been acting in the capacity of trustee of an estate which the plaintiff had inherited from his mother, and among the securities purchased by the bank in such capacity were notes, bought from itself, and two participation certificates. The bank's combined profits from these transactions, amounting to some $11,000, were declared a preferred claim. As the opinion is *per curiam,* it is difficult to ascertain the theory of the holding, but it was declared to be upon the authority of *Flack v. Hood,*[21] which is one of the specific deposit cases.

In the instant case, however, this theory is declared inapplicable on the grounds that the transaction was no more than a mere shifting of credits which did not augment the assets of the bank. Though there is some authority to the contrary,[22] North Carolina is in line with the United States Supreme Court, and a majority of states elsewhere, in holding that a check upon a deposit in the trustee bank itself is merely a shifting of credits, and, therefore, even when presented to the bank for the purpose of creating a trust or special deposit, will not give rise to a preferential claim upon the bank's insolvency.[23] Since the securities in the present case were paid for largely by checks drawn by the trust department upon deposits in the commercial department, these authori-

[17] Peoples Nat. Bank v. Waggoner, 185 N. C. 297 117 S. E. 6 (1923).

[18] See cases cited in note 16, *supra.*

[19] Roebuck v. National Surety Co., 200 N. C. 196, 156 S. E. 531 (1930); First & Citizens Nat. Bank v. Corporation Commission, 201 N. C. 381, 160 S. E. 360 (1931); Hicks v. Corporation Commission, 201 N. C. 819, 161 S. E. 545 (1931); *In re* Gardner Banking & Trust Co., 204 N. C. 791, 168 S. E. 813 (1933); *cf.* Underwood v. Hood, 205 N. C. 399, 171 S. E. 364 (1933).

[20] Lauerhass v. Hood, 205 N. C. 190, 170 S. E. 655 (1933).

[21] 204 N. C. 337, 168 S. E. 520 (1933).

[22] This is upon the theory that the transaction is tantamount to the depositor's withdrawing his money from the bank and handing it back in the form of a trust or special deposit. Thus, if the depositor does not have a balance sufficient to cover the check, the assets of the bank will not be augmented. Matzen v. Johnson, 127 Kan. 139, 272 Pac. 164 (1928).

[23] Blakey v. Brinson, 286 U. S. 254, 52 Sup. Ct. 516, 76 L. ed. 1089 (1932); Williams v. Hood, 204 N. C. 140, 167 S. E. 574 (1933); *In re* Bank of Pender, 204 N. C. 143, 167 S. E. 561 (1933); Dupree v. Harrell, 205 N. C. 595, 172 S. E. 214 (1933); *cf.* Zachery v. Hood, 205 N. C. 194, 170 S. E. 641 (1933) (Attachment of husband's deposit in wife's action for subsistence, and judgment that it be paid to plaintiff from time to time under court order, changed deposit from general to special).

ties might be controlling were it not for the fact that the money here alleged to be held under a trust was already the subject of an express trust before these checks were issued. It would seem that if the original trust money "had a string tied to it or an invisible legal fence about it, setting it apart from the general funds of the bank,"[24] it would take something more than a mere shifting of credits and exchange of checks between commercial and trust departments to sever the string or destroy the fence. The problem is not whether the bank got the money, but whether it got rid of it.[25]

JOEL B. ADAMS.

Conflict of Laws—Insurance—Validity of Statutes Localizing Insurance Contracts.

The decision of the Supreme Court of the United States in the case of *Hartford Accident & Indemnity Co. v. Delta & Pine Land Co.*[1] thwarted an attempt of the State of Mississippi to draw within the dominion of its local laws, by statutory enactment,[2] "all contracts of insurance on property, lives, or interests in" Mississippi. The device employed was a legislative declaration that all such contracts "shall be deemed to be made therein."

North Carolina is one of the few jurisdictions which have attempted in this way to "eliminate" the conflict of law between states,[3] and the

[24] First Nat. Bank v. Hood, 204 N. C. 351, 353, 168 S. E. 528, 529 (1933).

[25] In the case of Cocke v. Hood, 205 N. C. 832, 170 S. E. 637 (1933), the court experienced no difficulty in giving these same trustees a preferential claim for the $4,072.66 uninvested cash balance to the credit of the "Mortgage Pool Account." This was a byproduct of the same bookkeeping transaction. But *cf.* Edisto Nat. Bank v. Bryant, 72 F. (2d) 917 (C. C. A. 4th, 1934) (Funds on deposit before bank appointed co-executor held not to create trust in hands of receiver upon bank's subsequent insolvency).

[1] 54 Sup. Ct. 634 (U. S. 1934).

[2] MISS. CODE ANN. (1930) §5131.

[3] N. C. CODE ANN. (Michie, 1931) §6287. For cases in which this section has been applied or referred to, but not discussed, see Fountain & Herrington v. Mutual Life Ins. Co., 55 Fed. (2d) 120 (C. C. A. 4th, 1932); Horton v. Insurance Co., 122 N. C. 498, 29 S. E. 944, (1898); Blackwell v. Life Ass'n., 141 N. C. 117, 53 S. E. 833 (1906); Williams v. Life Ass'n., 145 N. C. 128, 58 S. E. 802 (1907); Williams v. Order of Heptasophs, 172 N. C. 787, 90 S. E. 888 (1916); Wilson v. Order of Heptasophs, 174 N. C. 628, 94 S. E. 443 (1917).

The above section also contains a provision that "all contracts of insurance the applications for which are taken within the state shall be deemed to have been made within this state and are subject to the laws thereof." This language will be found substantially duplicated in ALA. CODE (Michie, 1928) §8375. While this provision is not specifically dealt with in the text discussion, it is believed that the reasoning of the discussion adequately covers it.

Massachusetts at one time had a provision substantially like that of Mississippi. (Acts 1894 c. 522, §3). It was construed in Stone v. Old Colony St. Ry. Co., 212 Mass. 459, 99 N. E. 218 (1912) as not intended to regulate or prohibit contracts of insurance made outside Massachusetts. The present Massachu-