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Trustee Liability for Breach of the Duty of Loyalty: Good Faith Inquiry and Appreciation Damages

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NOTES

TRUSTEE LIABILITY FOR BREACH OF THE DUTY OF LOYALTY: GOOD FAITH INQUIRY AND APPRECIATION DAMAGES

Introduction

In remedying breaches of its vaunted duty of loyalty, the law of trusts in New York is fettered by rules that emphasize restitutionary principles. Created by a stubborn adherence to absolute liability, this emphasis persists because it was written into the Restatement of Trusts. Although absolute liability and restitution of gain may still

1. "Many forms of conduct permissible in a workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties. 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. As to this there has developed a tradition that is unbending and inveterate. 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. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.” Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928) (Cardozo, C.J.) (citation omitted). Professor Scott called it “the fiduciary principle.” Scott, The Fiduciary Principle, 37 Calif. L. Rev. 539, 555 (1949).


4. Restatement (Second) of Trusts (1959); Restatement of Trusts (1935). The Restatement of Trusts is one of several restatements of the law produced by the American Law Institute to analyze “the most important topics of the law and to state succinctly the rules which are shown by analysis to represent the predominant American authority.” Seavey & Scott, Restitution, 54 L.Q. Rev. 29, 29 (1938). This ambitious undertaking was believed necessary because “[i]t was apparent that the confusion, the uncertainty, was growing worse from year to year . . . [and] that the vast multitude of decisions which our practitioners are obliged to consult was reaching a magnitude which made it impossible in ordinary practice to consult them.” American Law Institute is Organized, 9 A.B.A.J. 137, 137 (1923) (quoting from speech by the
serve valid purposes, justice requires an inquiry into the character of the breach as well as full compensation of the beneficiary when a trustee makes a sale tainted with a conflict of interest.

The trustee owes a duty of loyalty to the beneficiary. The self-dealing trustee who neglects to obtain prior court approval is irre-

Hon. Elihu Root). To the project were brought the then current legal philosophies and prejudices. Austin Wakeman Scott was Reporter of the Restatement of Trusts (1935). He was also co-author of the Restatement of Restitution (1937). The latter tome covered "a group of situations having distinct unity [that] has never been dealt with as a unit and because of this has never received adequate treatment." Seavey & Scott, supra, at 29. These situations involve a person's "right to have restored to him a benefit gained at his expense by another, if the retention of the benefit by the other would be unjust." Id. at 32. The right to restitution when no wrong is committed filled a void in the law of torts and contracts. Id. at 35-36. Appropriately, it has found its place in the law of trusts in the absence of a breach. See Restatement (Second) of Trusts § 203 (1959); Trustee Accountability, supra note 2, at 144. It has also been used, however, as the basis for the measure of damages when the duty of loyalty was breached. See Restatement (Second) of Trusts § 206, Comment b (1959).

5. In the law of express trusts, restitution is the ordinary remedy in the absence of a breach of trust. Restatement (Second) of Trusts § 203 (1959); Trustee Accountability, supra note 2, at 141; Contemporary View, supra note 2, at 574-79; Unjust Enrichment, supra note 2, at 502. Restitution is the primary remedy for gain received by a corporate fiduciary when no loss is sustained by the corporation, but the fiduciary breached his duty of loyalty. For a comprehensive review of this subject, see Marsh, Are Directors Trustees?, 22 Bus. Law. 35 (1966). The wrongdoing usually involves manipulation by insiders of stock in large public corporations and is subject to some federal regulation. Because it involves a fiduciary relationship, however, principles and rules developed in the area are applied to trustees. Contemporary View, supra note 2, at 598-99; cf. People ex. rel. Manice v. Powell, 201 N.Y. 194, 201, 94 N.E. 634, 637 (1911) ("The relation of the directors to the stockholders is essentially that of trustee and cestui que trust.").

6. Contemporary View, supra note 2, at 599; Niles & Schwartz, supra note 2, at 189-90.

7. "The trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary." Restatement (Second) of Trusts § 170 (1959); see G. Bogert, Trusts and Trustees § 543 (rev. 2d ed. 1978); II A. Scott, Law of Trusts § 170 (3d ed. 1967).


buttably presumed to be disloyal— the no further inquiry rule bars consideration of good faith and fairness. Such absolute liability is intended to negate the temptation of self-interest. Because of the no further inquiry rule, however, honest and dishonest trustees are subject to the same measures of damages. These measures do not permit the beneficiary to recover from the trustee appreciation in property wrongfully sold if the property has been transferred beyond the point at which the law can compel reconveyance. Thus, the beneficiary is forced to affirm the transfer that frees the property from the trust. It should be determined, however, whether the beneficiary's best interests have been served by the transfer. A self-

10. In re Estate of DePlanche, 65 Misc. 2d 501, 501-03, 318 N.Y.S.2d 194, 195-96 (Sur. Ct. 1971). In Munson v. Syracuse, G. & C.R.R., 103 N.Y. 59, 8 N.E. 355 (1886), the court stated that the fiduciary "stood in the attitude of selling as owner and purchasing as trustee. The law permits no one to act in such inconsistent relations. It does not stop to inquire whether the... 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." Id. at 73-74, 8 N.E. at 358; accord, Restatement (Second) of Trusts § 170, Comments b, h (1959); II A. Scott, supra note 7, § 170, at 1298.

11. Munson v. Syracuse, G. & C.R.R., 103 N.Y. 59, 73-74, 8 N.E. 355, 358 (1886); Restatement (Second) of Trusts § 170, Comments b, h (1959); II A. Scott, supra note 7, § 170, at 1298.

12. Wardwell v. Railroad Co., 103 U.S. 651, 658 (1880); see, e.g., Marsh v. Whitmore, 88 U.S. (21 Wall.) 178, 183-84 (1874) ("The character of vendor and that of purchaser cannot be held by the same person. They impose different obligations. Their union in the same person 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."); Michoud v. Girod, 45 U.S. (4 How.) 502, 554-55 (1846) ("[T]he law acts not on the possibility, that, in some cases, the sense of... duty may prevail over the motives of self-interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self-interest will exercise a predominant influence, and supercede that of duty."); Stewart v. Lehigh Valley R.R., 38 N.J.L. 505, 523 (Ct. Err. & App. 1875) ("There may be isolated cases in which the trustee is willing to make a contract on more favorable terms for the cestui que trust than any one else, but the opportunities for self-advancement, at the expense of those whose concerns 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."); Bray v. Ford, [1896] A.C. 44, 51 (Lord Herschell) ("[H]uman nature being what it is, there is danger... of the person holding a fiduciary position being swayed by interest rather than by duty."). See generally 1 J. Story, Commentaries on Equity Jurisprudence as Administered in England and America § 322 (13th ed. M. Bigelow 1896).


14. See Restatement (Second) of Trusts § 206, Comment b (1959).

dealing honest trustee is primarily motivated by the beneficiary’s interest. Thus, affirmation of the sale or recovery of the trustee’s profits would adequately remedy the breach. A dishonest trustee, however, is motivated by personal interest. Affirmance of his tainted sale or recovery of his gain would fail to compensate the beneficiary for all the appreciation of the property that, but for the wrongful sale, may have accrued to the trust.

The trustee who is found to have had such a personal interest in a sale of trust property to an unrelated third party that his judgment in making the sale was affected has also breached his duty of loyalty. This breach has been treated as the equivalent of self-dealing. Consequently, the rules that were established to define the measure of damages for this breach are the same as those that apply in self-dealing cases. The no further inquiry rule has, however, been substantially abandoned in the equivalent of self-dealing cases. Thus, the presumption of disloyalty does not arise. Inquiry into the trustee’s motives and the fairness of the transaction is necessary to establish whether personal interest affected his judgment. Because honest trustees are exonerated by the inquiry, damage rules formulated

18. See Unjust Enrichment, supra note 2, at 497, 501-02.
21. Restatement (Second) of Trusts, § 170, Comment c (1959); II A. Scott, supra note 7, § 170.5, at 1310-11, § 170.10, at 1322-24.
23. Restatement (Second) of Trusts, § 206, Comment b (1959).
24. Phelan v. Middle States Oil Corp., 220 F.2d 593, 602-03 (2d Cir.) (conflict of interest was too remote to be inducement), cert. denied, 349 U.S. 929 (1955); Anderson v. Bean, 272 Mass. 432, 446-48, 172 N.E. 647, 653-54 (1930) (trustee in a potential conflict of interest position acted in good faith); Bullivant v. First Nat’l Bank, 246 Mass. 324, 334, 141 N.E. 41, 44-45 (1923) (inquiry revealed trustee’s good faith and honest belief that action taken was advantageous to all concerned and self-interest was not a motive); Rosencrans v. Fry, 12 N.J. 88, 103-04, 95 A.2d 905, 913 (1953) (mere existence of potential conflict of interest not determinative; there must be wrongdoing); Flagg Estate, 365 Pa. 82, 88-89, 73 A.2d 411, 414-15 (1950) (same), see Haggerty, supra note 3, at 19; Contemporary View, supra note 2, at 573-74, 595-99; Trustee Accountability, supra note 2, at 156; Niles & Schwartz, supra note 2, at 182-83.
25. Unjust Enrichment, supra note 2, at 501-02. Historically, the extent of the inquiry was the identity of the third party purchaser and whether he had any relation to the trustee. Scott, The Trustee’s Duty of Loyalty, 49 Harv. L. Rev. 521, 530-33 (1936).
to apply to both honest and dishonest trustees are inadequate to remedy or to deter bad faith breaches.26

Although the no further inquiry rule may be retained to determine liability in self-dealing cases,27 an inquiry into the conduct of the trustee will assist a court in fashioning appropriate remedies.28 Rules governing the measure of damages must be reconstructed, therefore, to account for a distinction between honest and dishonest trustees and to provide for appreciation damages when necessary to compensate the beneficiary.

26. Wellman, supra note 2, at 105-09; Appreciation Damages, supra note 15, at 393-95.

27. At the minimum, it will force some honest trustees to go to court for approval of self-dealing transactions, thus removing difficult questions of proof in a later suit in which a court is asked to ratify the sale. In re Estate of Rothko, 84 Misc. 2d 830, 841-42, 379 N.Y.S.2d 923, 938 (Sur. Ct. 1975), modified and aff'd, 56 A.D. 2d 499, 392 N.Y.S.2d 570, aff'd, 43 N.Y.2d 305, 372 N.E.2d 291, 401 N.Y.S.2d 440 (1977). In addition, the rule will immediately shift the burden of proof of good faith and fairness to the trustee when a court considers the question of damages. See notes 148-49 infra and accompanying text.

28. Courts of equity have the power to excuse the honest trustee in the absence of loss to the trust estate, In re Guthrie’s Estate, 320 Pa. 530, 538, 182 A. 248, 252, (1936); Restatement (Second) of Trusts § 205, Comment g (1959); III A. Scott, supra note 7, § 205.2, at 1674-75, or, when there is loss, to take good faith conduct into account in awarding damages. Morse v. Hill, 136 Mass. 60, 71-72 (1883); Restatement (Second) of Trusts § 205, Comment d (1959); cf. In re Estate of Talbot, 141 Cal. App. 2d 309, 323-27, 296 P.2d 848, 857-59 (1956) (statutory construction required consideration of good faith in assessing damages). Only one case, however, can be found in which the New York Court of Appeals has excused a fiduciary. The breach involved investment by a guardian in guaranteed mortgage certificates. The issue was whether the investment fell within the statute prescribing legal investments for trust funds. The court found that “under the circumstances disclosed, careful fiduciaries and their legal advisers could not reasonably doubt that the language used by the Legislature in describing investments of trust funds which fiduciaries might lawfully make was intended to include investments in certificates like those [in question].” In re Stupack, 274 N.Y. 198, 213, 8 N.E.2d 485, 491 (1937). Three cases decided soon thereafter, however, indicated that even when good faith and honesty were present, the court would not inquire into them, and that Stupack represented the exception. In re Durston’s Will, 297 N.Y. 64, 72-73, 74 N.E.2d 310, 313-14 (1947); In re Ryan, 291 N.Y. 376, 386, 52 N.E.2d 909, 912 (1943); City Bank Farmers Trust Co. v. Cannon, 291 N.Y. 125, 132, 51 N.E.2d 674, 676 (1943). These decisions led three commentators to call for legislative action. Hagerty, supra note 3, at 28; Niles & Schwartz, supra note 2, at 189-90. Section 19 of The Uniform Trusts Act provides that “[a] court of competent jurisdiction may, for cause shown and upon notice to the beneficiaries, relieve a trustee from any or all of the duties and restrictions which would otherwise be placed upon him by this Act, or wholly or partly excuse a trustee who has acted honestly and reasonably from liability for violations of the provisions of this Act.” Uniform Trusts Act § 19. Three provisions prohibit self-dealing. Id. §§ 4-6. Similarly, § 61 of the English Trustee Act states that if a trustee has committed a breach of trust “but has acted honestly and reasonably, and ought fairly to be excused for the breach of trust and for omitting to obtain the directions of the court in the matter in which he committed such breach, then the
I. THE INADEQUACY OF THE PRESENT REMEDIES

The Restatement of Trusts and Scott on Trusts are usually cited as primary authority for the finding of a breach of the duty of loyalty and the award of damages. Conflicting propositions by the two authorities, however, cause confusion for courts attempting to fashion a just award. The Restatement remedies for the breach overemphasize the court's discretion. A New York court may relieve him either wholly or partly from personal liability for the same."

English Trustee Act, 1925, 15 & 16 Geo. 5, c.19, § 61. New York has not adopted the Uniform Trusts Act, nor implemented any other legislation expressly empowering courts to excuse the honest trustee. In Rothko, the Surrogate said of a third executor who was found to be merely negligent that his "help as a candid witness, his verbal protests [against acts of two co-executors found to have divided loyalties], and absence of self-interest or bad faith motives, while not sufficient to afford him continuance in office or statutory commissions, might well be the ground for relieving him of surcharge. But such is not the law until the appellate courts so speak. All we can find in his favor is a lower measure of damages. . . ." In re Estate of Rothko, 84 Misc. 2d 830, 846, 379 N.Y.S.2d 923, 942 (Sur. Ct. 1975), modified and aff'd, 56 A.D.2d 499, 392 N.Y.S.2d 870, aff'd, 43 N.Y.2d 305, 372 N.E.2d 291, 401 N.Y.S.2d 449 (1977). The two appellate courts affirmed the lesser measure of damages and did not address the question of not surcharging him at all. 56 A.D.2d 499, 392 N.Y.S.2d 870, aff'd, 43 N.Y.2d 305, 372 N.E.2d 291, 401 N.Y.S.2d 449 (1977). For a listing of the seven states and one U.S. territory that have enacted the Uniform Trusts Act § 19, see III A. Scott, supra note 7, § 206, at 1675 n.5.

29. Restatement (Second) of Trusts (1959).
30. A. Scott, supra note 7.

32. Courts will cite both for a proposition that only one will support. e.g., In re Estate of Rothko, 84 Misc. 2d 830, 877, 379 N.Y.S.2d 923, 969 (Sur. Ct. 1975) (Scott
size restitutionary principles. Conversely, Scott reasserts the compensatory purpose of awarding damages in the corresponding sections of his treatise. Furthermore, each authority is internally inconsistent regarding the measure of damages.

A. The General Rules

Compensatory damages are awarded to compensate a loss that is causally related to a wrong. They are designed to put the injured party in a position substantially equivalent to that which he would have occupied had no wrong been committed. Although compensatory damages may include measures of a restitutionary nature if such would more fully compensate the victim, they should not be displaced by restitutionary principles. The purpose remains the restoration of the status quo ante.

Restitution, on the other hand, does not require a wrong. It is based on the perception that one "has received a benefit, the reten-
tion of which would be unjust."49 The finding that enrichment is unjust ordinarily implies that someone has sustained a loss." When the loss and benefit are coextensive, restitution fully compensates the plaintiff.50 The loss and benefit need not, however, be equal.51 If the recipient has committed no wrong in the acquisition of property, the measure of damages will be the value of his enrichment.52 If the recipient is at fault in the acquisition, however, the measure will be the loss suffered by the injured party, or the value of the enrichment, whichever is greater.53 Therefore, when a wrong has been committed, restitution is only a device for achieving the goal of compensation. If the loss exceeds the enrichment, the proper focus is the restoration of the status quo ante.54

Section 205 of the Restatement sets forth the general rule governing the liability for breach of trust.48 The beneficiary may charge the trustee with any loss resulting from a breach,49 compel payment
into the trust of any benefit received by him through a breach, 70 and in some instances, hold the trustee liable for any profits that would have accrued but for the breach. 71 The beneficiary has the choice of the remedy to pursue. 72 If he is under a disability, the court will pursue the remedy "most advantageous to him and most conducive to effectuating the purposes of the trust." 73 The rule is clearly compensatory. 74 Its purpose is to remedy an injury causally related to fault. 75

B. Breaches of the Duty of Loyalty

Section 206 applies the general rule of section 205 to the breach of the duty of loyalty. 76 Presumably, the compensatory purpose of sec-

value at the time of sale. He is not chargeable with appreciation subsequent to the sale. The only breach involved is the sale for less than value. Such a sale is not voidable because it merely evidences poor judgment on the part of the trustee as to the true value of the property. The trust is made whole by payment to it of the balance of the value on the date of sale. Id. § 205, Comment d.

50. Id. § 205. This clause finds its broadest application when the duty of loyalty is breached. See id. § 206; cf. id. § 203 (restitution of profit in the absence of a breach of trust).

51. Id. § 205. Comment i to § 205 provides that the trustee is chargeable with such loss when he sells property that he has a duty to retain, fails to purchase property that he has a duty to purchase, or fails to make trust property productive. Id. § 205, Comment i. These three situations are specifically addressed in §§ 208, 211, and 207 respectively. It is unclear whether the specificity of § 205, Comment i limits the availability of the lost profits remedy to these three breaches. Scott appears to support the proposition that the listing is not exclusive. In his own treatise, he uses an example of a self-dealing trustee with a power of sale to explain the remedy. III A. Scott, supra note 7, § 205, at 1667-68. But see Wellman, supra note 2, at 105.

52. Restatement (Second) of Trusts § 205, Comment a (1959). The options are measures that allow for the differing facts and circumstances of specific breaches. The "remedies are not always distinct and are not always all of them available." Id.

53. Id. § 205, Comment b (1959); accord, Eaves v. Penn, 426 F. Supp. 830, 838 (W.D. Okla. 1976), modified and aff'd, 587 F.2d 453 (10th Cir. 1978). Similarly, the court will choose the appropriate remedy when several beneficiaries cannot agree, or when one or more of them is under an incapacity. Morse v. Hill, 136 Mass. 60, 70-71 (1883); Restatement (Second) of Trusts § 214, Comment d (1959). Included in the factors to be considered are the "relative pecuniary advantages to the trust estate." Id.


55. See notes 36-38 supra and accompanying text.

56. Restatement (Second) of Trusts § 206 (1959).
tion 205 would be fundamental to the section 206 remedies. Comment b to section 206, however, emphasizes restitutionary principles because it only expressly allows the beneficiary to recover any profit realized by the trustee.

1. Self-Dealing

When the self-dealing trustee continues to hold the trust property, the beneficiary can compel reconveyance to the trust, or force a sale by the trustee and recover the proceeds. If the trustee has resold the trust property to a third party, however, the beneficiary is only authorized by the Restatement to compel the trustee to account for the profit. It is incongruous that the breaching trustee may thus fix his liability because he will be subject to none of the constraints, considerations, and duties of trust when making the second sale.

57. Id. § 206, Comment a.

58. Comment b, entitled “Sale of trust property to the trustee individually,” provides that if “the trustee in breach of trust sells trust property to himself individually, and the price paid by him was less than the value of the property at the time when the trustee purchased it, the beneficiary can compel him to pay the difference; or, at his option, the beneficiary can set aside the sale and compel the trustee to reconvey the property and account for any income which he has received therefrom . . . ; or he can compel the trustee to offer the property for sale and if it is sold for more than the amount which the trustee paid for it, compel him to account for the excess. If the trustee has resold the property at a profit, the beneficiary can compel him to account for the profit. Similarly, the trustee is liable where he does not purchase the property individually, but has such an interest in the purchase that he violates his duty of loyalty in making the sale.” Id. § 206, Comment b. Thus, in each case the trustee is only charged with the profit he retained or made on the transaction. See Appreciation Damages, supra note 15, at 392.

59. Restatement (Second) of Trusts § 206, Comment b (1959). It is well settled that the sale is voidable if the trustee breaches his duty of loyalty by purchasing trust property for himself individually. Michoud v. Girod, 45 U.S. (4 How.) 502, 552 (1846); City Bank Farmers Trust Co. v. Cannon, 291 N.Y. 125, 132, 51 N.E.2d 674, 676 (1943); Davoue v. Fanning, 2 Johns. Ch. 200, 214 (N.Y. 1816); In re Estate of Rothko, 84 Misc. 2d 830, 858, 379 N.Y.S.2d 923, 952 (Sur. Ct. 1975), modified and aff’d, 56 A.D.2d 499, 392 N.Y.S.2d 870, aff’d, 43 N.Y.2d 305, 372 N.E.2d 291, 401 N.Y.S.2d 449 (1977); Fox v. Mackreth, 29 Eng. Rep. 224, 234-38 (1788); see II A. Scott, supra note 7, §§ 170.1, 170.2. One commentator has suggested that reconveyance is included as an option because as long as the trustee holds the property individually there is the potential to realize more profit. Appreciation Damages, supra note 15, at 392.

60. Restatement (Second) of Trusts § 206, Comment b (1959). If the third party purchaser has notice of the breach, however, the beneficiary has various remedies against him. Restatement (Second) of Trusts § 291 (1959); see notes 75-79 infra and accompanying text.

61. E.g., Fox v. Mackreth, 29 Eng. Rep. 224, 234-37 (1788); cf. Appreciation Damages, supra note 15, at 392 (beneficiary forced to affirm second sale, but no reason to distinguish such sale from a sale by the trustee directly to a third party). See also note 147 infra and accompanying text.
The beneficiary may have suffered a loss in excess of the profits realized by the trustee because, but for the breach, the property may never have been sold, and all appreciation to the time of the suit would have accrued to the benefit of the trust. Because the primary purpose of awarding damages for breach of trust is to compensate the beneficiary, the resale should not be conclusive as to the

62. In *In re Estate of Rothko*, 84 Misc. 2d 830, 379 N.Y.S.2d 923 (Sur. Ct. 1975), modified and aff'd, 56 A.D.2d 499, 392 N.Y.S.2d 870, aff'd, 43 N.Y.2d 305, 372 N.E.2d 291, 401 N.Y.S.2d 449 (1977), the Surrogate stated that, if "in the area of trusts and estates the sole purpose of damages is to make the beneficiary whole, it would seem that when a fiduciary is authorized to sell and he sells to himself or to another with whom he is closely associated, the actual injury to the beneficiary is the difference, if any, between the price paid and the price which could have been obtained on the market." *Id.* at 876, 379 N.Y.S.2d at 968-69. This is not an accurate assessment of the injury that may be caused by a sale because it fails to ascertain whether the sale was justified. *Appreciation Damages*, supra note 15, at 392; see notes 43-44 supra and accompanying text.

63. See *McKim v. Hibbard*, 142 Mass. 422, 426-27, 8 N.E. 152, 154-55 (1886). In *McKim*, the court noted that "[i]f the trustee had sold the securities for the honest purpose of reinvesting the proceeds, and subsequently, yielding to temptation, had misappropriated the funds," *id.* at 426, 8 N.E. at 154, an award of damages equal to the proceeds plus interest to the date of the suit might be appropriate. *Id.*, 8 N.E. at 154. It found, however, that the sales "were not a part of an honest transaction, by which an investment of the trust estate was to be changed, but of a transaction by means of which the funds were to be misappropriated." *Id.* at 426-27, 8 N.E. at 155. The sale itself was called into question. Its timing and the amount received from it were not considerations made with the beneficiary's best interests in mind, but were based on the trustee's personal interests. The fact of the sale was, therefore, irrelevant. *Id.*, 8 N.E. at 155.

64. See note 54 supra.

65. The importance given to the resale by the Restatement may result from the use in equity of the constructive trust as a device to fashion the remedy. See Restatement (Second) of Trusts §§ 202, 206, Comment b, 291 (1959). See generally Restatement of Restitution §§ 160, 202 (1937); 3 J. Pomeroy, *Equity Jurisdiction* §§ 1044, 1045, 1052 (4th ed. 1918). "The specific instances in which equity impresses a constructive trust are numberless,—as numberless as the modes by which property may be obtained, through bad faith and unconscientious acts." *Id.* § 1044, at 2373-74. Courts of equity "have adopted principles exceedingly broad and comprehensive in the application of their remedial justice. . . . This is often done by converting the offending party into a trustee and making the property itself subservient to the proper purposes of recompense by way of equitable trust. . . ." 2 J. Story, *supra* note 12, § 1265, at 610-11; see G. Bogert, *supra* note 7, § 471, at 3-8. Justice Cardozo described a constructive trust as "the formula through which the conscience of equity finds expression." *Beatty v. Guggenheim Exploration Co.*, 225 N.Y. 380, 386, 122 N.E. 378, 380 (1919). A constructive trust is a restitutionary device directing reconveyance in specie. Note, *Constructive Trusts Based Upon the Breach of an Express Oral Trust of Land*, 20 Harv. L. Rev. 549, 552 (1907); see Restatement of Restitution § 202, Comment c (1937). It must, therefore, attach to property, the legal title of which is in the person who is unjustly enriched. *Id.*, Introductory Note to ch. 13, at 817; *id.* § 160, Comments i, j; cf. Restatement (Second) of Trusts § 74 (1959) (necessity of trust property for creation of a trust). Upon resale to a bona fide purchaser for adequate consideration, the property is freed from trust. Restatement of
value from which damages are to be measured. Forcing the beneficiary to affirm the resale defeats the compensatory purpose of the general rule.

In his treatise, Scott does not limit the beneficiary to a restitutionary recovery. In an explanation of the remedies available for breaches of the duty of loyalty, he states that

\[\text{[i]f the trustee sells trust property to himself individually, and subsequently resells the property to a third person, the beneficiaries have the option of charging him with the value of the property at the time of the sale with interest, or with the value of the property at the time of the suit, or they can hold him accountable for the proceeds.}\]

Permitting the beneficiary to recover appreciation subsequent to the resale acknowledges the necessity of distinguishing the self-dealing trustee’s resale from a bona fide sale from the trust directly to a third party.

2. Equivalent of Self-Dealing

Comment b to section 206 makes the trustee whose sale directly to a third party is motivated by his personal interest liable for the same damages as the self-dealing trustee. If the third party purchaser was without notice of the trustee’s breach, the beneficiary may only recover from the trustee the balance of fair value on the

Restitution §§ 172, 201, Comment a (1937); Restatement (Second) of Trusts §§ 284, 287 (1959); 3 J. Pomeroy, \textit{supra}, § 1058, at 2420-21; 2 J. Story, \textit{supra} note 12, § 1264. The beneficiary is consequently limited to a damage recovery from the transferor. See Restatement of Restitution § 172, Comment a (1937); Restatement (Second) of Trusts §§ 206, Comment b, 284, 295 (1959); 3 J. Pomeroy, \textit{supra}, § 1058, at 2420-21, § 1080, at 2481.

66. When the trustee retains the property, restitution is compensatory and is achieved by means of a constructive trust. The constructive trust, however, is employed only “as a device to make the beneficiary or principal whole.” G. Bogert, \textit{supra} note 7, § 481, at 275 (emphasis added). Its loss as a device to achieve restitution in specie should not be determinative of the measure of damages.

67. III A. Scott, \textit{supra} note 7, § 206, at 1675-76 (emphasis added). Until the decision by the New York Court of Appeals in \textit{In re} Estate of Rothko, 43 N.Y.2d 305, 372 N.E.2d 291, 401 N.Y.S.2d 449 (1977), no cases were cited by Scott in support of the proposition that the beneficiary may charge the trustee with appreciation subsequent to the resale. In new text added after the decision, Scott emphasized the compensatory nature of the remedy, extolling the “flexible principles of equity.” III A. Scott, \textit{supra} note 7, § 206 (Supp. 1980). Scott had entirely omitted the appreciation damage option from his more detailed section on remedies available to the beneficiaries for breaches of the duty of loyalty, II \textit{id.} § 170.2 (3d ed. 1967), but corrected this omission in new text. II \textit{id.} § 170.2 (Supp. 1980).

68. Restatement (Second) of Trusts § 170, Comment c (1959).

69. \textit{id.} § 206, Comment b; see note 56 \textit{supra}.

70. Restatement (Second) of Trusts § 284 (1959). “A person has notice of a breach of trust if . . . he knows or should know of the breach of trust. . . .” \textit{id.} § 297.
date of sale, if the price had been inadequate, 71 or the value of the benefit obtained by the trustee. 72 These remedies, however, will fail to compensate the beneficiary when the trustee's interest was the decisive factor in whether the sale would be made. 73 As in the case of the self-dealing trustee's resale, the beneficiary should not be forced to affirm such a sale. 74

Curiously, the beneficiary is not limited by the Restatement to a recovery based solely on restitutionary principles when the trustee has sold with a view to personal gain directly to a third party who has notice of the breach. 75 The beneficiary may compel reconveyance of the property if it is still held by the third party. 76 If the third party with notice has resold in a bona-fide transaction, however, the beneficiary may compel payment into the trust of either the profits realized on the resale 77 or the value at the time of the suit, 78 whichever is greater. 79 The rationale for this rule is that because the resale has precluded recovery of the property, the third party with notice must pay its value. 80 The award correctly emphasizes restoration of the beneficiary to the status quo ante and penalizes the wrongdoer. 81 The trustee remains liable, however, only for his profit or the fair value on the date of sale. 82 The inequity of permitting the self-dealing trustee to fix the beneficiary's recovery by resale, or of only charging the equivalent of self-dealing trustee with the value as of the sale date or the value of his personal gain, is magnified when these remedies are compared with the rationale underlying the liability of the third party

71. Id. § 206, Comments b, d.
72. Id. § 206, Comment d.
73. See pt. II(C) infra.
74. When the sale would have been made on or about the same time regardless of the conflicting interest, it is not unfair that the beneficiary must affirm it for the remedies are adequate. See notes 71-72 supra and accompanying text.
76. Restatement (Second) of Trusts § 291 (1959). The purchaser holds the property as a constructive trustee. Id. § 288.
77. Id. § 291, Comment d; see United States v. Dunn, 268 U.S. 121, 133 (1925).
78. Restatement (Second) of Trusts § 291, Comment g (1959).
79. The beneficiary has the choice of remedies. Id. § 291, Comment l.
80. Id. § 291, Comment g.
81. The third party purchaser with notice from a self-dealing trustee should be similarly liable. The trustee's purchase, without court approval or the beneficiary's effective consent, is voidable, and a constructive trust attaches to the property. This trust is not extinguished because under the rationale of Restatement § 288 and § 284, a third party purchaser for value with notice of the breach is not a bona fide purchaser. The Restatement does not, however, directly address this situation. Neither does Scott. If the third party were not so liable and the trustee were chargeable only with the profit realized by him on the resale, collusion would be rewarded. Appreciation Damages, supra note 15, at 395 & n.32. Moreover, courts would be powerless to make the beneficiary whole.
82. Restatement (Second) of Trusts § 206, Comment b (1959).
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purchaser with notice. Comment b to section 206 should be amended to allow the beneficiary the option to recover from the dishonest trustee the monetary equivalent of reconveyance when the property has been transferred beyond the trust.

II. APPRECIATION DAMAGES

The problem with the section 206 remedies arises from the reliance on the no further inquiry rule to deter both honest and dishonest trustees from breaches of the duty of loyalty. The policy implemented by the no further inquiry rule is based on two assumptions. First, absolute liability is the most effective deterrent of disloyalty. Second, equity is made more efficient because proof of fraud is elusive at best. Even if the first assumption is correct, it does not follow that a distinction cannot or should not be made between honest and dishonest trustees when damages are assessed. Nor is the same amount of deterrence needed for each. Moreover, it should not be presumed that the conduct of an honest trustee will have damaged a trust estate to the same extent as the conduct of the dishonest trustee. The judicial efficiency achieved by a refusal to

83. In re Estate of Rothko, 43 N.Y.2d 305, 322, 372 N.E.2d 291, 295, 401 N.Y.S.2d 449, 456 (1977). One commentator has noted this inconsistency, but suggests that, because the trustee is not liable for appreciation damages unless he was under a § 208 duty to retain, the third party should only be similarly liable when he purchases trust property with notice of the duty to retain. Wellman, supra note 2, at 107-08. Section 291 makes no such qualification and speaks only of notice of the "breach of trust." Because "breach of trust" is defined as a violation of "any" duty in § 201, narrowing the application of § 291 to breaches of the duty to retain is unreasonable. Although the third party's potential liability under § 291 is inconsistent with the lesser liability of the trustee with the power of sale under Comment b to § 206, the inconsistency should be resolved in favor of the compensatory goal of making the beneficiary whole by charging the trustee with the greater measure of damages in appropriate cases. See In re Estate of Rothko, 84 Misc. 2d 830, 879, 379 N.Y.S.2d 923, 971 (Sur. Ct. 1975), modified and aff'd, 56 A.D.2d 499, 392 N.Y.S.2d 870, aff'd, 43 N.Y. 305, 372 N.E.2d 291, 401 N.Y.S.2d 449 (1977).

84. See In re Will of Ryan, 291 N.Y. 376, 405-07, 52 N.E.2d 909, 922 (1943); Haggerty, supra note 3, at 1-2; Contemporary View, supra note 2, at 500.

85. In re Will of Ryan, 291 N.Y. 376, 405-07, 52 N.E.2d 909, 922-23 (1943); City Bank Farmers Trust Co. v. Cannon, 291 N.Y. 125, 132, 51 N.E.2d 674, 676 (1943); Kech v. Sandford, 25 Eng. Rep. 223, 223 (1726); Haggerty, supra note 3, at 1-2; Contemporary View, supra note 2, at 500 (as to self-dealing only).

86. Stewart v. Lehigh Valley R.R., 38 N.J.L. 505, 523 (Ct. Err. & App. 1875); accord, 1 J. Story, supra note 12, § 322; Wellman, supra note 2, at 98.

87. Appreciation Damages, supra note 15, at 393-95; see Trustee Accountability, supra note 2, at 142-43; Unjust Enrichment, supra note 2, at 475-78.


89. See pt. II(C) infra; cf. Hopkins v. Loebber, 332 Ill. App. 140, 145, 74 N.E.2d 39, 42 (1947) (dishonest trustee liable for greater damages than honest trustees); In re
establish culpability is at the expense of the honest trustee and the beneficiary.

The diligent trustee will avoid tainted transactions or go to court for approval. Some honest trustees, however, may negligently engage in self-dealing or its equivalent without court approval. The dishonest trustee, having weighed the potential reward against the risk of discovery and its consequent liability, may take the chance and cover his tracks to improve the odds. Different principles should be applied to the latter two. Limiting a trustee's liability to fair value on the date of sale or restitution of profit treats the honest trustee fairly because his liability is neither open ended nor greater than the gain that he has realized. The current rules, however, similarly limit the dishonest trustee's liability. A dishonest trustee will not long consider the interests of the beneficiary if he stands to lose only the gain he intends to make. Remedial rules that single him out to account for all loss resulting from a fraudulent sale, including appreciation in property that would have accrued to the trust but for his self-interest, will give him more reason to pause and will ensure that the beneficiary is restored to the status quo.

A. The Duty to Retain

In contrast to Comment b to section 206, section 208 allows the beneficiary the option of charging the trustee with appreciation damages when he sells property in violation of a duty to retain. The rationale is that but for the wrongful sale, the property would have

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90. See note 9 supra.


94. Trustee Accountability, supra note 2, at 142; Wellman, supra note 2, at 98; Unjust Enrichment, supra note 2, at 502.

95. Trustee Accountability, supra note 2, at 142; Appreciation Damages, supra note 15, at 394-95.


97. Restatement (Second) of Trusts § 205, Comment i (1959); id. § 208, Comment d (1959).
remained in trust. Because the beneficiary has such a protectable expectation, the only way to make him whole is to allow recovery of the value of the property at the time of the suit, even though the property is beyond the reach of a constructive trust or lien.9

The limitation of Comment b to section 206 and the allowance by the Restatement of appreciation damages against the trustee only when there is a duty to retain have spawned the fiction that improper exercise of a power of sale creates a duty to retain.100 The power of sale,101 however, is a privilege,102 subject to standards of proper exercise embodied in the prudent man rule.103 If these standards are not

98. See III A. Scott, supra note 7, § 208.3, at 1696.
100. In Rollins v. May, 473 F. Supp. 355 (D.S.C. 1978), aff'd per curiam, 603 F.2d 487 (4th Cir. 1979), the court quoted Restatement § 206 and Scott § 208.3 and measured the damages assessed against a trustee who had the power to sell by the value at the time of the suit of the property that had been sold. Id. at 366-67. In In re Estate of Talbot, 141 Cal. App. 2d 309, 296 P.2d 848 (1956), the court called the fiction a "play on words." Id. at 326, 296 P.2d at 859; see In re Estate of Rothko, 43 N.Y.2d 305, 321, 372 N.E.2d 291, 297-98, 401 N.Y.S.2d 449, 456 (1977). Appreciation Damages, supra note 15, at 391-92.
101. Restatement (Second) of Trusts § 190 (1959). The trustee has the power of sale if he is specifically authorized to sell trust property by the instrument creating the trust or if the "sale is necessary or appropriate to enable the trustee to carry out the purposes of the trust." Id. If the sale of specific property is expressly forbidden by the terms of the trust or if "it appears from the terms of the trust that the property was to be retained in specie," id., the necessity or propriety of sale must be passed upon by the court prior to the sale. Id. § 190, Comment f. The intent of the settlor is controlling, id. § 190, Comment a, and the purposes of the trust and the nature of the property are relevant factors in considering whether the trustee has a power of sale. Id. § 190, Comments c, d.
102. Id., Introductory Note to Topic 3, at 398.
met with respect to a particular sale, a duty to retain is not created. The trustee had the power to sell and may have properly exercised it with regard to the same property.

The fiction, equating misuse of the power of sale with the duty to retain, is clearly inapposite to the duty to retain contemplated by section 208. Comment b limits application of section 208 to situations in which "the trustee is under a duty to retain trust property throughout and has no authority to sell at any price, at any time, or under any conditions." The section, therefore, should be relegated to serve its limited purpose.

Appreciation damages, however, may be the correct remedy for a breach of trust in the making of a sale even though a section 208 duty to retain cannot be inferred from either an improper sale or imprudent reinvestment of the proceeds. Indeed, the precedent used as the source for section 208 suggests that appreciation damages should be available. In the third Tentative Draft of the Restatement, several cases cited to support the predecessor to section 208 involved trustees who had a power of sale.

104. Restatement (Second) of Trusts § 230, Comment e (1959); see note 103 supra.
106. Restatement (Second) of Trusts § 208, Comment b (1959).
107. In Rollins v. May, 473 F. Supp. 358 (D.S.C. 1978), aff'd per curiam, 603 F.2d 487 (4th Cir. 1979), the trustee was empowered to convey real estate held in the trust as she deemed advisable "for the purposes only of reinvesting the proceeds of such sale in other real estate."' Id. at 361 (emphasis added). The trustee, however, sold some of the real estate and gave the proceeds to the income beneficiary. Id. at 361-62. Considered as a case of misappropriation, therefore, the award of damages measured by the present value of the sold properties was appropriate because they were a satisfactory approximation of the present value of a proper reinvestment that the trustee was required to make. Id. at 366. The court cited § 208, id., but the trustee did not have a duty to retain the specific property, as defined by Comment b, nor did such a duty arise from the fact of misappropriation.
108. In four of the five cases cited in the Explanatory Notes to the predecessor to § 208, Restatement of Trusts, Explanatory Notes § 199, Comment d, at 157 (Tent. Draft No. 3, 1932), the trustee had a power of sale. In Phillipson v. Gatty, 65 Eng. Rep. 213 (1848), the Vice-Chancellor held that an unlawful reinvestment of the proceeds from an otherwise lawful sale made the sale itself unlawful and required the trustees to replace the property that was sold. Id. at 214. This, however, was not an abuse of the power to sell, but a breach of the investment terms of the trust. Today, this breach would be remedied by charging the trustee with the loss on the improper investment. Restatement (Second) of Trusts §§ 205, 227, Comment r (1959). Re Massingberd's Settlement, 63 L.T.R. (n.s.) 296 (1890), and Re Walker, 62 L.T.R. (n.s.) 449 (1890), followed the Phillipson rationale to negate broad powers of sale because
All beneficiaries have a protectable expectation that trust property will remain in trust until properly sold in a transaction "necessary or appropriate to enable the trustee to carry out the purposes of the

of reinvestment of the proceeds from an otherwise valid sale in improper investments. In each case, damages were measured by the value of the property "improperly" sold as of the time of suit. The change in investments in both these cases was accompanied by a breach of the duty to keep trust property separate, and it is unclear to what extent the courts were influenced in their ultimate decisions by the additional breach. It may be that the courts in all three English cases were merely using the value of the sold securities as a measure of damages. Some light is shed on this by the following passage in an 1869 New York case that dealt solely with surcharge for improper investment. "It is conceded, that in England, the rule is, and has long been settled, that a trustee, holding funds to invest for the benefit of his cestui que trust, is bound to make such investment in the public debt, for the safety whereof the faith of their government is pledged; or in loans, for which real estate is pledged as security. And that, although the terms of the trust commit the investment, in general terms, to the discretion of the trustee, that discretion is controlled by the above rule, and is to be exercised within the very narrow limits, which it prescribes." King v. Talbot, 40 N.Y. 76, 83 (1886); see III A. Scott, supra note 7, § 227.4, at 1813. Determining that no such narrow rule applied in this country, the court applied a prudent man standard and held the trustee liable for loss on the imprudent investments. King v. Talbot, 40 N.Y. at 84-88. The court's approach suggests that the three English cases cited to support a § 208 award of appreciation damages had nothing to do with a duty to retain. Rather, these cases should be viewed as dealing with breaches of an investment duty for which damages were measured by what appropriate investments would have been worth at the time of the suit. Two American cases were also cited in the Explanatory Notes. Hart v. Ten Eyck, 2 Johns. Ch. 53 (N.Y. 1816), involved a sale pursuant to a court decree that had been fraudulently obtained by the fiduciaries. Relying on a rule that allowed recovery of the value of converted stock as of the date of the decree, the court measured certain damages by the value of the property at the time of the suit. Id. at 91-95. This reasoning may be questioned because this rule has been abandoned in favor of the New York rule that the highest intermediate value within a reasonable period after notice of the conversion may be recovered. Hartford Accident & Indem. Corp. v. Walston & Co., 22 N.Y.2d 672, 673, 238 N.E.2d 754, 754, 291 N.Y.S.2d 366, 367 (1968); cf. Baker v. Drake, 53 N.Y. 211, 215-18 (1873) (criticizing old rule as windfall for plaintiff). On the other hand, when the converted asset is unique, the value at the time of suit may be an appropriate measure. Menzel v. List, 24 N.Y.2d 91, 99, 246 N.E.2d 742, 746, 298 N.Y.S.2d 979, 984 (1969); In re Estate of Rothko, 84 Misc. 2d 830, 879, 379 N.Y.S.2d 923, 971 (Sur. Ct. 1975), modified and aff'd, 55 A.D.2d 499, 503, 392 N.Y.S.2d 870, 874, aff'd, 43 N.Y.2d 305, 372 N.E.2d 291, 401 N.Y.S.2d 449 (1977). In any event, because the decree allowing the sale was fraudulently obtained, a duty to retain could be imputed, and the case may be proper support for § 208. In the fifth case cited, McKim v. Hibbard, 142 Mass. 422, 8 N.E. 152 (1886), however, the trustee had broad powers to sell and reinvest, but sold the securities to use the proceeds for his own purposes. The trustee concealed the sales and pretended to receive dividends on the investments after the sales, thus raising the presumption that he would have held the securities through the date of the suit. Accordingly, the award of the value of the securities as of the time of the suit was proper. Id. at 430-31, 8 N.E. at 157. The trustee, however, had no obligation to retain specific securities and could have disposed of them in a proper sale. Id. at 429-29, 8 N.E. at 153.
To stress, therefore, that the section 208 allowance of appreciation damages is based on the beneficiary's expectation when the trustee has no power of sale is to miss the point. The significance of the section 208 duty to retain is that it removes all difficulties of proof as to whether the property wrongfully sold would have been retained but for the breach until the date of the suit. Admittedly, it is difficult to establish whether the trustee with a power of sale would have made the sale but for the conflict of interest. That difficulties of proof exist, however, is no reason to deny the beneficiary adequate compensation. The protectable expectation of any beneficiary to sales made in his best interest confronted the New York courts in In re Estate of Rothko.

B. In re Estate of Rothko

Surrogate Midonick, in Rothko, found that two of the three executors of the will of Mark Rothko had breached the duty of loyalty in entering into two agreements with Marlborough galleries for the sale of 100 of decedent's paintings and the consign-
ment of 698. After inquiring into circumstances, conduct, and motives, the Surrogate determined that the agreements were drastically deficient from the estate's point of view, that the two executors, motivated by personal gain, had acted in bad faith, and that Marl-

35, 379 N.Y.S.2d at 932. Both corporations were part of a "maze of 21 legal entities," id. at 859, 379 N.Y.S.2d at 953, controlled by Francis K. Lloyd. Id. at 834, 379 N.Y.S.2d at 932. The court concluded that because of disregard of corporate entities and of common financial operation, the organization should be treated as a single entity indistinguishable from the beneficial interests and control that rested in Lloyd alone. Id. at 859, 379 N.Y.S.2d at 954. For the sake of simplicity, these two corporations will be referred to in this Note as Marlborough.

118. Id. at 848-55, 379 N.Y.S.2d at 944-50. The 100 paintings were sold for $1,800,000 payable over 12 years without interest. The Surrogate, because of the payment terms, discounted the per painting price to $12,000. This compared quite unfavorably with the average of more than $80,000 per painting received by Marlborough on resale during 1970. Id. at 850, 379 N.Y.S.2d at 946. The consignment agreement ran for 12 years, used prices from the appraisals obtained for estate tax purposes as minimums, and granted Marlborough a 50% commission. The Surrogate found that the consignment period was unreasonably long, id. at 850-51, 379 N.Y.S.2d at 946, the minimum price provision was inadequate as it placed the executors in the unreasonable position of urging a low estate tax valuation and then agreeing to hold Marlborough only to performance based upon it, id., 379 N.Y.S.2d at 946, and the commission should have been in the 20% to 33 1/2% range because an inter vivos consignment by Rothko allowed for a 10% commission, and consignments by estates of somewhat comparable artists had provided for 25% to 30% commissions. Id. at 852-53, 379 N.Y.S.2d at 948-49.

119. Id. at 837-47, 379 N.Y.S.2d at 935-42. Bernard Reis was a director of Marlborough and a collector and seller of art in his own right. Id. at 842-43, 379 N.Y.S.2d at 939. The Surrogate inferred that Reis sought to continue his prestigious status in the art world by currying favor with Lloyd and Marlborough. Through the latter he had sold some of his own and his family's collection for "substantial sums . . . before, during and after the critical period of these estate negotiations." Id. at 843, 379 N.Y.S.2d at 939. Reis had ostensibly disqualified himself from the negotiations, but reserved the right to disapprove or ratify the agreements. This neither absolved his conflict nor allowed him to serve the estate as he was duty bound to do. Id. at 842, 379 N.Y.S.2d at 938; see Stewart v. Lehigh Valley R.R., 33 N.J.L. 505, 523 (Ct. Err. & App. 1875); Marsh, supra note 5, at 37. Indeed, subsequent to execution of the agreements, Reis, alone and without the knowledge of his co-executors, amended the consignment agreement in a way deleterious to the estate. 84 Misc. 2d at 851, 379 N.Y.S.2d at 947. Theodoras Stamos, another executor, was termed a "not-too-successful artist." Id. at 845, 379 N.Y.S.2d at 941. During the pendency of the negotiations, Marlborough purchased a Stamos painting from a third party. The Surrogate discredited Stamos' denial of any notice of the purchase and concluded that the possibility of further sales and eventual representation by Marlborough prevented Stamos from negotiating with the rigorous loyalty due the estate. Id., 379 N.Y.S.2d at 941. Indeed, on January 1, 1971, Marlborough became his exclusive dealer agent on terms more advantageous to him than those in the estate agreements. Id. at 844, 379 N.Y.S.2d at 940.

120. The Surrogate discovered a "curious atmosphere involving absence of hard bargaining, arms-length negotiations, deliberate consideration and the presence of improvidence and waste verging upon gross negligence on the part of all the execu-
borough had notice of the breach. The third executor had no conflict of interest, but was found to have been negligent. At the time of suit, a total of 140 paintings had been sold by Marlborough to third parties in bona fide transactions. The Surrogate voided the two agreements and directed the return to the estate of the 658 paintings still held by Marlborough. The issue was narrowed to "whether the recovery [for the sold paintings] should be the actual value . . . at the time of the sales by Marlborough, or their present value including any appreciation in their value." The Surrogate held the two bad faith executors and Marlborough jointly and severally liable for the present value and the negligent executor liable for the value on the dates of sale.

The statement of the issue was correct. Because the duty of loyalty was breached, the agreements were voidable and, therefore, irrelevant to the issue of damages. The property was not held free of trust because Marlborough had notice of the breach. The beneficiaries had the right to demand restoration of the paintings not yet sold and could compel payment into the estate of any profits made on paintings sold to bona fide purchasers for adequate consideration. The beneficiaries could also compel payment by Marlborough of the value at the time of the suit of the paintings that had been sold.

tors as well as breach of duty of disinterested loyalty on the part of . . . Reis and . . . Stamos." Id. at 855, 379 N.Y.S.2d at 950. The Court of Appeals labeled the conduct "manifestly wrongful and indeed shocking." 43 N.Y.2d at 314, 372 N.E.2d at 293, 401 N.Y.S.2d at 451.

121. 84 Misc. 2d at 860, 379 N.Y.S.2d at 954. 122. Id. at 846, 879, 379 N.Y.S.2d at 941-42, 971. 123. Id. at 873, 379 N.Y.S.2d at 965. 124. Id. at 858, 379 N.Y.S.2d at 952. 125. Id. at 883, 379 N.Y.S.2d at 974. 126. Id. at 873, 379 N.Y.S.2d at 966. 127. Id. at 879, 379 N.Y.S.2d at 971.

128. The Surrogate rejected the contention that the measure of damages was the fair value of the paintings as of the date of the agreements. Id. at 873, 379 N.Y.S.2d at 966. The two dissenting judges in the Appellate Division would have measured damages according to the reasonable value of the paintings as of the date of the agreements. 56 A.D.2d at 507, 509, 392 N.Y.S.2d at 876-77, 878 (Capozzoli & Nunez, JJ., dissenting in part). Such an award would not have been the proper remedy under existing rules and would not have adequately compensated the beneficiaries. See notes 137-43 infra and accompanying text. A third judge concurred "in the basic conclusion" while expressing "reservations with respect to various factors to be considered in the calculation of damages." 56 A.D.2d at 505-06, 392 N.Y.S.2d at 876 (Kupferman, J., concurring in part, dissenting in part). Kupferman's interest was in expediting the appeal. His use of the word "calculation" appears to mean that he agreed with the theory of the measure of damages used by the Surrogate.

129. See notes 75-81 supra and accompanying text.

130. See United States v. Dunn, 268 U.S. 121, 133 (1925); notes 75-81 supra and accompanying text.

131. See notes 79-81 supra and accompanying text.
The problem created by Rothko is whether the award of appreciation damages was compensatory or punitive. In affirming the Surrogate’s decision, the Court of Appeals held that the award was compensatory. Reliance was placed on the policy supporting such an award when the duty to retain is breached. The executors, however, had the power to sell; thus, no duty to retain arose. Although the Surrogate had noted the general rule that “beneficiaries are entitled to be put in the position which they would have occupied if no breach of duty had been committed,” the award of appreciation damages was not necessary to achieve this end.

The beneficiaries had a right to properly executed sales, but no protectable interest in the appreciation of the paintings after the sales.

132. This problem divided the justices of the Appellate Division. Stating that it was adopting the Surrogate’s basis for the award of appreciation damages, the majority held the award to be compensatory. 56 A.D.2d at 502, 392 N.Y.S.2d at 873. One dissenting justice believed the award unnecessary to compensate the beneficiaries and labeled it punitive. Id. at 506, 392 N.Y.S.2d at 876 (Capozzoli, J., dissenting in part). The second dissenting justice asserted that the Surrogate had “expressly disavow[ed] petitioners’ entitlement to punitive damages,” but had awarded them in the guise of appreciation damages. Id. at 509, 392 N.Y.S.2d at 878 (Nunez, J., dissenting in part). It is noteworthy that nowhere in his opinion does the Surrogate disavow punitive measures. Both dissenting justices would have awarded damages based on the fair value of the paintings on the date of the original agreements. Id. at 507, 509, 392 N.Y.S.2d at 876-77, 878 (Capozzoli & Nunez, JJ., dissenting in part). See generally, Lipsig, A Recent Trend, N.Y.L.J., April 24, 1980, at 1, col. 1.

133. 43 N.Y.2d at 322, 372 N.E.2d at 298, 401 N.Y.S.2d at 456.

134. Id. at 321-22, 372 N.E.2d at 297-98, 401 N.Y.S.2d at 456. Using § 208 as a starting point, the court quoted Scott § 208.3 and Restatement § 205, Comment d, which indicate that when the trustee with a power of sale commits only the breach of selling for too little, appreciation damages are not appropriate. The court suggested, therefore, that when “the breach consists of some misfeasance, other than solely for selling ‘for too low a price’ . . . , appreciation damages may be appropriate.” Id. at 321, 372 N.E.2d at 297, 401 N.Y.S.2d at 455. A serious breach of the duty of loyalty, it concluded, was such misfeasance. The conclusion is correct. Appreciation damages are appropriate when necessary to compensate the beneficiary for loss resulting from a breach of the duty of loyalty. The problem is that neither of the quoted passages or treatises support the conclusion, except for the then unsupported statement by Scott in § 206. See note 67 supra and accompanying text. Interpreting the authority to suggest that “some misfeasance” in addition to selling for too little may make appreciation damages appropriate resurrects the fiction that improper exercise of a power of sale creates a duty to retain. See notes 100-06 supra and accompanying text. In addition, the Surrogate had cited Scott §§ 206 and 208.3 in his discussion of compensatory awards and appreciation damages. 84 Misc. 2d at 873-74, 379 N.Y.S.2d at 966. That he found it necessary to justify the award on the basis of deterrence indicates that he could not support the second conclusion reached by the Court of Appeals that the award of appreciation damages in this case was necessary to compensate the beneficiaries.

135. 84 Misc. 2d at 874, 379 N.Y.S.2d at 966; see notes 100-07 supra and accompanying text.

136. 84 Misc. 2d at 872, 379 N.Y.S.2d at 965.
by Marlborough. Although the decision to consign and sell the paintings was valid, the manner in which this decision was executed was not. In the best of all possible worlds, all the paintings would have been consigned on agreeable terms, under adequate controls for sale at appropriate times. The purpose of a consignment to a professional dealer is the skillful execution of sales that obtains the best price the market will allow. Once Marlborough had purchased the 100 paintings, its profit motive would also lead to this result. When the agreements were voided, the position of the estate became equivalent to a consignor as to these paintings. The beneficiaries, therefore, would have been fully compensated by recovery of the profits that were or should have been made by Marlborough. A similar assumption regarding the sales of paintings originally consigned by the executors, if under adequate controls, is reasonable.

Marlborough had, however, made some bulk sales at discount prices. The Surrogate, therefore, determined the actual value of some of the paintings on or about the time of sale and accepted the remaining sale values as bona fide. These findings were necessary to determine the liability of the negligent executor. An award so measured represented a complete compensatory remedy. The Surrogate justified the award of appreciation damages against the other two executors as a deterrent to bad faith conduct by fiduciaries.

137. See note 120 supra.

138. 84 Misc. 2d at 860-61, 379 N.Y.S.2d at 955. The Surrogate noted Marlborough's efforts "in creating a market . . . at higher prices, far higher than date of death values." Id. at 861, 379 N.Y.S.2d at 955.

139. See id. at 879-80, 379 N.Y.S.2d at 972-73.

140. Id. at 871-72, 879, 379 N.Y.S.2d at 964-65, 972-73. According to Lloyd, the sales were induced by the need to raise money for the defense of the litigation. Id. at 871, 882, 379 N.Y.S.2d at 964, 974.

141. Id. at 879-83, 379 N.Y.S.2d at 971-75. The award of actual value rather than proceeds from bulk sales was entirely appropriate. See Rippey v. Denver United States Nat'l Bank, 273 F. Supp. 718, 734, 738-44 (D. Colo. 1967); Powers v. Black, 159 Pa. 153, 156-59, 28 A. 133, 134-35 (1893) (per curiam); Appreciation Damages, supra note 15, at 395 n.34.

142. 84 Misc. 2d at 879, 379 N.Y.S.2d at 971.

143. The award is also in accord with the current Restatement remedies. Restatement (Second) of Trusts § 206, Comment b, § 291 (1959); see pt. I supra.

144. 84 Misc. 2d at 877, 379 N.Y.S.2d at 969. Although such an award may be justified in certain cases, it is questionable whether it was appropriate in this one. Return to the estate of the total actual value of the paintings that were sold, thereby denying Marlborough its 50% commission, may have been a sufficient penalty. Because of the extensive promotional and marketing effort, as well as storage and insurance costs, such denial would have been expensive to Marlborough. See 84 Misc. 2d at 852-53, 379 N.Y.S.2d at 947. The impact of the litigation on its reputation may also have eroded its good will in the art world. Similarly, removal of the executors and denial of their commissions, id. at 857, 379 N.Y.S.2d at 952, may have been sufficiently repugnant and stigmatizing to penalize the executors. See Trustee
C. The Good Faith Inquiry

The extent to which appreciation damages are necessary to compensate the beneficiary depends on whether, but for the breach, the property would have been retained. To resolve this issue, a court must inquire into the circumstances of the sale. Three variables are present in any sale: price, identity of purchaser, and timing. Although the Restatement remedies for breach of the duty of loyalty adequately consider the first two factors, they are woefully inadequate regarding the third.\(^\text{144}\)

The trustee under consideration has the power of sale. The self-dealing trustee’s resale and the equivalent of self-dealing trustee’s original sale are, however, both induced by the breaching trustee’s own personal interest. The question arises, therefore, as to whether, if the trustee were not so motivated by personal benefit, the sales would have been made at the same time.\(^\text{145}\) This is a question of fact.

\(^{144}\) Accountability, supra note 2, at 142. The award of appreciation damages may indicate, therefore, that the Surrogate was frustrated with the allocation of liability under the Restatement rules. The executors would have been liable only for the difference between the contract price and actual value of the transactions covered by the agreements, or the gain they realized. Restatement (Second) of Trusts § 205, Comment b (1959); see notes 58, 69 supra and accompanying text. Marlborough, on the other hand, would have been chargeable with the much greater amount represented by the actual value on the dates of sale. Restatement (Second) of Trusts § 291 (1959); see notes 75-81 supra and accompanying text. Such frustration would be understandable because the rules can lead to inequitable results. The paramount inequity occurs when the beneficiary is not fully restored to the status quo ante or when the third party is less culpable than the fiduciary. In Rothko, however, the beneficiaries would have been fully compensated by a lesser award, and Marlborough was as culpable as the executors. Allowance of appreciation damages against the trustee by reconstruction of Comment b to section 206 would correctly allocate liability.

\(^{145}\) Restatement (Second) of Trusts §§ 170, 205 (1959). As to price, the beneficiary can always recover the difference between the sale price and the actual value on that day. Id. § 205, Comment d; see note 49 supra and accompanying text. As to the identity of the purchaser, the trustee is in breach if, motivated by other than the beneficiary’s interest, he sells to himself, Restatement (Second) of Trusts § 170, Comment b (1959), to his spouse, id. § 170, Comment e, to a related third party, id., to an unrelated third party with the understanding that the property be reconveyed to the trustee, id., to an unrelated third party to benefit that party, id. § 170, Comment q, to a third party with notice of the breach, id. § 291, or to a bona fide purchaser. Id. § 284.

\(^{146}\) Timimg as a factor in a sale is a matter of prudence. Restatement (Second) of Trusts § 227, Comment o (1959). Liability for an imprudent sale depends on all of the circumstances that should have been considered by the trustee at the time of the sale and is not to be governed by hindsight. Id. §§ 227, Comment o, 230, Comment e. Because “the question of prudence is one dependent on the time and place of the making of an investment,” universal rules regarding the standard should not be fashioned. III A. Scott, supra note 7, § 227, at 1808-09.

\(^{147}\) Marcus v. Otis, 168 F.2d 649, 657, modified and aff’d, 169 F.2d 148 (2d Cir. 1948); Upson v. Otis, 155 F.2d 606, 611 (2d Cir. 1946); McKim v. Hibbard, 142
to be addressed in each case, before the beneficiary is forced to affirm either sale. No general rule will suffice. As a first step, it is necessary to inquire into why the sale was made. The second step is to determine whether, but for the breach, the property would have remained in the trust. Because the trustee has given rise to this uncertainty, he should bear the burden of proof as to both of these matters. If he fails in his proof, he should be chargeable with the value at the time of the suit. If good faith is established, the timing of the sale should not be in question. If there is evidence of a mere error in judgment regarding the fair value at the time of either sale, or if there has been appreciation between the two sales, the beneficiary may charge the trustee with either the difference in value at the time of the sale or the profits realized on the resale. In either case, the honest trustee is not penalized. In the first instance, he is justifiably required to compensate the trust estate for his error. In the second, he is restoring to the trust profit that he has actually realized.

Damages assume a primary role in achieving deterrence. Compensatory damages for breach of trust and restitution of benefit in the absence of a breach are sufficient deterrents to the "temptations" buffeting the honest trustee. Unavailability of appreciation damages for bad faith breaches takes the sting out of the no further inquiry rule with respect to dishonest trustees. Allowance of appreciation damages against dishonest trustees after a full inquiry with stringent allocation of burdens of proof will better deter those most susceptible to self-interest and ensure full compensation of the beneficiary.

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Mass. 422, 425-26, 8 N.E. 152, 154 (1886); cf. Dabney v. Chase Nat'l Bank, 196 F.2d 665 (2d Cir. 1952) (full inquiry into whether trustee in bankruptcy required debtor to repay loan owed to trustee prior to insolvency because of knowledge of impending solvency exonerated trustee). See also Appreciation Damages, supra note 15, at 395 nn.32 & 34.

148. The wrongdoer should bear the risk of the uncertainty created by his own wrongdoing. Bigelow v. RKO Radio Pictures, Inc., 327 U.S. 251, 265 (1946). In Phelan v. Middle States Oil Corp., 220 F.2d 593 (2d Cir.), cert. denied, 349 U.S. 929 (1955), the court stated that, in the instance of a conflict of interest, the burden rested on the petitioner to show that the conflict actually affected the fiduciary's conduct. Id. at 600-03. Once this burden is met, however, the fiduciary has the burden to show no loss was suffered because of his conflict. Id. at 600. In self-dealing cases, the trustee would immediately bear the burden because of the no further inquiry rule. See Haggerty, supra note 3, at 28-29.


150. Trustee Accountability, supra note 2, at 142.

CONCLUSION

Current day trusteeship is an onerous position. It requires a knowledge of law, tax, and general business matters and an uncompromised vigilance for pitfalls and traps. The trustee is now at risk to exercise such prudence and diligence in the care and management of the trust estate as prudent men employ in their own affairs. On such a rule is grafted the duty to administer the trust estate solely in the interest of the beneficiary. The two complement and overlap, but are quite distinct. The duty of loyalty is an absolute barrier, the prudent man rule an objective standard. That courts are willing to investigate as nebulous a standard as prudence indicates a confidence in subjecting the conduct of a trustee to rigorous scrutiny while serving justice competently. That courts would still fear an inquiry into the honor that lies at the heart of the duty of loyalty because the quarry may prove elusive is anomalous. Good faith is the threshold of honor and is no more mercurial than prudence.

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