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Basic Principles Underlying Duty of Loyalty

*by Judge Earl R. Hoover**
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When the Nation's 25th and 47th largest banks, The Union Trust Co. and The Guardian Trust Co. of Cleveland, cracked up in 1933, Ohio's Supreme Court cracked down on the violation of an old but little known rule of fiduciary law. Two test cases, *In re Binder,* 137 O. S. 26, and *In re Trusteeship of Stone,* 138 O. S. 293, drew into duel more than a dozen leading law firms. Settlement of about 500 claims awaited the outcome. When smoke of battle lifted, the banks' liquidators had to pay out several million dollars. The rule so expensive to violate is the duty of undivided loyalty.

Airing of the principles underlying the rule seems warranted. The rule necessarily is harsh, almost iron-clad. Defenses are few. A defendant inevitably cries on the court's shoulder the same old discredited excuses. Unless the court understands the reasons for the rule, such tears may sway it. Because violation is so costly, a client needs preventive advice. Because the loss may remain on the victim unless his counsel is familiar with the rule's reasons, counsel must know them. Importance also attaches because the rule is violated every day and it applies to all of the many fiduciary relations.[1]

Because the two Cleveland test cases involved testamentary trusts and the trustee's dealing with the trust property and not with the beneficiaries, this examination is conducted primarily from that angle although other situations will be called to testify.

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[1] *Agents,* 3 C. J. S. 6 *et seq.*; *Auctioneers,* 7 C. J. S. 1259; *Administrators and Executors,* 33 C. J. S. 1243; *Appraisers, Armstrong v. Huston's Heirs,* 8 Ohio 552; *Attorneys,* 7 C. J. S. 823 *et seq.*; *Banks,* 9 C. J. S. 241 *et seq.*, 530; *Brokers,* 12 C. J. S. 100 *et seq.*; *Corporate Directors and Officers,* 19 C. J. S. 161 *et seq.*; *Guardians,* 39 C. J. S. 162 *et seq.*; *Joint Adventurers,* 30 Am. Jur. 695 *et seq.*; *Judicial Sales,* 31 Am. Jur. 474; *Partners,* 40 Am. Jur. 221 *et seq.*; *Public Officers,* 43 Am. Jur. 81-82, 103 *et seq.*; *Receivers,* 45 Am. Jur. 112-113; *Trustees,* 54 Am. Jur. 246 *et seq.*

I. Definition of Duty of Loyalty—Avoiding Conflicts of Interest—Maintaining Disinterested Judgment.

A good starting line is the *Restatement of Trusts,* Sec. 170(1):

> "The trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary"

Yet if you haven't bumped into a loyalty situation, you may find it a little difficult with that definition to tell a trustee just what he can or cannot do. For a practical understanding, it helps to get down to cases. Listen to some:

> *Barker v. First National Bank,* 20 F. Supp. 185, 187: "In all his acts as trustee, he must display complete loyalty to the interests of his cestui que trust. All personal or selfish interests and all consideration of the interests of third parties must be excluded. His must be an undivided loyalty."
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> *Fidelity & Deposit Co. v. Freud,* 115 Md. 29, 33: "It was said by Lord Ellenborough * * * 'no man should be allowed to have an interest against his duty' * * * no one having fiduciary duties to discharge should 'be allowed to enter into any engagements in which he has, or can have, a personal interest conflicting, or which may possibly conflict, with the interests of those whom he is bound to protect.' "
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> *Whichcote v. Lawrence,* 3 Ves. Jr. 740, 750: "He who undertakes to act for another in any matter, shall not in the same matter act for himself."
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> *Gates v. Plainfield Trust Co.,* 121 N. J. Eq. 460, 487: "It is a principle universally recognized, as founded not only on common business morality, but sound public policy, that persons who act in a representative capacity, whether styled executors, administrators, trustees or agents, are not permitted, in the performance of their duties, to put themselves in a position antagonistic to the interests of those whom they represent."
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> *Matter of Ryan,* 291 N. Y. 376, 407: "Under the circumstances the corporate trustee had placed itself in a position where its interest was or might be in conflict with its duty. Either is sufficient to cause sur-charging of the trustee."
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> *Dufford v. Nowakoski,* 125 N. J. Eq. 262, 269: "The rule which forbids those who fill fiduciary positions from making use of them to benefit their personal interests * * * extends to all transactions, where the individual may be brought into conflict with his acts in his fiduciary capacity * * *. Where the possibility of such conflict exists, there is the danger intended to be guarded against by the absoluteness of the rule."

> *Magruder v. Drury,* 235 U. S. 106, 119: "The intention is to provide against any possible self-interest exercising an influence which can interfere with the faithful discharge of the duty which is owing in a fiduciary capacity."
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> *Smith v. Tolversen,* 190 Minn. 410, 413, saying that it is a trustee's "primary duty not to allow his interest as an individual even the opportunity of conflict with his interest as trustee."
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> *Thurston v. Nashville & Amer. Tr. Co.,* 32 F. Supp. 929, 936: "these salutary rules of equity * * * guarantee * * * that beneficiaries * * * shall at all times have the benefit of unbiased and disinterested judgment of the trustee * * *."
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> *Pyle v. Pyle,* 122 N. Y. S. 256, 259, aff'd. 199 N. Y. 538: "He owes an undivided duty to his beneficiary, and he must not, under any circumstances, place himself in a position whereby his personal interest will come in conflict with the interest of his cestui que trust * * * . The purpose * * * is to require a trustee to assume a position where his every act is above suspicion and the trust estate, and it alone, can receive, not only his best services, but his unbiased and uninfluenced judgment.
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> *Parsons v. Wysor,* 180 Va. 84, Syl. 4: "A trustee, in accepting and managing the trust property, must keep himself in a position to form an unbiased judgment upon questions affecting the property under his control. An unbiased judgment cannot be formed and a sound discretion cannot be exercised, within the meaning of the rule, if the trustee has a personal interest in the transaction or represents an interest therein adverse to the trust estate." [2]

From these you gather a general running description of a trustee's duty of loyalty as being something like this:

> A trustee must administer his trust solely in the interest of the beneficiary. He must exclude all self-interest, as well as all consideration of the welfare of third persons. He is prohibited from placing himself, or allowing himself to be placed in a position where interests of his own or of others conflict or may possibly conflict with the interest of his trust. He cannot have an interest that is against his duty. He must eliminate all adverse interests so he can render a disinterested judgment in trust affairs.

To one who has read thousands of cases involving loyalty and who has handled about 200 cases or claims involving it, the search for a rule of thumb to detect violation, led me to ask two

[2] See also 3 Bogert 1722, 1730, 1514; 2 Scott 856; 65 C. J. 652; 49 Harv. L. Rev. 522.

simple questions: (1) Does the trustee have a conflict of interest? and (2) Can the trustee render a disinterested judgment?

The duty of loyalty aims to eradicate conflict of interest. The existence of conflict is usually a violation. Conflict destroys an essential ingredient without which a fiduciary relation cannot function—disinterested judgment.

If a fiduciary's judgment is not disinterested, there is conflict of interest and generally a breach of loyalty. As long ago as 1838, the Ohio Supreme Court sensed this vital point when it said (*Armstrong v. Huston's Heirs,* 8 Ohio 552, 554):

> "Where the law creates fiduciary relations, it seeks to prevent the abuse of confidence, by insuring the disinterestedness of its agents."

A century later in the *Stone* case, 138 O. S. 293, 302, that court had no difficulty in getting to the nub of the rule again:

> "Since a trustee is a fiduciary of the highest order and is charged with the utmost fidelity to his trust, he must refrain from creating situations where his own interests conflict with those of the trust, and from doing those things which would tend to interfere with the exercise of a wholly disinterested and independent judgment."

Though the rule of "undivided loyalty" is ancient, it has not been known by that particular name very long. Counsel in the Cleveland litigation tried to pass it off as a new catch phrase coined in 1926 by Judge Cardozo in *Wendt v. Fischer,* 243 N. Y. 439, 444. If Cardozo had immortalized the rule under the label *"duty of disinterested judgment,"* he might have rendered even greater service in bringing it from the cloistered chamber down to the arena where not only the practitioner but the fiduciary could readily comprehend it.

II. Reasons for Duty of Loyalty.

The combination of three dangerous factors led courts to impose the duty of loyalty upon a trustee: (1) the trust relation readily lends itself to secret exploitation, (2) a trustee with a conflict of interest is bound to exploit his trust and (3) the chance of discovering such exploitation is remote.

The Trust Relation Readily Lends Itself to Secret Exploitation. The relation between trustee and beneficiary is a fiduciary one. The duty to avoid conflicts of interest is based upon the peculiar nature of this relation. It is not a relation of "arms length" between equals. Ordinary business ethics do not apply. There is utter inequality, the trustee being superior and the beneficiary inferior. There is great intimacy, disclosure of secrets, entrusting of power. The trustee's strategic position places him on the inside where he can manipulate, while the beneficiary, being on the outside, cannot know everything that is going on. Moreover, the beneficiary is off his guard.

Indeed the success of the relation is dependent upon the beneficiary being freed from the necessity of being on guard or of taking precaution step by step. What practical good would the relation be if the beneficiary had to be present to watch every move? Nevertheless, because of this, the relation readily lends itself to secret exploitation.[3]

A Trustee With a Conflict of Interest Is Bound to Exploit His Trust. Not only does the trust relation readily lend itself to secret exploitation, but a trustee with conflicting interests will inevitably exploit his trust. No man can serve two masters with conflicting interests.[4]

In *People v. Central Republic Trust Co.,* 20 N. E. 2d (Ill. App.) 999, 1004-1005, the court quotes *Thorp v. McCullum,* 6 Ill. 614:

> "Man cannot serve two masters; he will forsake the one and cleave to the other. Between two conflicting interests, it is easy to foresee, and all experience has shown whose interests will be neglected and sacrificed."

This truth is grounded on the well-known weakness of human nature. When a man's personal interest is involved, he cannot by his very nature be fair. It is inevitable that in most cases he will favor himself. Duty is bound to be sacrificed to self-interest. If a fiduciary undertakes to act when he has an adverse interest, Courts say the motive of his action must be ascribed to self-interest and not to a sense of duty. In *Estate of McLellan,* 8 Cal. 2nd 49, 54, the court describes a fiduciary who has a conflict of interest:

> "His duty calls upon him to act for the best interests of his principal; his self-interest prompts him to make the best

[3] 1 Bogert; 3 Bogert 1505, 1508; 2 Pomeroy's Eq. Jur. (4th ed.) 2039; 1 Page's Contracts (2nd ed.) Sec. 329; Ballentine's Law Dict. (1930 ed.) "Fiduciary Relation"; Meinhard v. Salmon, 249 N. Y. 458, 464; In re Binder, 137 O. S. 26, 37-38; 1 Lawrence's Eq. Jur. (1929 ed.) 453-454.

[4] McAllister v. McAllister, 184 A. (N. J. Eq.) 723, 727; In re Harbeck's Estate, 254 N. Y. S. 312, 320; Gates v. Plainfield Trust Co., 121 N. J. Eq. 460, 485-486, aff'd 194 A. (N. J.) 65; Piatt v. Longworth, 27 O. S. 159, 195.

bargain for himself. Humanity is so constituted that when conflicting interests arise the temptation is usually too great to be overcome; and duty is sacrificed to interest."

In *Loft, Inc. v. Guth,* 2 A. 2d (Del. Ch) 225, 239, it is said: "This case is but one of a line of cases which * * * hold that when a conflict between duty and self-interest arises in the breast of a person holding a fiduciary relation, the only safe rule to adopt in the interest of integrity of trust and quasi-trust relations, is the rule that ascribes to self-interest rather than to a sense of duty the motive power of ensuing action."

In *Rowland v. Kable,* 174 Va. 343, 366-367, it is said: "One who is entrusted with the business of another cannot be allowed to make that business an object of interest to himself * * *. The two positions impose different obligations, and their union would at once raise a conflict between interest and duty; and, constituted as humanity is, in the majority of cases duty would be overborne in the struggle."

The Chance of Discovering Such Exploitation Is Remote. Because of the inequality of the fiduciary relation, this inevitable exploitation by a fiduciary who has a conflict of interest cannot be discovered. I call it "indiscoverable fraud." Concealment is easy. Hence, to allow conflicts of interest would be to assure exploitation that cannot be discovered. Courts admit their helplessness to discover the inevitable fraud and exploitation that are bound to exist in most cases when self-interest sneaks into fiduciary relations. And, in most cases, it is a sneak play. However high his standing in the community, however good his afterthought pretensions at the trial, in most cases the trustee with adverse interests just didn't tell the beneficiary the whole story about his adverse interests while he was acting. Courts condemn adverse interests in the most deadly terms saying they are "poisonous" and that the fraud is "inaccessible to the eye of the court." One court says nine-tenths of these frauds cannot be detected; another says it is ninety-nine out of one hundred. Listen to the authorities:

4 *Kent's Commentaries* (9th ed.) 503: "The rule is founded on the danger of imposition and the presumption of the existence of fraud, inaccessible to the eye of the court."

Wilmington Trust Co. v. Carrow, 14 Del. Ch. 290, 294: "In view of the difficulty of unraveling fraud in these transactions, the policy of the rule is, to exclude the possibility of it by making the prohibition absolute."

Munson v. Railroad, 103 N. Y. 59, 73-74: "The law permits no one to act in such inconsistent relations * * *. It prevents frauds by making them as far as may be impossible, knowing that real motives often elude the most searching inquiry."

Clay v. Thomas, 178 Ky. 199, 204-205: "In such case the danger of yielding to temptation is so imminent, and the security against discovery is so great that * * * equity, at the instance of the cestui * * * if he applies in a reasonable time, will set aside the sale as of course."

Stewart v. R. R., 38 N. J. Law 505, 522-523: "There intervened before his (the fiduciary's) eyes the opposing interest of himself. The vice which inheres in the judgment of a judge in his own cause, contaminates the contract; the mind of the * * * trustee is the forum in which he and his cestui * * * are urging their rival claims, and when his opposing litigant (the beneficiary) appeals from the judgment there pronounced, that judgment must fall. It matters not that the contract seems a fair one. Fraud is too cunning and evasive for courts to establish a rule that invites its presence. There may be isolated cases in which the trustee is willing to make a contract on more favorable terms for the cestui * * * than anyone else, but the opportunity for self-advancement, at the expense of those whose concern he has in charge, and under circumstances where concealment is easy, are so much more numerous than these isolated cases, that in declaring a rule the latter are not worthy of consideration."

Piatt v. Longworth, 27 O. S. 159, 195-196: "In such cases the court will not suffer itself to be drawn aside from the application of this equitable rule by any attempt on the part of the purchasers to establish the fairness of the purchase, because of the danger of imposition and the presumption of fraud, inaccessible to the eye of the court * * * the sale will be set aside, not because there is fraud, but because there may be fraud. However innocent the purchaser in this case, it is poisonous in its consequences."

"There may be fraud and the party unable to prove it. It is to guard against the uncertainty and hazard of abuse, and to remove the trustee from temptation, that the rule permits the cestui que trust to come at his option and without showing actual injury and insist on the experiment of having another sale."

People v. Central Republic Trust Co., 20 N. E. 2d (Ill. A.) 999, 1004-1005, quoting *Thorp v. McCullum,* 6 Ill. 614: "The temptation of self interest is too powerful and insinuating to be trusted * * * The temptation * * * must be removed * * * for it would be impossible, in many cases, to ferret out the secret knowledge of facts and advantages of the purchaser * * *."

Conway v. Green's Admr., 1 Har. & J. (Md.) 151, 152: "The chancellor earnestly wishes it understood that, in his opinion, no rule of this court, adopted for the prevention of fraud ought to be relaxed; but that, on the contrary, rules against fraud ought to be as strict as possible * * *. If such sales were allowed, there would be practiced frauds impossible to be detected, as indeed are more than nine in ten of the frauds which are perpetrated."

Lawrence's Equity Jurisprudence (1929) 577: "The cestui is not bound to prove, nor the court to judge, that the trustee has made a bargain advantageous to himself. Though you may see in a particular case that he has not made advantage, it is impossible to examine sufficiently in ninety-nine cases out of a hundred whether he has made advantage or not."

Harrison v. Manson, 95 Va. 593, 598, quoting Lord Eldon: "* * * the purchase is not permitted in any case, however honest the circumstances; the general interests of justice requiring it to be destroyed in every instance, as no Court is equal to the examination and ascertainment of the truth in much the greater number of cases." [5]

III. Inflexibility of the Rule. Exploded Defenses.

The most striking feature of the rule of undivided loyalty is the persistency with which courts refuse to recognize exceptions to it. Disloyal trustees are persistent too—persistent in concocting new, ingenious defenses and persistent in picking off of the rubbish heap and trying to use again a defense junked in a hundred cases during a hundred years.

Somehow such a trustee will assume a halo complex and insist that an exception be made for him; but courts wisely realize that the rule must be adamant and that to allow exceptions to chip it away piecemeal would destroy it just as effectively as if its entirety were shattered with one sledgehammer blow. They therefore declare it "inflexible," "rigid," "stubborn," "strict," "incapable of relaxation." In emphasizing this feature, Judge Cardozo coined another classic (*Meinhard v. Salmon,* 249 N. Y. 458, 464):

"Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the disintegrating erosion of particular exceptions."

[5] See also, 3 Bogert 1515-1518; 1 Story's Eq. Jur. (14th ed.) Sec. 446; Lewin on Trusts (13th ed.) 1108; North Baltimore Bldg. Ass'n. v. Caldwell, 25 Md. 420, 424; Barrington v. Alexander, 6 O. S. 189, syl. 2; Caldwell v. Caldwell, 45 O. S. 512, 522.

In *Munson v. R. R.,* 103 N. Y. 59, 74, it is said:

"The value of the rule * * * lies to a great extent in its stubbornness and inflexibility." [6]

This is readily understood. The rule is designed to cope with a fraud that is inevitable and indiscoverable when conflicts of interest intrude into fiduciary relations. If a door is opened through an exception, these predatory conflicts will slip through and work their stealthy, indiscoverable exploitation. Protection can be achieved only by shutting all doors.

To understand the rule fully it is helpful to examine some of the defenses that have been tested and found wanting.

Good Faith. A disloyal trustee always urges his good faith. Almost universally the cases—hundreds of them—hold that this is not a defense. So immaterial is good faith that courts won't even inquire into it. In *Ottawa Banking & Trust Co. v. Crookston State Bank,* 185 Minn. 22, 23-24, it is said:

"* * * the law will not permit the trustee to debate his good faith * * *. The law will not put him to the test. It will not inquire."

It matters not that there was good faith (*In re Binder,* 137 O. S. 11, 57, syl. 11; *Wendt v. Fischer,* 243 N. Y. 439, 443), no bad faith (*Matter of Ryan,* 291 N. Y. 376, 386), innocence (*Caldwell v. Caldwell,* 45 O. S. 512, 522), no bad motives (*Heirs of Massie v. Matthew's Executors,* 12 Ohio 352, 354), no reason to distrust integrity (*Armstrong v. Huston's Heirs,* 8 Ohio 552, 554), bona fides (*Davoue v. Fanning,* 2 Johns Ch. 252, syl. 2), no actual collusion or artifice (*Barrington v. Alexander,* 6 O. S. 189, 195), honest intentions (*Piatt v. Longworth,* 27 O. S. 159, 201), honest motives (*Caldwell v. Caldwell,* 45 O. S. 512, 522), no intention to practice what the fiduciary considered fraud (*Riddle & Parker v. Roll,* 24 O. S. 572, 579), no actual fraud (*Dufford v. Nowakoski,* 125 N. J. Eq. 262, 269; *St. Paul Trust Co. v. Strong,* 85 Minn. 1, 5; *Armstrong v. Huston's Heirs,* 8 Ohio 552, 554; *Matter of Ryan,* 291 N. Y. 376, 405), a trustee guided solely by the interests of the cestui uninfluenced by its own conflicting interests (*Mar-*

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[6] In re Binder, 137 O. S. 26, 47; Wendt v. Fischer, 243 N. Y. 439, 444; St. Paul Trust Co. v. Strong, 85 Minn. 1, 5-6; Lawndale Nat. Bk. v. Kaspar Am. St. Bk., 288 Ill. A. 555, 558; In re Peck's Will, 273 N. Y. S. 552, 556; Larson v. Security Bank & Trust Co., 178 Minn. 209, 213; Bold v. Mid-City Trust & Sav. Bk., 279 Ill. A. 365; In re Riordan, 216 Ia. 1138, 1143; Smith v. Tolversen, 190 Minn. 410, 413; Conway v. Green's Admr., 1 Har. & J. (Md.) 151, 152; Wilmington Trust Co. v. Carrow, 14 Del. Ch. 290, 294; Dufford v. Nowakoski, 125 N. J. Eq., 262, 269; People v. Central Republic Trust Co., 20 N. E. 2d (Ill. A.) 999, 1005; 44 Harv. L. Rev. 1281.

celus v. First Trust & Deposit Co., 291 N. Y. 372, 374), no profit to the trustee (*Barker v. First Nat. Bk.,* 20 F. Supp. 185, 189; *In re Bender's Estate,* 192 A. (N. J. Prerog) 718, 721, aff'd. 196 A. (N. J.) 677; 49 *Harv. L. Rev.* 541) or no advantageous bargain to the trustee (*Barrington v. Alexander,* 6 O. S. 189, 197-198; 1 *Lawrence's Eq. Jur.* (1929 ed.) 577).

The reason good faith is not a defense is readily understood. We have seen that the inevitable exploitation by conflicts of interest is "inaccessible to the eye of the court." Courts cannot pierce the veil. In a fiduciary relation real motives are easily covered up; the mind is impenetrable. Even if there is bad faith, the faithless trustee can play act good faith. Bad faith, like the exploitation itself, is "inaccessible to the eye of the court."

Even assuming that a trustee with an adverse interest does not mean to do wrong, his judgment is so warped that he cannot be fair, and the taking of some indiscoverable advantage is almost certain. No one would have doubted the good faith of Justice Holmes or Cardozo, yet no one would have cared for them to sit on a case in which they were parties. Because they were men of good faith, they would not have attempted it.

Fair Value. Invariably the disloyal trustee will throw up fair value as a redoubt, but invariably the courts batter it down. In *Munson v. R. R.,* 103 N. Y. 59, 74, it is said:

> "The law * * * does not stop to inquire whether the * * * transaction was fair or unfair."

It is immaterial that there was fair value (*Stewart v. R. R.,* 38 N. J. L. 505, 523; *Barrington v. Alexander,* 6 O. S. 189, 198), fair consideration (*In re Binder,* 137 O. S. 26, 46, syl. 7), fullness of price (*Armstrong v. Huston's Heirs,* 8 Ohio 552, 554), full consideration (*People v. Central Republic Trust Co.,* 20 N. E. 2d 999, 1005), no loss (*In re Binder,* 137 O. S. 26, 38, 57; *Matter of Ryan,* 291 N. Y. 376, 386), no damage (*Wendt v. Fischer,* 243 N. Y. 438, 443), no actual injury (*Barrington v. Alexander,* 6 O. S. 189, 197), the best obtainable terms (*Wendt v. Fischer,* 243 N. Y. 439, 443) or an unobjectionable deal if it had been at arm's length with a third person (*Kinney v. Lindgren,* 373 Ill. 415, 422).

Likewise the immateriality of fair price is understandable. Fair price is not a mathematical thing like a pound in weight or a yard in length. Fair price is usually uncertain and variable. No two appraisers can agree. If you've been counsel in a condemnation case you know there is always a set of expert appraisers for the government and a set for the property owner, and that they are always poles apart.

Take a piece of property roughly worth $100,000. Send 10 of the best appraisers to evaluate it. Some may be as low as $90,000; some as high as $110,000, yet no one may be able to say $90,000 is not fair or that $110,000 is not fair. In that instance there is a variance of $20,000. If your trustee is buying that property for you, he may procure it for $90,000, but if he has a secret adverse interest, it may cost you $110,000. You may have lost $20,000, yet no one could say the price is unfair.

Furthermore, assuming the price for that property is fair, perhaps that particular property is not the most advantageous one to be acquired for your trust. It is your trustee's duty not only to pass on price, but, out of numerous available investments, to choose which is best for your trust. If he has an adverse interest you may miss some other more advantageous investment. What's more, you will never be able to know or prove what you missed.

Moreover, what may seem a fair price on the surface may not be a fair price because of secret information that the trustee has and that a beneficiary can never discover. If the value of an investment declines, the disloyal trustee always cries that he should not be judged by hindsight; while if the beneficiary only had the means of knowing the truth, it would show that the trustee acted with the most culpable foresight.

Besides, the beneficiary may labor under the handicap of the adverse interest not being discovered until many years after the act is committed, making it extremely difficult, expensive or impossible to establish a valuation as of a date long since past, or to get at the real facts.

The danger to the beneficiary from conflicts of interest, and the cestui's difficulty of proof are discussed in *St. Paul Trust Co. v. Strong,* 85 Minn. 1, 8-9, where the court observes:

> "And we have said nothing about the difficulty parties would have in establishing the actual value of real estate at the time the security was taken, when questions * * * as to value were at issue years after the transaction."
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> In 3 *Bogert* 1516, it is said: "Equity will not inquire into the fairness of particular sales. It realizes that, if it did, in many cases the unfairness would be so hidden as to be indiscoverable. The trustee might have secret information of values which the cestui cannot prove he had."

> In *Lewin on Trusts* (13th ed.) 1108, it is said: "The rule is now universal, that, however fair the transaction, the cestui que trust is at libery to set aside the sale and take back the property. If a trustee were permitted to buy in an honest sale, he may buy in a case having that appearance, but which, from the infirmity of human testimony, might be grossly otherwise. Thus the trustee for the sale of an estate might, by the knowledge acquired by him in that character, have discovered a valuable gold mine under it, and locking that up in his own breast, might enter into a contract for the purchase by himself. In such a case if the trustee chose to deny it, how could the court establish the fact against the denial? The probability is that a trustee who had once conceived such a purpose would never disclose it, and the cestui que trust would be effectually defrauded."

Benefit to the Trust. Frequently an attempt is made to show that the trustee's act in violation of loyalty is beneficial to the trust. Even conceding benefit, that is not a defense. A laudable end does not justify the use of a vicious means in obtaining it. In *Bennett v. Weber,* 323 Ill. 283, a disloyal trustee urged that his act "resulted in greater advantage to the estate" (p. 293). The Court held (syl. 5):

> "* * * end obtained by trustee cannot justify his acts. The end or result accomplished by the trustee is not, alone, determinative of the rights of the parties in a suit calling a trustee to account, but the trustee's method of executing the trust free from his individual interest is of the essence of the trust."

Just as there is some good in the most dangerous criminal or some talking point in favor of any cause however unworthy, so in some situation a conflict of interest may afford some by-product advantage to the trust, but that does not justify the trustee. As pointed out conflicts of interest are "poisonous." The pill can be no less poisonous because it is sugar-coated. The sugar coating makes it more dangerous. The indiscoverable fraud that stabs in the back is no less a menace because it offers presents to the face. While it may be offering advantage in one respect, it may be taking advantage in another. For this reason, courts do not allow a benefit to the trust to be used as a wedge for the intrusion of predatory conflicts into fiduciary relations.[7]

7 Magruder v. Drury, 235 U. S. 106, 119 (not a defense that disloyal act "benefited the estate"); In re Binder, 137 O. S. 26, 46 (corporate trustee cannot buy from itself even though "it is in a position to judge most wisely as to the value of such securities"); Munson v. R. R., 103 N. Y. 59, 74 (Court will not consider "advantages or disadvantages"); Gates v. Plain-

It is not an answer to say that the trust estate will be a loser if it cannot advantage itself of a benefit that may come occasionally through the trustee's conflict of interest. One can never know whether the conflict will give as much advantage as it secretly takes. If the disloyal transaction is such a bargain for the trust why is the trustee usually so clandestine about it? Lord Eldon aptly said (*Ex Parte James,* 8 Ves. Jr. 337, 348):

> "* * * it is better for the general interests of justice, that in some cases a loss should be sustained by the cestui que trust, than a rule established, which would occasion loss in more numerous cases."

Custom and Practice. Corporate trustees particularly like to urge custom and practice as a defense to their disloyal transactions, but undivided loyalty is so deeply rooted in public policy that the practice of violation can no more excuse it than can the ancient practice to violate criminal laws justify violation. This is sound. The menace of indiscoverable exploitation inhering in conflicts of interests is no less indiscoverable or predatory because offending trustees make a practice of engaging in conflicts. Does the practice of biased judgment make the judgment disinterested?

> In 3 *Bogert* 1542, it is said: "While in practice there has been doubtless much of this type of investment on the part of less scrupulous financial institutions, it is believed that it is a clear breach of trust."
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> In 44 *Harv. L. Rev.* 1281, 1282-1283, it is said: "* * * there seems to be little doubt that banks and trust companies frequently buy from themselves for their cestuis * * *. If the advantages and disadvantages of self-purchase weighed equally in the balance, the firm policy of equity to remove all temptation from fiduciaries should tip the scales against the practice * * * courts have, in general, frowned on such transactions.
>
> In *Loring's A Trustee's Handbook* (1928 ed.) 34-35, footnote 5, it is said in discussing the rule against self-purchase: "I am told that such is a usual practice. As the law now stands, it is clearly a breach of trust."

field Trust Co., 121 N. J. Eq. 460, 487, aff'd 194 A. 65 (Unimportant that cestui "may have been benefited"); Stewart v. R. R., 38 N. J. L. 505, 523 (not a defense that trustee may give "more favorable terms"); In re Lodge, 32 Ohio N. P. n. s. 40, 53, aff'd 19 Ohio Law Abstract 316, mot. to cer. den., 8 Ohio Bar 171, Case #25,453 (not a defense "even though the value is greater"); 44 Harv. L. Rev. 1281, 1282-83 (self-dealing by corporate trustee a breach even though "the practice has some potential advantages"); Tracy v. Willys Corp., 45 Fed. 2d 485, 486 (counsel for receiver denied compensation for effecting sale to himself and his group even though sale great boon to estate).

In *Barker vs. First National Bank,* 20 F. Supp. 185, 190, it is said: "The bank has committed a breach of trust, and the fact that the bank has pursued a course of action for a period of years makes its action as outlined above no less a breach of the equitable principles of trusts."

In *Gates vs. Plainfield Trust Co.,* 121 N. J. Eq. 460, 486-487, aff'd. 194 A. 65, the court condemned the purchasing of securities by a corporate trustee from its subsidiary and said: "The trust company in its assertion of good faith, and, in support of its conduct, called a number of witnesses, prominent in the banking world, to testify that it was a proper practice for a bank acting as a trustee, and owning stock in a title company, to purchase participating certificates with trust funds from the title company in which it was financially interested; yet, the evidence of such practice lends no merit to its legality. While I entertain feelings of the utmost admiration for the persons of many of those eminent witnesses, I legally, cannot subscribe to their declared practice. Sound legal authority condemns it. As between the choice of what appears to be the questionable practice of banks, and a well defined policy of the law, the courts are bound to ignore the former and adhere to the latter."

In the *Stone* case (138 O. S. 293), customary banking practice was one of the highlights of the defense. Trust and bank officials from Baltimore, Pittsburgh and Cincinnati were brought to testify about custom. The Ohio Supreme Court attached so little importance to it that it never mentioned the point.

No Self-Dealing. In the *Stone* case (*supra,* syl. 4), for the first time perhaps, a court of last resort held that "A corporate trustee may not * * * retain its own shares in the trust, unless express authorization therefor is contained in the instrument creating the trust, or in a provision of law." The defense urged that retention was not a deal, hence there was no self-dealing, hence no breach of loyalty. The term "self-dealing" is used so much in loyalty cases that counsel sometimes get a mistaken notion that self-dealing and breach of loyalty are synonymous. To the contrary, self-dealing is always a breach of loyalty, but a breach of loyalty is not always self-dealing.

"Self-Dealing" is a transaction in which the person who is a fiduciary is the acting party on both sides of the deal. Thus, if a Trustee sells his individual property to himself as trustee, or if as trustee he sells trust property to himself individually, he is dealing with himself; hence the description "self-dealing." Self-Dealing, ipso facto, violates loyalty. In *In re Young,* 293 N. Y. S. 97, 102-103, aff'd. 274 N. Y. 543, it is said:

> "A principle firmly fixed in equity is that a trustee may not deal with himself. The simple fact he did is enough to indicate disloyalty to the estate * * *."

However, breach of undivided loyalty is not synonymous with or limited to self-dealing. In *Meinhard v. Salmon,* 249 N. Y. 458, 467, Judge Cardozo says:

> "Equity refuses to confine within the bounds of classified transactions its precept of a loyalty that is undivided and unselfish."
>
> In *In re Binder,* 137 O. S. 26, 56-57, it is said: "Courts of equity do not set bounds to the principles which control the conduct and fix the accountability of trustees. The elasticity of these rules extends their applicability to all of the devices invented by unfaithful fiduciaries to evade their obligations."
>
> In *Rowland v. Kable,* 174 Va. 343, 366-367, it is said: "One who is entrusted with the business of another cannot be allowed to make that business an object of interest to himself * * *. This rule is of wide application, and extends to every variety of circumstances."

The rule forbids the trustee to place himself or allow himself to be placed in a position where self interest may conflict with duty. In *City Bank Farmers Trust Co. v. Cannon,* 291 N. Y. 125, 131, 132, it is said:

> "The standard of loyalty in trust relations does not permit a trustee to create or occupy a position in which he has interests to serve other than the interest of the trust estate. Undivided loyalty is the supreme test, unlimited and unconfined by the bounds of classified transactions * * *. The rule is designed to obliterate all divided loyalties which may creep into a fiduciary relationship * * *."

"Conflict of interest" is the generic term. "Self-dealing" is but one specific type of such conflict. The only reason self-dealing is wrong is because, in self-dealing, there is conflict of interest which prevents the fiduciary from exercising a disinterested judgment. Necessarily, any other situation, though not self-dealing, which involves conflicting interests and destroys disinterested judgment is, by the same reasoning, a wrong, full of potential fraud "inaccessible to the eye of the court" and a breach of loyalty.

Armstrong v. Huston's Heirs, 8 Ohio 552, demonstrates this truth. There, the purchase by one of three appraisers at an administrator's sale was set aside. There was conflict of interest but no self-dealing. The fiduciary did not deal with himself or sell the property to himself. He was not both vendor and vendee. He did not own the property. He was merely an appraiser. Nevertheless the court set the transaction aside because of conflict of interest. The key to the decision, as well as the essence of the duty of loyalty, is found in the court's statement that (p. 554):

> "Where the law creates fiduciary relations, it seeks to prevent the abuse of confidence, by insuring the disinterestedness of its agents."
>
> Similarly, in *Matter of Filardo,* 221 Wis. 589, 599-600, the court said: "It is ably argued on behalf of the appellants that Mr. Bishop, as guardian, was not dealing with himself in purchasing the securities in question from the Iowa County Bank; that he was merely a stockholder and officer in the banking corporation from which the questioned securities were purchased for the trust estate. True, Mr. Bishop owned only 66 shares of the 1000 shares of capital stock outstanding. A substantial ownership of the stock of the bank is not the only test as to whether he, in fact, was acting in dual capacity. His income, on account of his official connection with the bank as its chief executive officer may have more significance than the number of shares owned or the actual value thereof. Upon the undisputed facts, it must be held that Mr. Bishop had a substantial personal interest in the bank and in keeping it a going institution."

A few of the many situations that violate loyalty even though there is no strict self-dealing are listed below: [8]

[8] Purchase by individual fiduciary, for the fiduciary estate, of property owned by a corporation of which he is an officer or director. Ottawa Banking & Trust Co. v. Crookston State Bank, 185 Minn. 22. 12 Wis. L. Rev. 73; Matter of Filardo, 221 Wis. 589. Purchase by a corporate trustee of property from its officer or director. 49 Harv. L. Rev. 544. Purchase by corporate trustee of property from its affiliate or subsidiary. 3 Bogert 1542. 44 Harv. L. Rev. 1286; 49 Harv. L. Rev. 544, 1 Restatement, Trusts, Sec. 170, comment "i." Agreement by trustee with a third party to exchange business. 44 Harv. L. Rev. 1286. Lease of trust property to trustee's wife. Wilmington Trust Co. v. Carrow, 14 Del. Ch. 290. An employee's taking a lease to begin on expiration of his employer's lease. Steinberg v. Steinberg, 206 N. Y. S. 134. Acceptance by a trustee for himself from third person of any bonus or commission for any act done by him in connection with administration of the trust. 1 Restatement, Trusts, 438. Purchase by a fiduciary for himself from a third person of property rights which are adverse to those of his beneficiary. Nebraska Power Co. v. Koenig, 93 Neb. 68. Renewal of lease by one co-adventurer to exclusion of his associate. Meinhard v. Salmon, 249 N. Y. 458. Purchase by trustee from third person of encumbrance owned by latter on trust property. Strickler Estate, 328 Pa. 145, 150.

Further citation is unnecessary. Disloyalty is not confined to self-dealing. A fiduciary's third-person dealing or just sitting with no-deal may also violate loyalty if he has a conflict of interest.

Trust Company Trustee. Sometimes a disloyal corporate trustee urges that the rule of loyalty shouldn't apply to it because being a separate entity owned by shareholders and operated for them by corporate agents, there is not the same self-interest as in the case of the individual trustee. However, courts apply the rule equally to the corporate trustee. (3 *Bogert* 1541-1542; 1 *Restatement, Trusts,* Sec. 170, comment "i"; 44 *Harv. L. Review* 1281, 1282-1283; 49 *Harv. L. Rev.* 521, 543-544).

> In *Kelly v. First Minneapolis Trust Co.,* 178 Minn. 215, 218, the court said: "Though corporations, trust companies are dominated by human nature."
>
> In 44 *Harv. L. Rev.* 1282, it is said: "Corporations are likely to be more partial to their stockholders' than to their customer-beneficiaries' interest."

Sometimes a trust company urges that it is an advantage to the trust to be able to buy securities from the trust company's securities department because the company is in an excellent position to judge its own securities and because it can let the trust have the securities at a lower price than is current on the street. There are several answers to this.

As we have seen, benefits to the trust cannot excuse disloyalty. How can a trust company pass sound judgment on its own securities any more than a parent can pass sound judgment on its child? Assuming that the trust company is in a better position to pass judgment on its own securities and to let the trust in on a bargain, how can any one tell whether its biased judgment is being exercised for its own or for the trust's advantage; or whether the trust is being used as a dumping ground? (In *re Binder,* 137 O. S. 26, 46-47). The latter has happened. (*First Nat. Bank of St. Petersburg v. Solomon,* 63 F. 2d 900). What wise man could pretend to pierce the mist and distinguish devotion from promotion?

Technicality. In recent years disloyal trustees have particularly yelled that the rule of undivided loyalty is a mere technicality. Thus in 1943, in *In re Ryan's Will,* 291 N. Y. 376, 385, the court said:

> "The corporate trustee argues that we have here formerly well-satisfied beneficiaries endeavoring to take advantage of a technical rule * * *."

The same contention was made in the Cleveland litigation with equal failure. Similarly in *St. Paul Trust Co. v. Strong,* 85 Minn. 1, 10, the court noted without approval:

> "Counsel for the company make the claim that as these investments were technically irregular only * * * it should be exonerated."

This particular attempt at evasion goes back at least to Lord Cairns' time. In *J. C. Penney Co. v. Schulte Real Estate Co.,* 292 Mass. 42, 44, the court observed:

> "As Lord Cairns said this rule is not a technical or arbitrary rule. It is founded on the highest and truest principles of morality."
>
> In *Bennett v. Weber,* 323 Ill. 283, syl. 5, it is said: "* * * the trustee's method of executing the trust free from his individual interest is of the essence of the trust."

Judge Cardozo referred to the rule as "the life of every trust." (*Carrier v. Carrier,* 226 N. Y. 114, 126.) Further, he said (*Globe Woolen Co. v. Utica Gas & Electric Co.,* 224 N. Y. 483, 489):

> "* * * the great rule of law * * * which holds a trustee to the duty of constant and unqualified fidelity, is not a thing of forms or phrases."

How counsel can still urge technicality is amazing. Undivided loyalty is the antithesis of technicality.

Violation of loyalty is a constructive fraud. Courts declare it fraud even without proof of actual fraud. In *In re Culhane's Estate,* 269 Mich. 68, 75, the court said:

> "The law esteems it a fraud in such a trustee to take for his own benefit, a position in which his interest will conflict with his duty."
>
> In *Matter of Ryan,* 291 N. Y. 376, 407, it is said: "The rule is inflexible, that he shall not place himself in a position where his interest is or may be in conflict with his duty. The reason for the rule * * * is to bar the more effectually every avenue of fraud. Such a purchase, though it may not originate in any purpose to defraud, is a constructive fraud." [8a]

[8a] Armstrong v. Huston's Heirs, 8 Ohio 552, syl. (purchase by appraiser set aside "as infected with fraud"); 3 C. J. S. 7 (violations of loyalty "considered in light of frauds"); Michoud v. Girod, 45 U. S. 503, syl. 2 (purchase of fiduciary property by trustee or agent "carries fraud on the face of it"); Joliet Trust & Savings Bank v. Ingalls, 276 Ill. A. 445, 452 (trustee purchasing securities from itself, a "fraud upon the estate"); Leaphart v. Nat. Surety Co., 167 S. C. 327, 336 (investment of ward's money in fiduciary's own property, a "fraud").

How can a rule designed to cope with fraud be technical? Courts declare conflicts of interest "poisonous." Since when is poison so harmless that safety rules are mere technicalities?

Courts declare conflicts of interest against public policy. In 25 *C.J.* 1120, it is said:

> "It is against public policy to allow persons occupying fiduciary relations to be placed in positions in which there will be constant danger of a betrayal of trust by the vigorous operation of self motives."

(*Ulmer v. Fulton,* 129 O. S. 323, 336; *Gates v. Plainfield Trust Co.,* 121 N. J. Eq. 460, 487, aff'd 194 A. 65; *Estate of McLellan,* 8 Cal. 2d 49, 54; 3 *C. J. S.* 7.)

How can a rule designed to eradicate a menace to public policy be technical?

Courts declare that good faith, fair value and a benefit to the trust are not defenses to divided loyalty. Wouldn't it seem, therefore, that the thing attempted to be stamped out is fundamentally vicious?

Negligence. Frequently, too, the disloyal trustee urges that he was not negligent. He might just as well aver that it was a pleasant day when the transaction occurred. Negligence and violation of loyalty are two entirely different concepts. One has to do with lack of due care, the other with conflicts of interest. The fact that "many outstanding, successful and conservative business men" in the community approved such type transaction,[9] or that there was a custom or practice to do such a thing or that the particular investment if bought from a third person would be proper[10] does not exonerate divided loyalty. In *Smith v. Tolversen,* 190 Minn. 410, 413, the court said:

> "Defendant is charged primarily, not because of what he bought or sold, but because, as trustee, he bought from or sold to himself, or tried to. * * * his liability follows, not because of the character of the things he purchased or sold, but because the manner of purchase or sale was a violation of his primary duty not to allow his interest as an individual even the opportunity of conflict with his interest as trustee."
>
> In *Grodsky v. Sipe,* 30 F. Supp. 656, 661, it is said: "* * * he (the trustee) is not given the same freedom of choice that may be exercised by prudent business men in their own affairs but is held to a higher standard of duty * * *. He is forbidden to deal with trust property for his own advantage."

9 Thurston v. Nashville Trust Co., 32 F. Supp. 929, 937.

10 Restatement, Trusts 560; 49 Harv. L. Rev. 539; Barker v. First National Bank, 20 F. Supp. 185, 188; Bold v. Mid-City Tr. & Sav. Bk., 279 Ill. A. 365, syl.

> In *Thurston v. Nashville & Amer. Trust Co.,* 32 F. Supp. 929, 936, it is said: "* * * a court does not stop to inquire * * * whether it was prudent * * *. Neither a showing of good faith nor prudence can make permissible such a transaction * * *."

Testator-Settlor a Stockholder and Director and Knew Practices. In *Gates v. Plainfield Trust Co.,* 121 N. J. Eq. 460, aff'd. 194 A. 65, complaint was made because a corporate trustee purchased securities from its subsidiary. The testator-settlor had been director of the trustee company about six years before his death, during which time, to the testator's knowledge, it purchased the same type of securities for its trusts from the subsidiary. The court disapproved the investment as disloyalty, saying with reference to the testator's connection with the trustee and his knowledge of these practices (pp. 483-484):

> "But such array of facts * * * cannot warrant the conclusion that the trust company was justified in departing from its plain duty to cling strictly to legal investments. The testator, despite his activities as a director of the trust company, his evident knowledge of its interest in the mortgage company (the subsidiary), and his acquaintance with the purchases by the trust company of mortgage certificates from the mortgage company, did not, in his will, or codicil, authorize the purchase of such certificates. While, in life, he, as director of the trust company, sanctioned certain practices, still his testament conveys no mandate to his representatives to pursue the same rule of conduct."

In *Lawndale Nat. Bank v. Kaspar Amer. State Bank,* 288 Ill. A. 555, the defendant bank had been both executor and trustee of an estate. The court disapproved the sale of the defendant's individual property to the estate although the testator had been a director and stockholder of a predecessor bank that had been consolidated into the defendant bank.

In *Kinney v. Lindgren,* 373 Ill. 415, a suit to require payment to trust beneficiaries of money invested by trustees in bonds of a trust company of which the trustees were officers, it was held (syl. 4 and pp. 421-422) that evidence that the settlor had placed bonds (which she had purchased from a predecessor of the trust company) in the hands of officers of the trust company, in trust for the settlor and her daughter, was insufficient to establish that the trustees were authorized to purchase bonds for the trust from the trust company; and that evidence that before the trust agreement was signed, the settlor, who died before the bonds were purchased, informed the attorney for the trust company's predecessor that the settlor wished the predecessor to be trustee so that it could buy bonds for the trust of the type dealt in by that company, and that the attorney informed the settlor that the same result could be obtained by appointment of the individual trustees, was inadmissible.

This position is sound. Even though most intimately connected with a trust company during his life, a testator cannot know what is going to happen when he is no longer there to watch what is going on. The possibility of indiscoverable fraud inhering in all conflicts of interest, lives though he dies.

This holding is in keeping with the two points next discussed: Even though the settlor makes (1) a relative or (2) himself the trustee, that does not imply the right to violate loyalty.

Trustee, A Relative. When a settlor makes a relative the trustee—with all the trust that blood and marriage imply—he certainly gives management to one in whom he has the greatest confidence, greater ordinarily than in case of a stranger. Yet courts do not even consider relationship strong enough to overcome temptation and probability of abuse when conflicts of interest enter the family circle. There is no implication from relationship that the settlor meant to free the trustee from the prohibition against conflicts. Accordingly, the prohibition applies to a relative the same as to a stranger.[11]

Trustee, The Settlor. Even when a settlor appoints himself the fiduciary, and the trust instrument gives him "absolute and uncontrolled" power over investments, he cannot violate loyalty.[12] If, from the confidence and knowledge a settlor has in and of himself, it cannot be implied that he waives the rule against self-interest as to himself, certainly it cannot be implied from his confidence and knowledge regarding a trust company that he waives the rule against self-interest as to it. To contend otherwise, one may as well argue that because a testator (or his trusted agent at his direction) drilled his money into paper gold mines or freely exchanged it for chips at Monte Carlo, his trustee could go and do likewise. Assume too that that agent later became his testamentary trustee and thus knew that the testator

11 Gould v. Gould, 213 N. Y. S. 286—trustees, children of settlor; McAllister v. McAllister, 184 A. (N. J. Eq.) 723—trustees, settlor's son and son-in-law; Matter of Petrie, 5 Dem. Sur. (N. Y.) 352—trustees, settlor's sons; Murphy-Bolanz Land & Loan Co., 236 S. W. 2d 78—one co-trustee, relative by marriage.

12 Carrier v. Carrier, 226 N. Y. 114, 125, 126; 49 Harv. L. Rev. 521, 546.

had had no hesitancy investing his money in shafts or roulette. Is it not obvious that a new, distinct code becomes protector when death or living signature gives property to fiducial care?

Complex Business Age. In the Cleveland litigation it was intimated that undivided loyalty was a bit horse and buggy, a relic from days when trustees were individuals and a single trustee's trusts, few—whereas now a corporate trustee might be a stable for 5000 trusts investing $20,000,000 in one revolution of the sun around the ecliptic.[13].

We live in a modern world with modern business conditions but we are confronted with a human nature that has changed little during the centuries. It is the same human nature dominated by the same self-interest. The complicated innovations condemned in the Cleveland litigation were creatures of the Twentieth Century. The duty of loyalty is a simple rule that stands guard over fiduciary relations, however complex the modern device that attempts to cross its threshold. Through that door, modernity and complexity cannot pass if they do not respect loyalty. In *Nebraska Power Co. v. Koenig,* 93 Neb. 68, 76-77, in discussing loyalty, the court said:

> "The philosophy on which these rules of law and equity rest come down through the centuries from the Chancellor of Galilee. The wisdom and necessity of such doctrines become more apparent as the forms in which property is held multiply under new conditions, and as earning capital in control of agents or trustees follow new enterprises over the world, where it is not under the watchful eye of the owner. Courts of equity do not set bounds to the principles which control the conduct and fix the accountability of trustees. The elasticity of these rules extends their applicability to all of the devices invented by unfaithful fiduciaries to evade their obligations or to defeat the imperative demands of business integrity and sound public policy."

(*In re Binder,* 137 O. S. 26, 56.)

Difficulty of Procuring Satisfactory Investments. It did not appear in the Supreme Court's opinion, but in the Cleveland litigation counsel failed to revive a very dead defense when they urged—"desirable trust investments were not easy to obtain." Long ago in *In re Long Island Loan & Trust Co.,* 87 N. Y. S. 65 aff'd, 179 N. Y. 520, the court disapproved a corporate trustee's sale of its own property to its trust although an executive committee resolution explained that it was "in consequence of the

[13] In re Binder, 137 O. S. 26, 34.

difficulty of procuring satisfactory" investments. This conclusion is reasonable. Indiscoverable fraud that exploits a trust when self-interest competes with duty, can gouge as easily when good investments are difficult to procure as when they are not difficult to procure. The difficulty makes fraud no less "inaccessible to the eye of the court."

Depression. Since 1929 it has been fashionable for disloyal trustees to pass the buck on to the depression, blaming it for all losses, saying that every one, even the wisest investor, lost his shirt, so that if, in a disloyal investment, the trust lost its shirt, it didn't lose anything that it wouldn't have lost anyway. The Ohio Supreme Court couldn't see that argument saying (*In re: Binder,* 137 O. S. 26, 57):

> "* * * the right * * * to rescind does not depend on whether the trust estate has suffered a loss * * * he (the trustee) may be surcharged with any decline in value * * * notwithstanding there may be no causal relation between his self-dealing and the loss or depreciation incurred."

The New York Court, too, flayed the depression argument (*Matter of Ryan,* 291 N. Y. 376, 385):

> "The corporate trustee argues that we have here 'formerly well-satisfied beneficiaries endeavoring to take advantage of a technical rule against self-purchase' of securities and that their objections are after thoughts due to the real estate collapse in the years succeeding 1929. Whether or not the beneficiaries are thus motivated is irrelevant * * *. Even though over a long period breaches of those rules have not resulted in loss * * * the rules continue to operate as a protection * * * and beneficiaries * * * may point to those rules and insist that the trustee be surcharged when loss * * * eventually ensues by reason of the breaches."

How could a court hold otherwise? Before the depression a court could set aside a disloyal investment because infected with exploitation and fraud "inaccessible to the eye of the court." Now the depression arrives. How does the depression automatically extract the exploitation and fraud or render them accessible to the court's eye? If a court cannot put its eye on the inevitable exploitation and fraud, how can it gauge the life blood that parasitic self-interest has sucked from the investment rendering it easier prey to depression?

Of course, most complaints against disloyalty don't come until an investment has depreciated. Why? Because there's a fiduciary relation. The trustee is trusted. The beneficiary does not eavesdrop on every thought, or shadow every move of the trustee. He is not required to distrust the trustee. The relation would be useless if he were. Consequently the beneficiary doesn't automatically know it when his trustee violates loyalty. Usually the trustee will take pains to see that he does not learn of it. Not until the investment depreciates does the beneficiary become alarmed into making investigation that may uncover the conflict of interest.

The trustee who risks disloyalty knows the likelihood of economic change and uncertain future values. When caught, isn't it a little absurd if he can tell the beneficiary—"The economic cycle determines whether you have a right of redress. The cycle is now in my favor. A depression has intervened." There cannot be one set of rules for periods of prosperity and another for periods of depression.

Insolvency of the Trustee. In the Cleveland litigation, the corporate trustees were insolvent. Liquidators thought that that should be a defense, urging that to allow trusts to establish claims would penalize depositors and creditors. Further it was urged that the ban against disloyalty was but a technical rule to take temptation away from the trustee, and now that the trustee was dead there was no need to worry about tempting it. The Supreme Court rejected these contentions (*In re Binder,* 137 O. S. 26, 57-58).

Of course it would gratify any creditor if all other types of creditors were excluded from the liquidation pile. By the same reasoning, it hurts a trust creditor if depositors are allowed to share. Moreover, there is something more basic to undivided loyalty than curbing the trustee's prospective temptations. To expose the fiduciary relation to conflicts of interest means indiscoverable abuse. Assuredly, beneficiaries must be protected from future abuse. But, to have exposed fiduciary relations to conflicts means that indiscoverable abuse has already been busy. No less must the beneficiary have redress for past abuse. There cannot be one law for the past and another for the future; one law for the beneficiary who has suffered abuse and another for the one who will suffer. Courts do allow redress though the trustee is insolvent.[14]

[14] In re Trusteeship of Stone, 138 O. S. 293; Baxter v. Union Industrial Trust & Savings Bank, 273 Mich. 642; Joliet Trust & Savings Bank v. Ingalls, 276 Ill. A. 445; Lawndale Nat. Bk. v. Kaspar Amer. St. Bk., 288 Ill. A. 555; People, etc. v. Canton Nat. Bk., 288 Ill. A. 418.

Acquiescence, Waiver, Estoppel, Ratification, Release. In any disloyalty trial you can bet on one or more of those at the defense table. If the disloyal trustee has sold his own property to the trust, his story usually goes like this:

> "This beneficiary knew at all times that I bought this very X Bond for the trust. I sent him a written statement showing it. He knowingly accepted the income from this bond. He approved its purchase. He even gave me a written release."

All that does not exonerate the trustee. Two essentials are absent: (1) he did not disclose that he bought the bonds from himself and (2) he did not tell the beneficiary what his legal rights were.

The disloyal trustee usually has an idea that he is pulling something. He parts with just enough information so he can argue his respectability if caught, but he hesitates to risk killing the deal by disclosing everything. Recognizing this, courts say that the trustee must make a full disclosure of all the facts including the fact of his self-interest. In *St. Paul Trust Co. v. Strong,* 85 Minn. 1, 11, the court said:

> "Imperfect and incomplete information is insufficient * * *."

Judge Cardozo said:

> "If dual interests are to be served, the disclosure to be effective must lay bare the truth, without ambiguity or reservation, in all its stark significance." (*Wendt v. Fischer,* 243 N. Y. 439, 443).

However, full disclosure of facts alone will not exonerate the trustee. Knowing that the average beneficiary is ignorant of his legal rights even when he knows the facts, courts go one step further and say that the trustee must tell the beneficiary what his legal rights are under those facts. The trustee must tell the beneficiary that what the trustee did is a breach for which the court will give redress. A trustee who procures a written approval or release from a beneficiary without disclosing all facts and explaining the latter's legal rights is wasting his ink. The burden of proving full disclosure of facts and explanation of legal rights is on the trustee; and proof must be full and satisfactory.[15]

[15] Matter of Ryan, 291 N. Y. 376, 417, syl. 13; In re Trusteeship of Stone, 138 O. S. 293, 305; St. Paul Trust Co. v. Strong, 85 Minn. 1, 10-11; Hodge v. Mackintosh, 248 Mass. 181, 187; In re Long Island Loan & Trust Co., 87 N. Y. S. 65, 67, aff'd. 179 N. Y. 520; McAllister v. McAllister, 184 A. (N. J. Eq.) 723, 727-729; Kinney v. Lindgren, 373 Ill. 415, 422; In re Bender's Estate, 192 A. 718, 722-723 (N. J. Prerog.), aff'd 196 A. 677; Baxter v. Union

In concluding this point it is well to remember this warning (*Caldwell v. Caldwell*, 45 O. S. 512, 523):

> "There are considerations of public policy requiring the utmost fidelity and a rigid compliance with all his fiduciary obligations which forbid this court prosecuting a diligent search for grounds of estoppel, acquiescence, waiver or excuse, for the purpose of relieving such a trustee from the uncompromising discharge of his trust."

Other Excuses. Disregard for loyalty is not excused because the trust instrument waives the ordinary rules as to investments and gives the trustee the widest possible discretion,[16] or the disloyal trustee is but one of a number of co-trustees,[17] or there is sympathy for an already overburdened and distressed community,[18] or those in charge of the trust company are men of standing in the community,[19] or the profit made by the trustee is no more than the services are reasonably worth,[20] or the investment complies with the statutory requirements, is perfectly secured and bears the highest rate of interest,[21] or there is no causal relation between the disloyalty and the loss.[22] These are by no means exhaustive; they are but illustrative.

IV. Some Procedural Aspects.

The duty of undivided loyalty is a rule of substantive law, *City Bank Farmers Trust Co. v. Cannon*, 35 N. Y. S. 2d 870, syl. 1, but it has procedural aspects that are well to remember, namely:

Industrial Trust & Savings Bank, 273 Mich. 642, 648; In re Riordan, 216 Ia. 1138; Marchant v. Wannamaker, 176 S. C. 369; Smith v. Hawlett, 51 N. Y. S. 910, syl. 2; In re Peck's Will, 273 N. Y. S. 552, syl. 3; In re Young's Estate, 293 N. Y. S. 97, 104, aff'd 274 N. Y. 543; Gates v. Plainfield Trust Co., 121 N. J. Eq. 460, 488, aff'd 194 A. 65; Smith v. Tolversen, 190 Minn. 410, 414; Joliet Trust & Savings Bank v. Ingalls, 276 Ill. A. 445, 453-454; Lawndale Nat. Bk. v. Kaspar Amer. St. Bk., 288 Ill. A. 555, 565; Murphy-Bolanz Land & Trust Co. v. McKibben, 236 S. W. 78; First Nat. Bank v. Solomon, 63 F. 2d 900.

16 In re Binder, 137 O. S. 26, 43-44, syl. 10; In re Trusteeship of Stone, 138 O. S. 293, 305; Carrier v. Carrier, 226 N. Y. 114, 119, 125-126; In re Harbeck's Estate, 254 N. Y. S. 312, 314; In re Peck's Will, 273 N. Y. S. 552, 554; Barker v. First Nat. Bank, 20 F. Supp. 185, 186.

17 Tracy v. Central Trust Co., 192 A. (Pa.) 869, 870.

18 In re Culhane's Estate, 269 Mich. 68, 77.

19 Matter of Ryan, 291 N. Y. 376, 386.

20 Magruder v. Drury, 235 U. S. 106, 120; Bold v. Mid-City Trust & Sav. Bk., 276 Ill. A. 365, 369.

21 Bold v. Mid-City Trust & Sav. Bk., 279 Ill. A. 365, 371, 374.

22 In re Binder, 137 O. S. 26, 57.

1. The burden is on the trustee to prove that he complied with his duty of loyalty. (*Malcolmson v. Goodhue County Nat. Bk.*, 198 Minn. 562, 567; *Smith v. Tolversen*, 190 Minn. 410, 414.)

2. All ambiguities in the trustee's records and all doubts are resolved against the trustee (*Malcolmson v. Goodhue County Nat. Bk.*, 198 Minn. 562, 567).

3. In determining whether a trustee has breached his loyalty as to a particular investment, the fact that he has breached it as to other investments may be significant (*Malcolmson v. Goodhue County Nat. Bk.*, 198 Minn. 562, 568-569).

4. A statute that modifies the rule of loyalty is in derogation of the common law and must be strictly construed against the trustee (*Matter of Ryan*, 291 N. Y. 376, 400).

5. In accepting a trust the trustee is presumed to know his duties including that of loyalty. (*In re Trusteeship of Stone*, 138 O. S. 293, 302-303).

6. The burden of proving acquiescence, estoppel, ratification, waiver or release is on the trustee. The trustee must prove by "full and satisfactory" evidence that all the facts were disclosed to the beneficiary and that the beneficiary was apprised of his legal rights.

V. Conclusion.

The trust relation is a fiduciary relation. It is a relation of inequality, readily lending itself to secret exploitation of the beneficiary by the trustee. Human nature is such that a person cannot fairly serve two masters with conflicting interests especially when one master is himself. In such conflict the danger of fraud and exploitation is so certain, and the ability of a beneficiary or Court to discover and prove them is so remote, that only prohibition of adverse interests can secure protection. In *Armstrong v. Huston's Heirs*, 8 Ohio 552, 554, it is said:

> "The temptation to abuse power for selfish purposes is so great that nothing less than that incapacity is effectual, and thus a disqualification is wrought by the mere necessity of the case."

Judge Cardozo said (*Wendt v. Fischer*, 243 N. Y. 439, 443-444):

> "The law does not stop to inquire whether the contract or transaction was fair or unfair. It stops the inquiry when the relation is disclosed, and sets aside the transaction or refuses to enforce it, at the instance of the party whom the fiduciary undertook to represent, without undertaking to

deal with the question of abstract justice in the particular case."

In concluding, it may be well to relieve the mind of the trustee who is always sure that the strict application of undivided loyalty is going to impede or ruin the trust business. In *Ottawa Banking & Trust Co. v. Crookston State Bank,* 185 Minn. 22, 23-24, the Court aptly warns the Trustee:

> "The mere statement that the law does not permit a trustee as an individual to deal with himself as trustee should be enough. Slight reflection ought to persuade a trustee that if as trustee he can trade with himself as an individual his usefulness as a trustee is gone; and with it will go the opportunity of acting as such among those who understand that he has such power; for if he has such power no one will want him long as trustee."

(*Matter of Filardo,* 221 Wis. 589, 599.)

In *Matter of Ryan,* 291 N. Y. 376, 385, the Court so truly says of the loyalty rules:

> "The common law rules * * * are of very long standing. Within those rules there is ample room for the exercise by trustees of wise judgment and discretion."

It is inspiring the way a trustee can buckle down after a disloyalty trial and do, or do without, the things that, at the trial, he was sure couldn't be done or done without. These splendid post-trial performances prove the statement in *Farmers' & Merchants' Bank of Los Angeles v. Downey,* 53 Cal. 466, 468-469:

> "* * * as observed by the Court of Appeals of the State of New York, in *Bow v. Bow,* 56 N. Y. 288, 'when agents and others, acting in a fiduciary capacity, understand that these rules will be rigidly enforced, even without proof of actual fraud, the honest will keep clear of all dealings falling within their prohibition, and those dishonestly inclined will conclude that it is useless to exercise their wits in contrivances to evade it'."