Fordham Law Review

Volume 18 | Issue 1 Article 1

1949

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FORDHAM LAW REVIEW

VOLUME XVIII
1949

302 BROADWAY
NEW YORK 7
1949

The Heffernan Press
Worcester, Mass., U. S. A.

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VOLUME XVIII MARCH, 1949 NUMBER 1

CONFLICTING INTERESTS OF ESTATE FIDUCIARIES IN NEW YORK AND THE "NO FURTHER INQUIRY" RULE

BY LOUIS C. HAGGERTY†

IN 1928, Judge Cardozo wrote the opinion of the New York Court of Appeals in the now famous case of *Meinhard v. Salmon,* which involved the question of good faith among business associates. In it, he phrased in unforgettable language the standard of conduct which is applicable to all persons occupying positions of trust and particularly to all estate fiduciaries. He said:

"A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."[1]

This rule for the conduct of a fiduciary, whether expressed with the felicity of language that Judge Cardozo employed, or by others, both before and after him, is basic and fundamental. It permits of no exceptions or deviations, and may properly be the subject of universal application. The extent to which this standard of conduct will be enforced was illustrated more recently when Judge Conway stated that the prohibition against self-dealing by a fiduciary did not depend upon any question of fraud but was made absolute to avoid the *possibility* of fraud, and to avoid the *temptation* of self-interest[2] and that a fiduciary was subject to surcharge if it placed itself in a position where its interest "was or *might be* in conflict with its duty."[3]

There has been annexed to this doctrine, however, and it is an annexation and not an addition, another doctrine which may be called the "no further inquiry" rule. Its history may be briefly recited. On September 14, 1875, a man named Edgar Munson made a contract in

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1. Meinhard v. Salmon, 249 N. Y. 458, 464, 165 N. E. 545, 546 (1928). Unfortunately this was an expensive victory for the plaintiff, as the accounting proceedings filed in the Surrogate's Court of New York County will reveal.

2. Matter of Ryan, 291 N. Y. 376, 405, 52 N. E. 2d 909, 922 (1943) (emphasis by the court).

3. *Id.* at 407, 52 N. E. 2d at 913 (emphasis by the court).

the State of New York with the Syracuse, Geneva and Corning Railroad Company, whereby he agreed to sell to it, and the railroad company agreed to buy from him certain bonds. Mr. Munson was at the time one of a number of directors of the company. Later on, the latter refused to make the purchase agreed upon and Mr. Munson sued for specific performance. The Court of Appeals found no evidence of actual fraud or collusion on the part of any one but nevertheless ruled that the contract was not enforceable by Munson. Judge Andrews, writing for a unanimous court, said that if a person occupying a position of trust made a contract on behalf of the person to whom he bore a fiduciary relationship, with himself individually, the court would not stop to inquire whether the contract was fair or unfair. It would stop any inquiry as soon as the fiduciary relationship was disclosed and would refuse to enforce it or would set it aside 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."[4] Although this rule had the laudable purpose of discouraging fraud by "taking away motive for its perpetration,"[5] the deliberate refusal of a court to consider the abstract justice of any case may seem surprising to some and possibly shocking to others. But the courts have entertained no doubts about the validity of the doctrine. Judge Cardozo himself had defended it, prior to *Meinhard v. Salmon,* on the ground that "only by this uncompromising rigidity has the rule of undivided loyalty been maintained against disintegrating erosion."[6]

The "no further inquiry" rule has several weaknesses. It may and often does miss its real target, the faithless fiduciary, and hit the one who has acted in the best of faith.[7] It may operate not to protect beneficiaries from wrongdoers but to give them undue and undeserved advantages over fiduciaries who thought they were obeying the rules.[8] For these and other reasons, it is not always enforced. Although it

4. Munson v. Syracuse, Geneva & Corning R.R. Co., 103 N. Y. 58, 74, 8 N. E. 355, 358 (1886).

5. Ten Eyck v. Craig, 62 N. Y. 406, 420 (1875).

6. Wendt v. Fischer, 243 N. Y. 439, 444, 154 N. E. 303, 304 (1926).

7. Anyone who reads the cases on divided loyalty, will observe in the great majority of them:

A—that the courts found either affirmative good faith or else no evidence of bad faith;

B—that in those cases in which bad faith appeared, a surcharge could have been made without invoking the "no further inquiry" rule.

8. A fiduciary may in the best of faith engage in a series of transactions of identical character, some resulting in profits and others in losses. If the court should later hold that the transactions involved self-dealings, no inquiry will be made into the profits which were made and they will not be applied to off-set the losses. This result, however, is not limited to cases where the "no further inquiry" doctrine is applied.

has been said that self-dealing in itself is against public policy,[9] it is not against public policy for a testator or settlor of a trust to authorize a fiduciary to enter into transactions in which the fiduciary may have an interest.[10] In some cases, the testator or settlor has been responsible for placing the fiduciary in a position of conflicting interests, and the courts have been obliged in the interests of justice to inquire into the facts and then to hold that there had been an implied waiver of the rule against self-dealing.[11] In some situations, it would seem that the courts have refrained from enforcing the "no further inquiry" rule because they peeked a little and saw that if it was enforced, the effect would be to destroy the testamentary intent and to injure the very estate which the court had to protect.

It may, therefore, be of interest to consider, with respect to estate fiduciaries:

A—Situations in which the rule against divided loyalty has been enforced.
B—Situations in which the rule against divided loyalty has not been enforced.
C—Situations in which the interests of the trust estate suggest that the rule against divided loyalty be waived in order to get away from the "no further inquiry" rule.

THE ENFORCEMENT OF THE RULE AGAINST DIVIDED LOYALTY

Transactions of Purchase and Sale

The doctrine is enforced with particular strictness when a fiduciary buys from, or sells to himself individually, property belonging to his trust estate. Good faith and sincerity are immaterial.[12] Even the fact that the transaction may have been entered into by the fiduciary against his own interest will not validate it.[13] A transaction in which only one

9. Matter of Long Island, Loan & Trust Co., 92 App. Div. 1, 87 N. Y. Supp. 65 (2d Dep't 1904), *aff'd*, 179 N. Y. 520, 71 N. E. 1133 (1904).

10. Matter of Balfe, 245 App. Div. 22, 24, 280 N. Y. Supp. 128, 130 (2d Dep't 1935); Matter of Durston, 297 N. Y. 64, 71, 74 N. E. 2d 310, 312 (1947). The waiver may be a statutory one, as, for example, N. Y. Laws, 1917, c. 385.

11. As for example, Matter of Hubbell, 119 N. Y. L. J. 554 (Surr. Ct. Feb. 11, 1948).

12. Matter of Long Island Loan & Trust Co., 92 App. Div. 1, 87 N. Y. Supp. 65 (2d Dep't 1907), *aff'd*, 179 N. Y. 520, 71 N. E. 1133 (1904). The "no further inquiry" rule may be applied with substantial justice in many transactions of purchase and sale but not universally. For example, a gift from a grantor-fiduciary to his trust and reported as such for tax purposes, which takes the form of a sale to the trust of property at a price admittedly below a readily realizable market value would come within the rule. Such a transaction is entitled to at least an inquiry.

13. In Matter of Kilmer, 187 Misc. 121, 61 N. Y. S. 2d 51 (Surr. Ct. 1946), three executors wished to accept an offer of $116,000.00 for a parcel of real estate, at a price exceeding all appraisals and other bids. The fourth executor thought he could get a better price from a chain-store company and agreed in writing that if he could not, and if, as

of several fiduciaries has a private interest receives no different treatment from one in which there is only one fiduciary.[14] The fact that the sale was made at public auction at which the fiduciary was the highest bidder makes no difference.[15] A transaction between a fiduciary and his or her spouse is treated as a transaction between a fiduciary and himself or herself,[16] and a sale by a fiduciary to his own child is likewise voidable.[17] And as a fiduciary cannot validly contract with a firm of which he is a partner,[18] a sale by a fiduciary to his own firm will not stand up under attack. As a matter of fact, a fiduciary who sells to or buys from any relative by blood or marriage or any business associate is asking for trouble. It must be kept in mind constantly, and it is not easy to do so, that factors such as complete honesty of purpose, adequacy of price, or a desire in the best of faith to help the estate are not material. The test is merely whether there "might be" a conflict of interest.

A transaction between a fiduciary and a corporation of which he is an officer, as, for example, where a fiduciary buys a mortgage for his trust from a corporation of which he is president and director constitutes a violation of the rule.[19] It is not necessary to "pierce the veil of corporate entity." The existence of a conflict of interest is in itself sufficient to void the deal.

Transactions between a corporate fiduciary and an associated corporation, albeit one with a separate legal entity, may be set aside or may result in surcharges, if the circumstances are such that a conflict of interest "may exist."[20] However, the fiduciary will not be surcharged

a result of the delay in accepting the offer of $116,000.00, the latter was withdrawn, he would buy the property himself for that price. He had to make good on his agreement. Upon a later accounting, the sale was rescinded. If, in the meanwhile, he had sold the property at a profit and paid an income tax thereon, or if he had improved the property, the attempt to aid the estate might have been highly expensive.

14. Munson v. Syracuse, Geneva & Corning R.R. Co., 103 N. Y. 58, 74, 8 N. E. 355, 358 (1886). The court said: "The law cannot accurately measure the influence of a trustee with his associates, nor will it enter into the inquiry. . . . " Among other cases in which only one of several trustees had an interest in transactions held voidable are: Matter of Durston, 297 N. Y. 64, 74 N. E. 2d 310 (1947); Matter of Huffnagel, 258 App. Div. 1088, 18 N. Y. S. 2d 76 (2d Dep't 1940); Matter of Ewald, 266 App. Div. 799, 42 N. Y. S. 2d 39 (2d Dep't 1943).

15. Davoue v. Fanning, 2 John Ch. 252 (N. Y. 1816).

16. *Ibid.* Matter of Randolph, 134 N. Y. Supp. 1117 (Surr. Ct. 1911), *aff'd*, 150 App. Div. 902, 175 N. Y. Supp. 1138 (1st Dep't 1912); Matter of Fulton, 253 App. Div. 494, 2 N. Y. S. 2d 917 (3d Dep't 1938); RESTATEMENT, TRUSTS § 170 (1) (1935).

17. Matter of Segal, 170 Misc. 673, 11 N. Y. S. 2d 306 (Surr. Ct. 1939).

18. Matter of Meyers, 131 N. Y. 409, 417, 30 N. E. 135, 137 (1892).

19. Matter of Huffnagel, 258 App. Div. 1089, 18 N. Y. S. 2d 76 (2d Dep't 1940).

20. Matter of Ryan, 291 N. Y. 376, 52 N. E. 2d 909 (1943); Albright v. Jefferson County Nat. Bank, 292 N. Y. 31, 53 N. E. 2d 753 (1944); Matter of Whitmore, 172

for any commissions or profits which accrue to the associate, if the fiduciary does not share in them.[21] The conflict of interest may be other than a financial one. Thus, a mortgage investment made by a corporate fiduciary was set aside and charged to the fiduciary individually when it appeared that the mortgaged property was subject to restrictive covenants which were controlled by the owners of adjacent property, among whom was an executive officer of the fiduciary.[22] A court has held that an executor was guilty of misconduct when he participated in buying property from a corporation in which the estate had an interest, although the sale took place *before* he had qualified as executor.[23] And if a fiduciary has been guilty of self-dealing, there can be no valid ratification of the transaction unless the beneficiaries are in full possession of all the pertinent facts involved.[24]

Clerical errors, however, will be taken into consideration. The court refused to surcharge a fiduciary for selling a mortgage to one of its trusts upon proof that it had intended to buy the mortgage in the first instance for the trust but by mistake acquired it in its own name.[25] A fiduciary may also sell the asset of one trust to itself as trustee of another trust if the sales is at a fair price.[26] And, if there are reasons why a trustee should be permitted to enter into a transaction of purchase and sale with itself, the court may authorize it and thus validate it.[27]

A case recently decided by Surrogate Griffiths in Westchester County illustrates how easy it is for a fiduciary to find himself in conflict with a trust estate created by his own funds. The trustee in question had transferred all his assets to a holding corporation, including the apartment in which he resided and a commercial building in which his business corporation was a tenant, and then gave half of the stock of the holding company to his wife. She died, leaving her residuary estate, which consisted principally of the stock which her husband had given her, in trust for the life of her husband; made him the income beneficiary and ap-

Misc. 277, 15 N. Y. S. 2d 379 (Surr. Ct. 1939); Matter of Jones, 155 Misc. 315, 280 N. Y. S. 2d 521 (Surr. Ct. 1935).

21. Albright v. Jefferson County Nat. Bank, 292 N. Y. 31, 53 N. E. 2d 753 (1944); Wendt v. Fischer, 243 N. Y. 439, 154 N. E. 303 (1929).

22. Matter of Lewisohn, 294 N. Y. 596, 63 N. E. 2d 589 (1945).

23. Matter of Fensterer, 79 N. Y. S. 2d 427 (Surr. Ct. 1948).

24. Matter of Young, 249 App. Div. 495, 293 N. Y. Supp. 97 (2d Dep't 1937).

25. Matter of Montant, 72 N. Y. S. 2d 318 (Surr. Ct. 1947), *aff'd*, 274 App. Div. 757, 80 N. Y. S. 2d 357 (1st Dep't 1948).

26. Matter of Kramer, 172 Misc. 598, 15 N. Y. S. 2d 700 (Surr. Ct. 1939).

27. Matter of Smythe, 36 N. Y. S. 2d 605 (Surr. Ct. 1942).

pointed him and a trust company as the trustees. The husband continued to live in the apartment house owned by the corporation and his business corporation continued as a tenant of the commercial building. Other beneficiaries sought to remove him as trustee on the ground that a conflict of interest existed between his position as a tenant in the two buildings and his trust status as his own landlord. Fortunately, for the interests of justice, the court did not stop its inquiry when the fiduciary relationship was disclosed but ruled that the widow must have foreseen that a conflict of interest would arise and had waived it.[28]

The Right of a Corporate Fiduciary to Purchase or Hold Its Own Stock

The right of a corporate fiduciary to administer shares of its own stock as part of the assets of a trust estate is a question on which the courts of various states are in disagreement. Consequently and regardless of whether the practice is advisable or inadvisable, it is obvious that a bank doing business in the state of *A* cannot well be the subject of strong moral condemnation for doing something that would be permitted to a bank doing business in the state of *B*.

The attitude taken by the courts of New York on the issue has a curious history. In 1934, Surrogate Taylor of Orange County refused to surcharge a corporate fiduciary for buying and retaining shares of its own stock when acting under a will which permitted it to engage in self-dealing and the Appellate Division upheld him,[29] although Judge Lazansky wrote a strong dissent. The particular language of the will serves to keep the case from being a precedent on the main issue. But the court enunciated the general doctrine that a waiver of the rule against self-dealing does not impinge public policy or involve "the doing of anything *malum in se* or *malum prohibitum*."[30] Just about the same time, the Appellate Division of the Fourth Department upheld the retention by a corporate fiduciary of shares of its own stock when acting under a will which directed that the stock should be held and divided among the trusts created by the will and should not be disposed of until it became

28. Matter of Hubbell, 119 N. Y. L. J. 554 (Surr. Ct. Feb. 11, 1948).

29. Matter of Balfe, 245 App. Div. 22, 280 N. Y. Supp. 128 (2d Dep't 1935). The will contained the following provision:

"I furthermore authorize and direct that my said Executor and Trustee may freely act under all or any of the powers of this Will given in all matter concerning my estate and the trusts herein created without the necessity of obtaining the consent or permission of any person interested therein or the consent or approval of any court, notwithstanding that such Executor and Trustee may also be acting or interested either individually or as trustee of other trusts or as agent for other persons or corporation interested in the same matter."

30. *Id.* at 24, 280 N. Y. Supp. at 130.

necessary to do so to settle the estate. Here, also, the language of the will created a special situation. It is interesting to note however that the brief filed by the objectants limited the issue to negligence and did not refer to the issue of divided loyalty.[31]

In 1936, the following year, the Appellate Division of the Second Department passed upon the right of a corporate fiduciary to buy shares of its own stock when acting under an inter vivos trust agreement. Here, the objectants urged that it was contrary to public policy for a corporate fiduciary to buy its own stock. The trustee claimed that the settlor's father, who had been her agent in establishing the trust, had approved of the investment. The trial court dismissed the objection and the Appellate Division of the Second Department affirmed in a per curiam opinion in which it made no reference whatsoever to the issue of divided loyalty, cleared the fiduciary of negligence and held affirmatively that the settlor's agent had approved the transaction, and that consequently the objectants were estopped to attack it. Costs were awarded to the trustee, to be paid personally by the adult appellants. The Court of Apeals denied leave to appeal.[32] Perhaps the most interesting feature of this, the *Ellinger* case, is that the only testimony upon which the Appellate Division could have based its finding of ratification and approval was testimony which the trial court had stricken out as immaterial.

In 1937, Surrogate Foley decided a case in which the corporate fiduciary was restricted to legal investments except to the extent of being permitted to retain any securities which the testator had owned. Among them were shares of stock of a trust company which the corporate fiduciary retained. Four years later, the trustee merged with the trust com-

31. Matter of Roche, 245 App. Div. 192, 281 N. Y. Supp. 77 (4th Dep't 1935).

32. Ellinger v. Brooklyn Trust Co., 248 App. Div. 897, 290 N. Y. Supp. 616 (2d Dep't 1936), *leave to appeal denied,* 273 N. Y. 677 (1936).

The only portion of the record which the attorneys for the trustee referred in their brief in support of the claim that the settlor's agent had approved of the transaction consisted of one question and answer of an officer of the bank and the colloquy which followed:

(Defendant's Counsel)

"Q. I now ask you particularly, Mr. McDonald, with respect to the rights to subscribe to the Brooklyn Trust Company stock as enumerated in Schedule A, Part I and ask you whether or not the Brooklyn Trust Company as trustee was requested to purchase those rights?

"A. My recollection is that Mr. Eshbaugh (The settlor's father) expressed a desire to have some Brooklyn Trust Company stock into this trust. I am speaking now from memory."

(Plaintiff's Counsel)

"I move to strike out now the answers with respect to Mr. Eshbaugh.

"The Court: I cannot see that it has anything to do with this case so I grant the motion.

"(Defendant's Counsel): I respectfully except."

pany whose shares it held, and upon the merger received and retained shares of its own stock which later depreciated in value. It was surcharged with the loss upon the ground that the two institutions were of entirely different types and that the right to retain the stock of the trust company did not include the right to retain the stock of the commercial bank with which it merged. Like the interest of Mr. Sherlock Holmes in the barking dog because it had not barked, the case is of interest on the right of a trustee to hold its own stock because the court did not make any mention of this factor.[33]

No reported case on the topic, at least of any importance, seems to have been decided thereafter until 1942, when the Surrogate of Lewis County upheld the retention by a corporate trustee of shares of its own stock under a will which authorized the retention of any securities left by the testator, even if non-legal. The attack was based on negligence and not on divided loyalty and the Appellate Division of the Fourth Department found no difficulty in affirming the ruling.[34]

Around this time, two other cases were being litigated, both of which were to go to the Court of Appeals and which may be considered together. In *Central Hanover Bank v. Russell,* the corporate fiduciary became successor trustee of an inter-vivos trust, which was unrestricted as to investments. The trust was irrevocable but the settlor retained power of appointment over the disposition of the principal of the trust. The original trustee had purchased for the trust some shares of stock of the successor trustee which the latter retained when it took over. In October 1929, it purchased 500 additional shares of its own stock. On a subsequent accounting, the investment was challenged squarely on the proposition that the purchase by a trustee of its own stock was a violation of the rule against divided loyalty. The successor trustee offered evidence in support of its claim that the transaction had been approved by the grantor of the trust and her agent but since the grantor, her agent and the bank officer who handled the matter had died prior to the trial, the evidence before the referee was necessarily incomplete. The plaintiff, however, established that it was not its policy to invest trust funds in its own stock, unless requested to do so by someone interested in the trust.[35] Probably because of the death of all three parties to the transaction, the referee went outside the record to the extent of stating at the hearing that he had known the deceased bank officer and was sure he would not

33. Matter of Rolston, 162 Misc. 194, 294 N. Y. Supp. 112 (Surr. Ct. 1937).

34. Matter of Easton, 178 Misc. 611, 35 N. Y. S. 2d 546 (Surr. Ct. 1942), *aff'd,* 266 App. Div. 713, 41 N. Y. S. 2d (4th Dep't 1943).

35. It was the practice of the trustee in the *Ellinger* case, at the time of making the investment complained of, to purchase its own stock for its trusts.

have bought the stock of his own bank for the trust without the consent of the settlor.[36] The referee went further, moreover, and dismissed the objections to the investment on the law as well as on the facts. The Appellate Division of the Second Department affirmed without opinion on May 4, 1942.[37]

In *City Bank Farmers Trust Co. v. Cannon*,[38] the corporate fiduciary was acting under a revocable inter-vivos trust and was not restricted to "legals." It received from the settlor shares of stock of another bank, with which it later affiliated and it continued to retain the shares of the affiliated company, admittedly at the express direction and insistance of the grantor. Upon a later accounting, the Appellate Division of the Second Department held that the retention by a corporate fiduciary of its own stock violated the rule against divided loyalty, but that the trustee before it should not be surcharged because of the acquiescence of the settlor and of the income beneficiary in the investment. This decision was handed down on June 29, 1942, eight weeks after it had affirmed the *Russell* case.

The *Russell* case was argued in the Court of Appeals on the 11th day of January, 1943.[39] The brief of the objectant was based largely on the ruling of the Appellate Division in the *Cannon* case that the retention by a corporate fiduciary of its own stock was a violation of the rule against divided loyalty. Hence, the issue of divided loyalty was squarely before the Court of Appeals which affirmed without opinion the dismissal of the objection to the transaction complained of. It seems fair to state that this affirmance, in the face of the ruling of the Appellate Division in the *Cannon* case, and the prior refusal of the Court of Appeals to grant leave to appeal in the *Ellinger* case, where the only testimony as to ratification had been stricken out by the trial court as immaterial, tended to indicate that the Court of Appeals did not consider that the retention and perhaps even the purchase by a corporate fiduciary of its own stock violated the rule against divided loyalty.

Two months after the *Russell* case was affirmed, Surrogate Foley upheld the right of a corporate fiduciary to retain its own stock when acting under a testamentary power to retain the decedent's own investment, noting in addition that there had been a long time association between the bank and the family of the testatrix.[40]

36. Mr. Justice Stareleigh's ruling in *Bardell v. Pickwick* that what the soldier said was not evidence, might be applied to this comment. But it makes good sense nevertheless.

37. Central Hanover Bank v. Russell, 264 App. Div. 771, 35 N. Y. S. 2d 276 (2d Dep't 1942).

38. City Bank Farmers Trust Co. v. Cannon, 264 App. Div. 429, 35 N. Y. S. 2d 870 (3d Dep't 1942).

39. Central Hanover Bank v. Russell, 290 N. Y. 593, 594, 48 N. E. 2d 674 (1943).

40. Matter of Schell, 109 N. Y. L. J. 2110 (Surr. Ct. May 29, 1943).

In November 1943, the Court of Appeals decided the *Cannon* case and in its opinion held flatly that the purchase and retention by a corporate fiduciary of its own stock was a violation of the rule against divided loyalty. It is true that it affirmed the judgment appealed from and refused to surcharge the trustee before it upon the ground that since the trust was revocable by the grantor, who had ratified the investment under attack, the objectants were estopped to criticize it, but this did not serve to weaken its ruling on the basic issue.[41]

However, the Surrogates of New York County did not interpret the *Cannon* case as a prohibition against the retention by a corporate trustee of its own stock, when acting under a testamentary authorization to keep the securities owned by a testator at his death. Following the *Cannon* decision, Surrogate Foley upheld such retention in at least two cases,[42]

41. City Bank Farmers Trust Co. v. Cannon, 291 N. Y. 125, 51 N. E. 2d 674 (1943). The opinion of the court makes evident how difficult it is to evaluate an affirmance without opinion. In the official report of the *Russell* case, the digest of the fact and issues ends with the following:

"In over-ruling the guardian's objections the referee stated that he was unable to find either that the purchase and retention of the stock were improper and in bad faith as a matter of fact or were illegal as a matter of law."

When this is followed by "Judgment affirmed with costs payable out of the trust fund. No opinion," it is submitted that one is apt to think that the affirmance was on both the facts and the law. But the opinion of the court in the *Cannon* case described its holding in the *Russell* case as being to the effect that when the settlor of a trust who had retained a power of appointment over the principal of a trust, had approved of an investment made by a trustee, the appointees of the power were precluded from objecting to it, which limits the affirmance to the precise facts before the court.

42. Matter of Frissell, 111 N. Y. L. J. 1565 (Surr. Ct. April 22, 1944). The will contained the following provisions:

"I hereby authorize and empower my Executors to retain and transfer to themselves as Trustees of the trust created by this my Will, and my Trustee to receive and retain as a part of the principal of said trusts, any securities or other form of property or investments of which I may die seized or possessed, without regard to the proportion which any investment or investments of a similar character may bear to the entire amount of my estate or of the trust funds, and notwithstanding that the same may not be such as are authorized by law for the investment of trust funds."

Matter of Ryan, 186 Misc. 688, 57 N. Y. S. 2d 462 (Surr. Ct. 1945). The will provided as follows:

"I hereby give my executors and trustees full power and authority in their discretion to hold and retain any property coming to them under my will in the same form of investment as that in which it may exist at the time of my death although it may not be of the character of investments permitted by law to trustees."

In addition, the testator wrote a letter to his trustees, requesting them to retain his securities unless there was such a change of circumstances as to lead them to believe that he himself would have changed his mind about keeping them.

Surrogate Delehanty in at least one case[43] and Surrogate Collins in at least one case.[44] In Kings County, Surrogate McGarey held that when a testator created trusts, consisting of shares of stock of the bank which he appointed as the trustee thereof, and directed that upon the termination of each trust, the trustee should deliver "the said shares of stock" to the remainderman, he indicated his intention that the fiduciary should retain its own stock.[45]

In the summer of 1947, the Court of Appeals decided the *Durston* case.[46] The testator owned, among other assets, shares in a bank of which he was a director and which his father had helped to incorporate. He gave his residuary estate, which included the bank stock to three trustees, the bank itself, his brother-in-law who was its president, and his attorney, and authorized them:

" . . . to hold, care for, manage and control the same, to sell and convert into money any part of all thereof, without the authorization or approval of any court, to invest or reinvest the same, or portions thereof, in such interest bearing or income producing securities or property as to the said trustees in the exercise of their discretion, may seem best, with all the authority and powers in connection with the same, I would possess, if living."

They retained the bank stock left to them and bought more shares when the capital of the bank was increased. There was a substantial loss on the investment for which they were surcharged in the courts below. The Court of Appeals affirmed on the ground that the investment powers above quoted did not constitute a waiver of the rule against divided loyalty. It said that if the testator intended that the investment powers so given to the trustees could be exercised without regard to the rule against divided loyalty, the authority should have been stated. It is, however, difficult to conceive of a more comprehensive grant of investment power in every respect than to give "all the authority and powers . . . I would possess, if living." This alone, to say nothing of the collateral facts in the case, serves to make Judge Fuld's dissent convincing.

The court indicated clearly, however, and it is an important dictum, that if the stock of the corporate fiduciary had come into the hands of

43. Matter of Stillman, 53 N. Y. S. 2d 718 (Surr. Ct. 1945). The will gave to the trustees "full power and authority, in their discretion, to hold and retain any property coming to them under this will in the same form of investment as that in which they may receive it from my executors, although it may not be of the character of investments now permitted by law to trustees."

In addition, the trustees received and filed the express consent of the beneficiaries to the retention of the stock of the corporate trustee.

44. Matter of Von Volkenburgh, 116 N. Y. L. J. 83 (Surr. Ct. July 15, 1946).

45. Matter of Edminster, 113 N. Y. L. J. 1972 (Surr. Ct. May 23, 1945).

46. Matter of Durston, 297 N. Y. 64, 74 N. E. 2d 310 (1947).

the fiduciaries after April 1, 1938, which was the effective date of Section 111 (6) of the Decedent Estate Law[47] and of Section 21 (6) of the Personal Property Law,[48] the trustees would have had enjoyed the statutory authority to retain it, and that the trustee in the *Cannon* case would have been likewise protected by those statutes, had the time element been different in that case also. It might, of course, be argued that since the statutes referred to were substantially codifications of a doctrine long established by the Court of Appeals itself,[49] the right of a corporate fiduciary to retain shares of its own stock received from the testators estate existed before as well as after April 1, 1938.

The *Durston* case left in doubt the question whether the right of a corporate fiduciary to retain its own stock was included in a testamentary direction to retain the securities owned by the testator. The doubt arose in part from the fact that the court changed the wording of its opinion in the *Durston* case. In the opinion first made public, the court said that if the testator had intended to permit his trustees to disregard the "fundamental rule of absolute loyalty and fidelity prohibiting any purchase or retention of securities involving a divided loyalty, the authority should have been explicitly stated by an express grant of power to retain the shares of the corporate trustee and to purchase additional shares." But later, the court omitted the word "explicitly" and the entire clause "by an express grant of power to retain the shares of the corporate trustee and to purchase additional shares." Consequently, the opinion now reads that "If the testator intended that all these things could be done without regard to the fundamental rule of absolute loyalty and fidelity prohibiting any purchase or retention of securities involving a divided loyalty, the authority should have been stated."[50] Any number of interpretations can be placed upon the revised language, particularly in the light of the elisions referred to.

In any event, the doubt was soon dispelled. In April 1948, the Court of Appeals decided the *Ridings* case[51] which involved the retention by a corporate trustee of shares of its own stock which had been owned by the testator, who had provided in his will that:

47. N. Y. DECEDENTS ESTATE LAW § 111 (6) provides as follows:

"No fiduciary shall be liable for any loss incurred with respect to any investment not eligible by law for the investment of trust funds if such ineligible investment was received by such fiduciary pursuant to the terms of the will, deed, decree of court or other instrument creating the fiduciary relationship, or if such ineligible investment was eligible when received, or when the investment was made by the fiduciary; provided such fiduciary exercises due care and prudence in the disposition or retention of any such ineligible investment."

48. N. Y. PERS. PROP. LAW § 21 (6) is to the same effect.

49. Matter of Weston, 91 N. Y. 502, 508 (1883).

50. Matter of Durston, 97 N. Y. 64, 72 N. E. 2d 310, 313 (1947).

51. Matter of Ridings, 297 N. Y. 417, 79 N. E. 2d 735 (1948).

"... said Trustee, in the investment of said trust funds, shall not be confined to investments legal for trust funds in the State of New York, but may continue any investment as left by me or may sell the same and invest said funds in such investments and securities as to it, through its proper officer or officers, shall seem best in its, his or their own proper discretion."[52]

The court held that this general power to retain any securities which the decedent left was sufficient to justify a corporate trustee to retain its own stock, which, it might be noted, was what Surrogate Moran of Lewis County had held on June 12, 1942[53] and what Surrogate Foley had held on May 29, 1943.[54]

The pertinent doctrines relative to the administration by a corporate fiduciary of shares of its own stock may perhaps be summarized as follows:

A—They may not be retained nor purchased without statutory or testamentary authority to do so.

B—Section 111 (6) of the Decedent Estate Law and Section 21 (6) of the Personal Property Law seems to constitute statutory authority as to retention, if the stock is received on or after April 1, 1938 in the manner prescribed by those statutes.

C—A general power in a will or trust indenture to retain securities received from the testator or settlor is sufficient to authorize the retention of the corporate fiduciary's own stock.

D—A general power to invest in non-legal securities, no matter how broad and sweeping, is *not* sufficient to permit a fiduciary to purchase shares of its own stock. There must appear, in addition, an intention to waive the rule against divided loyalty. Whether this intention must be express or whether it may be implied from the language used is in doubt.[55]

It will be noted from the foregoing that the provisions of A, B, and C will apply with equal force and effect to all other non-legal securities. The only rule applicable to the administration of the stock of a corporate fiduciary which is not equally applicable to other non-legal investments is D.

There are, however, other matters for consideration. The right of a

52. *Id.* at 418, 79 N. E. 2d at 735.

53. Matter of Easton, 178 Misc. 611, 35 N. Y. S. 2d 546. (Surr. Ct. 1942), *aff'd*, 266 App. Div. 713, 41 N. Y. S. 2d (4th Dep't 1943).

54. Matter of Schell, 109 N. Y. L. J. 2110 (Surr. Ct. May 29, 1943).

55. It is obvious from Matter of Durston, 297 N. Y. 64, 74 N. E. 2d 310 (1947), that a testamentary appointment as executor or trustee of a bank or trust company whose stock is owned by the testator, does not constitute an implied waiver of the rule against divided loyalty. It might well be so held, however, under the excellent rulings on implied waiver to be found in Matter of Hubbell, 119 N. Y. L. J. 554 (Surr. Ct. Feb. 11, 1948) and Matter of Cowen, 148 Misc. 35, 265 N. Y. Supp. 40 (Surr. Ct. 1933).

trustee merely to retain its own stock, whether testamentary or statutory, does not include the right to acquire additional shares upon an increase of capital, at least if Surrogate Wingate's decisions on that general question are adopted by other courts.[56] And if the fiduciary merges with another bank, the question of its right to retain the new stock must be decided in accordance with the general doctrines applicable to such a situation.[57] In a recent case, it appeared that the testatrix authorized her corporate trustee to retain the investments which she left, which included shares of the trustee bank. Later on, the trustee merged with another bank. Surrogate Collins authorized the retention of the stock of the merged institutions, applying the capitalization test and pointing out that both banks had only one class of stock, which was not subjected to the lien of any bonds or the priority of any other class of stock.[58]

The right of a trustee to retain or purchase its own stock does not, of course, give it any immunity from maladministration of the investment. As a matter of fact, a corporate fiduciary will be held to a particularly high degree of responsibility in administering its own stock. An individual who held as trustee, shares of the bank of which he was president, was charged with knowledge of all the facts concerning the bank,[59] and there is no reason to doubt that a corporate fiduciary will be charged with similar knowledge, not because it is a corporate trustee but because it necessarily knows all about itself.

It might also be mentioned at this point that a national bank which holds as sole trustee, shares of its own stock, may not vote the stock for the election of directors, except in accordance with the directions of any grantor or beneficiary who has reserved the right to give such direc-

56. Matter of Davidson, 134 Misc. 769, 236 N. Y. Supp. 437 (Surr. Ct. 1929), *aff'd*, 230 App. Div. 867, 245 N. Y. Supp. 731 (2d Dep't 1930); Matter of Blake, 146 Misc. 776, 263 N. Y. Supp. 317 (Surr. Ct. 1933); Matter of McCafferty, 147 Misc. 179, 264 N. Y. Supp. 38 (Surr. Ct. 1933).

57. The leading case is Mertz v. Guaranty Trust Co., 247 N. Y. 137, 159 N. E. 888 (1928). In the *Rolston* case, the court held that the City Bank Farmers Trust Company as trustee, could not, under the *Mertz* decision, retain stock of the National City Bank, and did not refer to any issue of divided loyalty. In the *Cannon* case, the court held that the City Bank Farmers Trust Company, as trustee, could not, under the rule against divided loyalty, retain stock of the National City Bank and did not refer to the *Mertz* decision. One safe deduction to be drawn from this is that the lawyer's life, like the policeman's, is not a happy one.

58. Matter of Read, 120 N. Y. L. J. 239 (Surr. Ct. Aug. 12, 1948). This "capitalization" test was applied by Surrogate Delehanty in Matter of Erwin, 19 N. Y. S. 2d 863 (Surr. Ct. 1939).

59. Matter of Richardson, 149 Misc. 192, 266 N. Y. Supp. 388 (Surr. Ct. 1928), *modified and aff'd*, 229 App. Div. 738, 241 N. Y. Supp. 890 (2d Dep't 1930), *rev'd on stipulation and consent and not as an adjudication on the merits of the appeal*, 255 N. Y. 632, 175 N. E. 346 (1931).

tions. If there is more than one trustee, the other trustee or trustees vote the stock, and the corporate trustee has no voice as to how it is voted.[59]

The rule adopted by the Court of Appeals, that the retention by a corporate fiduciary of its own stock violates the rule against divided loyalty follows the Illinois and Ohio rule,[61] but is not the universal rule. New Jersey and Pennsylvania think differently and permit a trustee to hold its own stock.[62]

Conflict of Interest Arising Out of Contracts of Employment

When a fiduciary seeks to obtain compensation other than statutory commissions for services rendered by him, which arise either directly or indirectly out of his fiduciary position, he has to overcome two doctrines which are well established by the courts of this state over a long period of time. The first one is that it is the law of New York that an executor or administrator who continues to manage or operate the business of the decedent is not entitled to any salary for his services in so doing and must content himself with his statutory commissions. This is true in spite of the fact that the testator has not only authorized but has directed that his executors continue his business.[63] The doctrine has been applied in cases where it appeared that the fiduciary had rendered the same services to the decedent at a salary during his lifetime,[64] and when the operations resulted in a profit to the estate.[65] The courts enforce the rule even if the attitude of the beneficiaries is "ungracious"[66] and regardless of the hardship which may result.[67]

The second hurdle to overcome is that of conflict of interest. If a

60. REV. STAT. § 5144 (1875), *as amended*, 49 STAT. 704, 710 (1935), 12 U. S. C. § 61 (1940).

61. In Illinois: People *ex rel.* Kerner v. Canton National Bank, 288 Ill. App. 418, 6 N. E. 2d 220 (1937). In Ohio: *In re* Stone, 138 Ohio St. 293, 34 N. E. 2d 755 (1941).

62. In New Jersey: Matter of Griggs, 125 N. J. Eq. 73, 4 A. 2d 59 (Prerog. Ct. 1939), *aff'd sub nom. In re* Patterson Nat. Bank, 127 N. J. Eq. 362, 12 A. 2d 705 (Ct. Err. & App. 1940); Matter of Riker, 124 N. J. Eq. 28, 1 A. 2d 13 (Prerog. Ct. 1938), *aff'd*, 125 N. J. Eq. 350, 5 A. 2d 685 (Ct. Err. & App. 1939); Matter of Oathout, 25 N. J. Misc. 186, 52 A. 2d 42 (Orphans Ct. 1947). In Pennsylvania: Matter of Greenawalt, 343 Pa. 413, 21 A. 2d 890 (1941); Matter of Shipley, 337 Pa. 571, 12 A. 2d 343 (1940).

63. Matter of Hayden, 54 Hun 197, 7 N. Y. Supp. 313 (Sup. Ct. 1889); Matter of Froelich, 122 App. Div. 440, 107 N. Y. Supp. 173 (2d Dep't 1907), *aff'd*, 192 N. Y. 566, 85 N. E. 1110 (1908); Matter of Rosenberg, 251 N. Y. 115, 167 N. E. 190 (1929).

64. Matter of Ferrante, 190 Misc. 537, 74 N. Y. S. 2d 728 (Surr. Ct. 1947); Matter of Hayden, 54 Hun 197, 7 N. Y. Supp. 315 (Sup. Ct. 1889).

65. Matter of Ferrante, 190 Misc. 537, 74 N. Y. S. 2d 778 (Surr. Ct. 1947).

66. Matter of Peck, 79 App. Div. 296, 80 N. Y. Supp. 76 (3d Dep't 1903), *aff'd*, 177 N. Y. 538, 69 N. E. 1129 (1903). The use by the court of the word "ungracious" is somewhat of an understatement.

67. Matter of Hayden, 54 Hun 197, 7 N. Y. Supp. 313 (Sup. Ct. 1889).

fiduciary renders service to an estate or to a corporation in which the estate has an interest, for a compensation other than his statutory commissions, he is technically occupying a position where his own interest conflicts with his duties. In the *Pyle* case,[68] which is probably the leading case in this state on the subject, the decedent and his brother were partners in a business under an agreement which provided that upon the death of either, the business was to be incorporated and the stock divided equally between the survivor and the estate of the deceased partner. The will of the testator placed his estate in trust and appointed the widow and the surviving brother-partner as trustees. The corporation agreed upon was organized and the stock distributed as agreed. Thus, the surviving brother became the owner of one-half of the stock for his own account and the owner of the other half as co-trustee with the widow. He insisted that he be elected president at a substantial salary and although he subsequently reduced it, the widow and co-trustee eventually sought to remove him as trustee. In holding that the complaint set forth a cause of action, the court said that it was not necessary to determine whether the fiduciary had acted in bad faith or had received more in salary than he would have received, had he not been a trustee; that since his salary would diminish by one-half what would otherwise have been received by the beneficiary of his trust, he could not act in conflict with his trust. It he would have received had he not been a trustee; that since his salary did not reduce the income of the trust *pro tanto* to its interest in the corporation. But the argument that a salary would have to be paid to someone else for doing what the fiduciary had done, does not satisfy the courts.[69] And lawyers would do well to bear in mind that if they use stock held by themselves as fiduciaries to become attorneys for corporations in which their estates are interested and if the beneficiaries complain about the fees which they charge the corporation, the reasonableness of the fees may not be a factor for consideration.[70]

The rule, however, is not inflexible and the courts will sometimes employ discretion in allowing fiduciaries to serve as salaried employees of a corporation in which the estate is interested, This may be because the services paid for are entirely outside the ordinary scope of the duties of an executor or trustee,[71] or because the fiduciary had received a salary

68. Pyle v. Pyle, 137 App. Div. 568, 573, 122 N. Y. Supp. 256, 260 (1st Dep't 1910), *aff'd*, 199 N. Y. 538, 92 N. E. 1099 (1910). Other illustrations of the application of this doctrine will be found in Matter of Kirkman, 143 Misc. 342, 256 N. Y. Supp. 495 (Surr. Ct. 1932); Matter of Grossman, 157 Misc. 164, 283 N. Y. Supp. 323 (Surr. Ct. 1935).

69. Matter of Popp, 123 App. Div. 2, 107 N. Y. Supp. 277 (2d Dep't 1907).

70. Matter of Hirsch, 116 App. Div. 367, 101 N. Y. Supp. 893 (1st Dep't 1906), *aff'd*, 188 N. Y. 584, 81 N. E. 1165 (1907).

71. Matter of McCord, 2 App. Div. 324, 326, 37 N. Y. Supp. 852, 853 (1st Dep't 1896);

during the life time of the decedent,[72] or because irregularities in managing the affairs of a family corporation can be overlooked.[73] But even where the practice is permitted, the salaries are closely checked in relation to services rendered. One testator directed that his business enterprises, conducted in corporate form, should be continued separately from the administration of his estate. His widow, the executrix, was elected president of the corporation at a salary because of her knowledge of the business and the salary paid to her originally was approved by the court. But she remarried and the second husband was also employed at a salary for services which duplicated to some extent the work of the executrix herself. Consequently, she was surcharged for an amount equal to the excess of the joint salaries over her original salary.[74]

Directors fees paid to fiduciaries by corporations in which the estate is interested appear to be permissible in New York.[75] Mention is made of this because an English court directed a trustee to repay to his trust estate the fees he had received from the directorship which he acquired through the stock of the estate.[76]

The Restatement of the Law of Trusts states that a fiduciary who procures his election as an officer of a corporation at a salary in excess of the value of his services is accountable to his trust for all or part of his salary but that it is not necessarily improper for him to be paid the value of necessary services.[77] The question of accounting for any such compensation has its own difficulties. If the salary is excessive, the fiduciary should, for his own protection, first repay to the corporation the amount of the excess, and, if necessary, account to the trust for the

Matter of Berri, 130 Misc. 527, 224 N. Y. Supp. 466 (Surr. Ct. 1927); Matter of Gerbereux, 148 Misc. 461, 266 N. Y. Supp. 134 (Surr. Ct. 1933); Matter of Davison, 173 Misc. 323, 17 N. Y. S. 2d 790 (Surr. Ct. 1940), which cites a number of cases on the point.

72. Matter of Block, 186 Misc. 945, 60 N. Y. S. 2d 639 (Surr. Ct. 1946). There is a suggestion to the same effect in Matter of Grossman, 157 Misc. 164, 283 N. Y. Supp. 323 (Surr. Ct. 1935). In Matter of Horowitz, 297 N. Y. 252, 79 N. E. 2d 598 (1948), the court tacitly approved the receipt by an executor of a salary from the testator's corporation which was comparable to that paid while the testator was alive, but disallowed bonuses and severance pay.

73. Matter of Gerbereux, 148 Misc. 461, 226 N. Y. S. Supp. 134 (Surr. Ct. 1933). The testator had expressed a desire that his widow receive from his corporation the same salary after his death that he had received, and the directors voted it. She was a trustee of the estate. The salary was upheld.

74. Matter of Smythe, 36 N. Y. S. 2d 605 (Surr. Ct. 1942).

75. Matter of Horowitz, 297 N. Y. 252, 78 N. E. 2d 598 (1948).

76. *In re* Francis, 74 L. J. Ch. 487 (1905).

77. RESTATEMENT, TRUSTS § 170, comment *n*. In a Maryland case, a trustee was elected an officer of a corporation in which the estate had a one-half interest and was directed to account to his estate for one-half of the salary he had received. Mangels v. Safe Deposit & Trust Co. of Baltimore, 167 Md. 290, 173 Atl. 191 (1934).

balance. But he may still face an income tax problem. One trust instrument provided specifically that the trustees must pay over to the trust all salaries which they received through their trust position. One trustee who did so was later told by the Federal Court that he was nevertheless liable for an income tax on the salary which he had turned over to his trust.[78]

Miscellaneous Instances in Which the Rule against Divided Loyalty Has Been Enforced

There may be a conflict of interest within different departments of a corporate trustee. In one instance a trust company, as trustee, had the right to invade the principal of a trust for the benefit of an income beneficiary. The latter borrowed money from the commercial department of the same bank, the lending officer relying on the powers of invasion for reimbursement. The practice was disapproved as creating a conflict of interest between the trust and the banking departments of the trust company.[79]

In another case, a threat by a trustee to violate the rule against divided loyalty was sufficient to justify the court in removing him. A husband had created a trust for his wife, making himself trustee and reserving broad powers of management over the principal of the trust, including the right to buy from and sell securities to himself, and to make unsecured loans. Later, in the course of a dispute with his wife, he threatened to make unsecured loans to himself. For this, he was removed.[80] If a fiduciary undertakes to buy an interest in an estate from a beneficiary of it, he must impart to the latter all possible information concerning the estate, and if he fails to do so, the purchase of the interest can be set aside.[81] Where the testator had lent money to his own firm and made one of his partners his executor, the latter allowed the loan to run at the same rate of interest agreed upon with the testator. But the court told him that he was not free as executor to contract either on this or on any matter with the firm of which he was a partner.[82]

An executor who has been directed by a testator to continue the latter's business may find the type of business to be a profitable one, but this does not mean that he may go into the same business for his own

78. Comer v. Davis, 107 F. 2d 355 (C. C. A. 5th 1939).

79. Matter of Osborn, 252 App. Div. 438, 299 N. Y. Supp. 593 (2d Dep't 1937).

80. Carrier v. Carrier, 226 N. Y. 114, 123 N. E. 135 (1919).

81. Matter of Humpfner, 163 Misc. 91, 296 N. Y. Supp. 593 (Surr. Ct. 1937); Matter of Rees, 72 N. Y. S. 2d 598 (Surr. Ct. 1947).

82. Matter of Meyers, 131 N. Y. 409, 30 N. E. 135 (1892).

account, and compete with himself as executor. If he does, he will find he must account to the estate for his individual profits.[83]

WHEN THE "NO FURTHER INQUIRY" RULE IS NOT ENFORCED

The rule requiring a fiduciary to deal with his estate on the highest possible level of honesty and good faith is based upon principles of justice and is never relaxed, waived or ignored. It is susceptible of application at all places and times.

The "no further inquiry" rule is of a different character. The proclamation in the *Munson* case that the court will not inquire into considerations of abstract justice in a case involving a transaction between a fiduciary and himself is pietistic rather than morally sound. It is understandable how it has caught popular fancy as a slogan and judicial cliché. A feeling of self-righteousness and a glow of self-satisfaction, not too far removed from smugness, are apt to accompany the denunciation of ill-advised conduct on the part of others. But the rule is not universally enforced, even by the courts which proclaim it, and this because the abandonment of abstract justice, which is an abandonment of natural law, is itself unnatural and unnatural results follow from it. The "no further inquiry" rule is not a standard of conduct in itself but only an aid to the enforcement of a standard. It should not be allowed to dominate, and sometimes to discredit a doctrine which it was created merely to serve.

It is by its own nature, an acknowledgment of weakness, as it is based on the fear of an inability to determine the true rights of the parties involved. This fear of course, may have been justified in 1886 when the *Munson* opinion was written. At that time, the business empires of the United States were in the making and some of their promoters were very much "on the make". It may well have been difficult at the time to establish proof of illegality or bad faith in financial transactions. But today, with all the books and records which must be kept and with all the powers of examination and of inspection which may be envoked, neither the courts nor the parties are helpless. With the truth within grasp, it should be sought and if possible obtained. There is no reason why the abstract justice of a case should not at least be inquired into in cases when the good faith of a fiduciary is established. Conflicts of interest exist for any number of reasons, and in innumerable cases they must be and are allowed to continue.

83. Matter of Offen, 45 N. Y. S. 2d 348 (Surr. Ct. 1943). The executor utilized the estate's office and facilities for his own business as well. Other recent cases illustrating miscellaneous violations of the rule against divided loyalty are Matter of Dawes, 12 N. Y. S. 2d 6 (Surr. Ct. 1939); Matter of Soss, 71 N. Y. S. 2d 23 (Surr. Ct. 1947).

A universal example of a permitted conflict arises out of the fact that the very nature of the laws governing estate administration forces a fiduciary to occupy a position whereby he is in conflict with his trust estate. A fiduciary is entitled to compensation for handling the funds entrusted to his care and he is liable to surcharge for mishandling them. As a result, two forms of conflict are created. Consider, as an illustration, the case of an individual trustee who has received non-legal securities from a testator and is not restricted with respect to their retention or reinvestments. A compliance with the testator's wishes involves keeping at least a part of the estate invested in non-legals. This in turn means that the fiduciary must spend time and his own money in determining what to retain, what and when to sell and what and when to buy. As an alternative, he may sell the non-legal securities, and reinvest in government bonds, thus reducing to a minimum the time and the personal funds which have to be spent in administering the estate and the risk of surcharge. The conflict between the testator's wishes and the fiduciary's own interest will continue to exist until the invention of a fiduciary who has neither assets nor the will to acquire any and who can thus function without hope of gain or fear of loss.

Another form of conflict of interest which is permitted to exist arises out of the ownership by a fiduciary of securities in a corporation or other entity in which he has his own financial interest. The rule against divided loyalty is strictly enforced when the circumstances tend to establish more than a mere possibility of a conflict of interest. Surrogate Foley removed one trustee who invested estate funds in unissued preferred stock of a small corporation in which he had an interest as an officer and stockholder.[84] But the situation is different when the stocks or bonds involved are those of large corporations and when the estate funds do not flow to the company in which the trustee is interested through the purchase of new securities but are utilized to purchase in the open market securities already issued and outstanding.

Theoretically and sometimes actually, the value of any security is affected favorably when it is purchased by others, and is affected unfavorably when it is sold by others. It follows, therefore, that if a fiduciary owns shares of General *X* Corporation for his individual account and additional shares for his trust, he has placed himself in a position where his private interests might conflict with his duties as a fiduciary. His judgment as to retaining or selling the shares held by the trust may be influenced by the effect of such a sale upon his own shares.

If the courts were to confine themselves to this sole factor, and bar a fiduciary from owning as fiduciary any security whose retention or sale

84. Matter of Wohl, 36 N. Y. S. 2d 926 (Surr. Ct. 1942).

might affect his individual interests, absurd results would follow, such as removing any fiduciary who held government bonds both individually and for his trust, or prohibiting a corporate fiduciary from owning as trustee any security which it might hold for its individual account, either in its portfolio or as collateral for a loan. The difficulty is to know where to draw a line. For while it is easy to say that a fiduciary may not, on the one hand, invest estate funds in a small corporation in which the fiduciary has an interest but may on the other hand, purchase and hold government bonds both individually and as trustee, there is the widest possible combination of facts and circumstances between these two extremes. It necessarily follows that the theoretical conflict which arises out of the ownership of the same security by a fiduciary for his own account as well as for his trust estate is not such a conflict as to invoke the "no further inquiry" rule. An inquiry will be made into the facts and circumstances in order to determine if the fiduciary, in holding the same securities for himself and for his estate, has violated the "punctilio of an honor the most sensitive".[85]

Supporters of the "no further inquiry" rule may argue that it was not intended to apply to general situations, such as those arising out of the nature of a fiduciary's right and obligations and mutual ownership of widely distributed securities but only to limited sets of circumstances. Yet conflicts in limited sets of circumstances are also permitted. It is not unusual for a person to borrow money from the bank which he has named as his executor and die with the debt unpaid. The executor forthwith finds himself in a conflict of interest. As an executor, it owes money to itself as a bank. In considering the question, the natural reaction is to look at it from the standpoint of abstract justice. For instance, it is the part of orderly administration for an executor to pay all debts, and it may be held liable for failure to do so with sufficient promptness.[86] And again, the debt has most probably been reduced to writing, so that there will be little difficulty in establishing its amount and little doubt as to its validity. But these and other pertinent factors are matters of further inquiry, which would not be considered under the rule of the *Munson* case. However, everyone is attracted to abstract justice by natural law just as the apple is attracted to the ground by law of gravitation, which may explain why the fact that an executor is also a creditor of the testator is not in itself a reason for barring the executor from qualifying or for removing him after he was qualified.[87]

85. Meinhard v. Salmon, 249 N. Y. 458, 464, 165 N. E. 545, 546 (1928).

86. As for example, Matter of Witkind, 167 Misc. 885, 4 N. Y. S. 2d 933 (Surr. Ct. 1938).

87. An actual, and not a theoretical, conflict is apt to appear if the debt is based on

Another instance where the courts permit a fiduciary to occupy a position in conflict with his duties is where the fiduciary has his own interest in an estate. Quite often, an executor is a residuary legatee of an estate[88] and is not removed by reason of that fact. And in almost every instance, an administrator is also a distributee since the law favors as administrators those whose kinship make them distributees.[89] It should also be realized that although there is a well defined conflict in interest between an income beneficiary of a trust, a trustee may have an interest in either the income or the principal of a trust without subjecting himself to removal for that reason *per se*.

The acceptance of some of these situations may be explained on the grounds of implied waiver by the testator.[90] But it requires a stretch of the imagination to construe a failure of a decedent to make a will as an intended waiver of the rule against conflicting interests between the distributee who becomes administrator and the other distributees.

In some instances the conflict of interest is permitted by statute. Ordinarily, a trustee may not lend money to himself.[91] But in New York, a corporate fiduciary may lend money to itself by keeping estate funds

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a collateral note and if a question exists as to the advisability of selling the collateral. The distributees are apt to urge a postponement of sale if the market is falling. In Matter of Stallo, 82 Misc. 135, 143 N. Y. Supp. 775 (Surr. Ct. 1913) the administrator, a bank, held decedent's collateral note, and sold the collateral in spite of the objections of the family who claimed that the bank had agreed to extend it. Surrogate Cohalan removed the administrator saying, it was a "travesty on justice" to continue it in office when it appeared that its interest was opposed to the interests of the estate. The Appellate Division reversed on the ground that the Surrogate had not taken testimony and made findings of fact, as required by § 2685 of the N. Y. Code of Civil Procedure, Matter of McDonald, 160 App. Div. 86, 145 N. Y. Supp. 267 (1st Dep't 1914). The Court of Appeals affirmed, 211 N. Y. 272, 165 N. E. 407 (1914). The reversal on the grounds specified leaves in doubt the question whether the appellate courts ignored the "no further inquiry" doctrine or deemed it subordinate to the statutory requirement that findings of fact must be made.

88. Illustrations of situations where there was an actual conflict between general legatees and residuary legatees will be found in two opinions by Surrogate Delehanty. In Matter of Stumpf, 153 Misc. 92, 274 N. Y. Supp. 466 (Surr. Ct. 1934), two of the three executors were also residuary legatees. In Matter of James, 120 N. Y. L. J. 1695 (Surr. Ct. Dec. 30, 1948), there was a close identity between the executors and the directors of the residuary legatee, a charitable corporation.

89. N. Y. SURR. CT. ACT § 118.

90. In Matter of Cowen, 148 Misc. 35, 265 N. Y. Supp. 40 (Surr. Ct. 1933).

91. As an illustration, see Jonger v. First Trust & Deposit Co., 147 Misc. 260, 263 N. Y. Supp. 619 (Sup. Ct. 1932). The trustees were given "absolute and uncontrolled discretion" in administering the trust and at the express request of the grantor, made a loan to one of the fiduciaries, the son-in-law of the grantor. As the trust was irrevocable, the request had no value. The court said that "absolute and uncontrolled" discretion could not be exercised in a transaction in which a fiduciary had his own interest.

on deposit with itself, provided proper bookkeeping entries are made.[92] This is merely another illustration of the fact that a conflict of interests is not evil in itself; it becomes evil only if principles of abstract justice are violated. The risk is reduced to a minimum by reason of the statutory preference given to estate accounts over ordinary accounts.[93] The interest rate is also fixed by statute.[94] The statute follows the practice sanctioned by the courts of this state over a long period of time.[95] The Restatement of the Law of Trusts does not approve of deposit of estate funds by a corporate fiduciary with itself,[96] which is somewhat inconsistent with the recognized right of a corporate fiduciary to exercise uncontrolled custody of negotiable securities or other readily saleable assets of an estate.

Another conflict of interest permitted for a time by statute allowed a trust company to purchase a mortgage in its own name, and thereafter allocate shares in it to its trusts, provided it gave prompt notice to each adult income beneficiary.[97] The practice had received prior judicial sanction.[98] The permission was revoked nineteen years after it had been granted. Although the losses on mortgage participations were severe after 1931, they were due primarily to the collapse in real estate values which commenced in 1930 or 1931 although there were also cases of "unloading."[100]

92. N. Y. BANKING LAW § 100 (b).

93. *Ibid.*

94. *Ibid.*

95. Herzog v. Title Guarantee & Trust Co., 148 App. Div. 234, 132 N. Y. Supp. 1114 (1st Dep't 1911), *modified on other grounds and aff'd*, 210 N. Y. 531, 103 N. E. 885 (1913); Matter of Haigh, 133 Misc. 240, 232 N. Y. Supp. 322 (Surr Ct. 1928); Matter of Peoples Trust Co., 169 App. Div. 699, 155 N. Y. Supp. 639 (2d Dep't 1915); Matter of Sudds, 32 Misc. 182, 66 N. Y. Supp. 231 (Surr. Ct. 1900); Matter of Johnson, 57 App. Div. 494, 67 N. Y. Supp. 1004, *modified on other grounds*, 170 N. Y. 139, 63 N. E. 63 (1902).

96. RESTATEMENT, TRUSTS § 170, Comment *m* (1935).

97. N. Y. Laws, 1917, c. 385.

98. Matter of Union Trust Co., 219 N. Y. 514, 114 N. E. 1057 (1916).

99. N. Y. Laws, 1936, c. 898.

100. Since the practice of selling mortgage participations to trusts is no longer permitted, it will not be discussed at any further length. With respect to mortgage participations still held in any trust, it should be remembered:

A—The statute permitted the sale of participations in a mortgage but not of an entire mortgage. Matter of Ryan, 291 N. Y. 376, 52 N. E. 2d 909 (1943).

B—Failure to give notice invalidates the transaction in its entirety. Matter of Ryan, 291 N. Y. 376, 52 N. E. 2d 909 (1943).

C—A guardian of an infant income beneficiary is entitled to notice and failure to notify him is a failure to comply with the statute. Matter of Bearns, 251 App. Div. 222, 295 N. Y. Supp. 618 (1st Dep't 1937), *aff'd sub nom.* City Bank Farmers Trust Co., 276 N. Y. 590, 12 N. E. 2d 590 (1937).

D—"Prompt" notice has been held to include notice given eighteen months after the

It will not take much thought to bring to mind other situations in which fiduciaries occupy positions which are theoretically in conflict with their duties or which may be in conflict with them and which are nevertheless accepted as proper. The estate continues to be protected because any real breach of abstract justice will be punished. The difficulty which confronts fiduciaries and their counsel is that the "no further inquiry" rule is still very much alive and no one can tell when it will be envoked. Seeming judicial acquiescence in a practice over a long period of time is no protection as is evidenced by the history of the cases on the right of a corporate fiduciary to administer its own stock.

Situations in Which the Interest of the Trust Estate Suggest That the Rule Against Divided Loyalty Should Be Waived

One of the self-condemning defects of the "no further inquiry" rule is that its enforcement may operate to injure the estate which the rule was designed to protect. Consequently, draftsmen should consider carefully whether a conflict of interest may arise between a fiduciary and his trust estate, and if so, whether the rule against divided loyalty should not be waived, not for the benefit of the fiduciary but for the benefit of the trust estate. Such a waiver need not be an over-all one. It may be limited to particular situations in which the interests of the estate and the preservation of the testamentary intention need protection against the holding in the *Munson* case and the "no further inquiry" rule.

It is important to realize that a waiver of the rule against divided loyalty is in no sense a waiver of the high standard of conduct demanded of fiduciaries. They remain "nevertheless bound to exercise this power (of self-dealing) in the best of faith and to evince the highest degree of disinterestedness, loyalty and honor."[101] A waiver operates only to the extent of requiring the court to inquire into the abstract justice of the particular case and decide it upon its merits rather than on a slogan. Thus, a fiduciary who has been given the broadest powers to buy and sell securities from and to a firm in which he is interested is in no sense free to enrich himself by fixing his own prices. He must adhere to market values on all transactions and the profits or compensation must be the

transaction, but before any default. Matter of Dodge, 39 N. Y. S. 2d 186 (Surr. Ct. 1943), *aff'd*, 266 App. Div. 845, 43 N. Y. S. 2d 512 (1st Dep't 1943).

E—The "notice" need not be a formal one, but seemingly will include anything found in any statement or paper sent by the trustee to an income beneficiary that can possibly be construed as notice. The test of Wendt v. Fischer, 243 N. Y. 439, 443, 154 N. E. 303, 304 (1926), as to "laying bare the truth without ambiguity or reservation with all its stark significance" is ignored in its entirety.

101. Heyman v. Heyman, 33 N. Y. S. 2d 235, 241 (Sup. Ct. 1942).

usual and customary ones.[102] In other words, the waiver serves only to give him the same rights he would have if he were not the fiduciary. The waiver, moreover, will be strictly construed. One trustee was allowed to engage in self-dealing on the purchase and sale of securities and was also allowed to make unsecured loans, but the court held he could not add the two powers together so as to make unsecured loans to himself.[103] The very fact that a testator allows fiduciaries to occupy conflicting positions means that they will be held to exact special standards of fiduciary conduct.[104] While a waiver of the rule against self-dealing will be upheld, the courts will not permit themselves to be deprived by exculpatory clauses from exercising their jurisdiction over the administration of the trust.[105] Consequently, defenders of the "no further inquiry" rule, if they are any, cannot argue that the lifting of it whether in whole or in part will result in the looting of estates. The fiduciary will continue to be answerable for his conduct, and if anything, bound by a higher standard of principles.

Obviously, it would be impossible to enumerate all the sets of circumstances under which a waiver of the rule against self-dealing might be advisable. But a few illustrations may be in order, based upon reported decisions, and upon hypothetical but practical and ordinary situations.

For example, it appeared in one decided case[106] that the testator had owned 80% of the stock of a corporation of which he was president. The remaining 20% of the stock was owned by his associates. In order that the company might enjoy sufficient working capital, he had allowed his salary and dividends on his stock to remain unpaid so that when he died, the corporation owned him $145,000.00. The testator appointed as his trustees, men who were officers or stockholders in the corporation. They reduced the debt to about $100,000.00 and administered the balance as if it were a funded asset of the estate. In keeping the money in the business, they were following the policy which the testator himself had inaugurated, and the court found that they acted in good faith.

The trustees, however, were occupying a position of conflicting interests. As trustees, they held a claim against the corporation in which they were personally interested. They had no protection under the will, either to retain the claim against the corporation as an asset or to deal with themselves, and the court had to direct them to pay off the debt. Perhaps in this particular case, the loan was paid without im-

102. *Ibid.*
103. Carrier v. Carrier, 226 N. Y. 114, 123 N. E. 135 (1919).
104. Matter of James, 120 N. Y. L. J. 1695 (Surr. Ct. Dec. 30, 1948).
105. Heyman v. Heyman, 33 N. Y. S. 2d 235 (Sup. Ct. 1942).
106. Matter of Keane, 95 Misc. 25, 160 N. Y. Supp. 200 (Surr. Ct. 1916).

pairing the value of the stock of the corporation which was owned by the estate. But it is easy to conceive of circumstances where forcing a small corporation to pay a debt of this character, which the testator did not wish to have paid, would either destroy or substantially impair the value of the estate's equity in the corporation. A testator owes it to his beneficiaries to see to it that his fiduciaries may exercise judgment and discretion, free from the burden of operating under the judicial threat that they will not be allowed to defend their actions.

In another case,[107] the testator was in partnership with his brother under an agreement which provided machinery for valuing the assets of the business upon the death of either partner for the purpose of liquidating the interest of the deceased partner in the assets of the firm. The testator made his brother one of his trustees. The inevitable happened. The widow disagreed with the brother as to the method of valuing the assets; the brother's conflicting interests were obvious and because a conflict existed, he was removed. The "no further inquiry" rule was enforced at the expense of frustrating the testamentary intent that the brother function as a trustee. If the testator had waived the rule against divided loyalty, the brother could have continued as trustee, and his appraisal of the assets of the partnership would have been measured by "the highest degree of disinterestedness, loyalty and honor."[108]

Of course, these cases could have been decided differently by applying the doctrine of an implied waiver of the rule against divided loyalty. This was done in the one case[109] where the testator created a trust and gave the trustees power to invade the principal for the benefit of the income beneficiary. The testator then proceeded to make one of his trustees a remainderman of the trust, thus placing him in a position where any invasion of principal would in effect come out of his own pocket. The testator should have waived expressly the rule against divided loyalty which was automatically created. The court however did it for him, to the extent of denying the application of the income beneficiary to remove the trustee, ruling that it was the testator and not the fiduciary who was responsible for the situation.

Another instance in which the rule against divided loyalty may well be waived is where it appears that a fiduciary may live in a building which is a part of the trust estate. The waiver need go no further than to authorize the fiduciary to occupy the conflicting relationship of landlord and tenant.[110] If he charges himself too little rent, the waiver will not

107. Matter of Keller, 142 App. Div. 454, 127 N. Y. Supp. 16 (1st Dep't 1911).

108. Heyman v. Heyman, 33 N. Y. S. 2d 235, 241 (Sup. Ct. 1942).

109. Matter of Cowen, 148 Misc. 35, 265 N. Y. Supp. 40 (Surr. Ct. 1933).

110. In Matter of Hubbell, 119 N. Y. L. J. 554 (Surr. Ct. Feb. 11, 1948), a waiver was implied.

interfere in the slightest degree with the right of a court to fix a proper rent.

The waiver of the rule against divided loyalty may become highly advisable in circumstances where a testator or settlor of a trust wishes to appoint a salaried associate or employee as a trustee. The *Pyle* case held that since a conflict of interest exists when a trustee becomes a salaried officer of the corporation whose stock he holds as trustee, a trustee who accepts such a salary is liable to removal.[111] This may have been modified by the recent *Horowitz* case[112] which tacitly approved the acceptance by a trustee of the same salary which he was receiving when the testator died. But since the court disapproved the bonus and severance pay given to the fiduciary in the *Horowitz* case without discussing the circumstances or the merits of the payments, it would seem that the compensation of an employee named as a fiduciary must be frozen at the level as of the date of death. This, of course, might well serve to persuade the employee named as a fiduciary to relinquish either his position as fiduciary or as employee or both, particularly if the employee was young with increasing earning power ahead of him. He might well decide that the statutory compensation of a trustee was far less attractive than the salary increases which he might obtain if not tied down by the "no further inquiry" rule.

Consequently, a testator contemplating appointing a salaried employee or a partner or fellow corporate officer as a fiduciary of his estate should consider carefully the advisability of waiving the rule against divided loyalty. If he elects to do so, he will not be taking any great risk. If the fiduciary employs his trust powers to vote himself an excessive salary, the courts are always available to protect the trust estate.

If the testator prefers, he may grant a limited waiver of the rule against divided loyalty to the extent of providing that one fiduciary may engage in self-dealing with the approval of co-fiduciaries having no personal interest in the transaction. This would get away from the present doctrine, also derived from the *Munson* case, that all fiduciaries are equally liable in a transaction of self-dealing in which only one has an interest, on the theory that the court will not undertake to measure the influence that one fiduciary may have over his fellow fiduciaries. This makes some sense in a corporate transaction where one director, through his stock interests, may cause to be elected to serve with him a group who will be subservient to him. But it has nothing to commend it in an

111. Pyle v. Pyle, 137 App. Div. 568, 573, 122 N. Y. Supp. 256, 260 (1st Dep't 1910), *aff'd*, 199 N. Y. 538, 92 N. E. 1099 (1910).

112. Matter of Horowitz, 297 N. Y. 252, 78 N. E. 2d 598 (1948).

estate where the testator or the settlor of a trust has selected his own fiduciaries.[113]

In situations where one of several fiduciaries is also a salaried employee of a corporation, shares of stock of which are held by the trust estate, the testator may wish to provide that the stock shall be voted only by those fiduciaries who are not employees. Such a provision would be along the lines of the federal statute restricting the right of a national bank to vote at elections of its own directors, such shares of its own stock as it may hold as trustee.[114]

It should be again emphasized that a waiver of the rule against divided loyalty is in no sense an invitation to a fiduciary to loot his estate nor is it even giving him an opportunity to do so with impunity. For it does not lower in the minutest degree the standards of conduct imposed upon the fiduciary. They continue to be of the highest and they will continue to be enforced by alert courts in exacting fashion. The waiver of the rule will merely substitute the application of principles of abstract justice for an arbitrary refusal to inquire into justice.

The "no further inquiry" rule is so firmly entrenched in our law that its revocation should come from the legislature and not the courts, unless the doctrine of "stare decisis" is to be further weakened. Admittedly, it will take some courage to make the change. The rule sounds so plausible; it appears to be so noble of purpose; it rings with such honesty. It has everything except the ability to resist analysis. It is pleasing as rhetoric, but it is bad law, as is any law, statutory or judge-made, which establishes a policy rather than abstract justice as the standard of individual guilt. It has not even the justification of necessity, if necessity can ever justify a bad law. Both statutes[115] and well established judicial doctrines will protect an estate against actual wrong-doing.[116] If further protection is needed, it can be obtained through the establishment of a rule that the burden of proof as to the fairness of any transaction between

113. In Matter of Berri, 130 Misc. 527, 224 N. Y. Supp. 466 (Surr. Ct. 1927), one of the grounds for permitting a fiduciary to accept a salary was that his co-fiduciaries who voted in favor of it had been selected by the testator and that the salaried fiduciary had no part in their selection.

114. REV. STAT. § 5144 (1875), *as amended,* 49 STAT. 704, 710 (1935), 12 U. S. C. § 61 (1940).

115. Sec. 111 (2) Decedent Estate Law and § 21 (2) Personal Property Law provide that "no trustee shall purchase securities here under from himself."

116. The numerous cases examined in connection with the preparation of this article indicate that there are no signs that the high standards of conduct imposed upon fiduciaries are being subjected to the "disintegrating erosion" that Judge Cardozo referred to in Wendt v. Fischer, 243 N. Y. 439, 154 N. E. 303 (1929).

a fiduciary and his estate, not already prohibited by statute, is upon the fiduciary.

The important thing is to recall principles of abstract justice from the exile to which they were condemned by the opinion in the *Munson* case. No doctrine of law which affirmatively and almost gleefully disclaims interest in the abstract justice of any case has a place in American jurisprudence.