Trust Investments: Earmarking or Nominees?

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TRUST INVESTMENTS: EARMARKING OR NOMINEES?

By George G. Bogert*

AMERICAN LAW AS TO EARMARKING PRIOR TO MAY, 1935

Until the early 1930’s the American courts of equity were nearly unanimous in holding that trustees were under a duty to earmark trust property, that is, that mortgages, deeds, stock certificates, registered bonds, and bank accounts should show on their faces that they were held by the trustee for a particular trust. The one exception was in the case of bearer bonds which were held lawful because of their great convenience and a widely adopted practice.

This duty to earmark was absolute. It was not an obligation to earmark as far as reasonable or as far as the trustee thought best. It was a duty to label the trust assets as clearly as the nature of the documents would permit. Furthermore the trustee was required to tag the trust property in such a way as to give the public the maximum notice and not merely to keep records in his own office which would

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2Mitchell v. Moore, 95 U.S. 587 (1877); De Jarnette v. De Jarnette, 41 Ala. 708 (1888) (note and mortgage); Chancellor v. Chancellor, 177 Ala. 44, 58 So. 423 (1912) (bank account); In re Arguello, 97 Cal. 196, 31 Pac. 937 (1893) (bank account); White v. Sherman, 168 Ill. 589, 48 N.E. 128 (1897) (railroad stocks); Gilbert v. Welch, 75 Ind. 557 (1881) (bank stock); In re Riordan, 216 Iowa 1138, 248 N.W. 21 (1933) (bank account); Pedigo v. Pedigo’s Committee, 247 Ky. 403, 57 S.W. (2d) 54 (1932) (title to realty); Carey v. Safe Deposit & Trust Co., 168 Md. 501, 178 Atl. 242 (1935) (bank account); McAllister v. Commonwealth, 30 Pa. 536 (1858) (bank account); Freas’s Estate, 231 Pa. 256, 79 Atl. 513 (1911) (title to realty in name of nominee of corporate trustee); Re Hodges’ Estate, 65 Vt. 70, 28 Atl. 663 (1893) (note and mortgage).

distinguish the trust property from his own property. What might
be called "external" earmarking was demanded, and not merely
"internal" bookkeeping. The rule was applied to individual and
corporate trustees alike.

The case law was equally clear as to the effect of a breach of this
duty, namely, that the beneficiary could avoid the investment which
was not earmarked, could treat it as being held by the trustee for
his own account, and could hold the trustee personally liable for the
amount of the trust funds invested in the unlabelled asset. This
option was given the cestui in all cases, and not merely in those
instances where the trustee acted in bad faith or no benefit resulted
to the trust from lack of earmarking. This sanction for breach of
duty was clearly stated to be in the nature of a penalty, the object
of which was to deter trustees in general from engaging in a practice
which was regarded as highly dangerous to the beneficiaries. The
courts did not require proof of damage arising from failure to ear-
mark. In imposing this penalty the courts adopted the same attitude
as in the cases of disloyalty by a trustee, where they had held in
scores of cases that if the trustee placed himself in a position of con-
flicting interest while acting for the trust, the transaction was ab-
solutely voidable by the beneficiary, without proof of actual bad
faith or damage. Indeed the earmarking rule might well have been
regarded as merely one phase of the loyalty doctrine, although there
does not appear to have been any express statement to that effect.

In a few states the rule was codified. Thus, in the Field Code in
California we find the declaration that "A trustee who wilfully and
unnecessarily mingles the trust property with his own, so as to
constitute himself in appearance its absolute owner, is liable for its
safety in all events, and for the value of its use." And this section
was copied in Montana, North Dakota, and South Dakota except

\[\text{\textsuperscript{3}}\text{White v. Sherman, 168 Ill. 589, 48 N.E. 128 (1897); Freas's Estate, 231 Pa. 256,}
\text{79 Atl. 513 (1911).}

\[\text{\textsuperscript{4}}\text{In re Arguello, 97 Cal. 196, 31 Pac. 937 (1893); Gilbert v. Welch, 75 Ind.}
\text{557, 561 (1881) (the court said: "there should be no inquiry permitted into}
\text{the good faith of such transactions, the secret springs of which, in most cases, it would}
\text{probably be impossible to discover").}

\[\text{\textsuperscript{5}}\text{"The rule is designed to protect the trustee from temptation, from the hazard}
\text{of loss, and of being a possible defaulter, as well as to protect the trust fund."}
\text{Re Hodges' Estate, 66 Vt. 70, 73, 28 Atl. 663, 664 (1893).}

\[\text{\textsuperscript{6}}\text{Cal. Civ. Code (Deering, 1941) §2236. But see Laws of 1943, c. 811, as to}
\text{use of nominees.}

\[\text{\textsuperscript{7}}\text{Mont. Rev. Codes (1935) §7896.}

\[\text{\textsuperscript{8}}\text{N. D. R. C. 1943, §59-0117.}

\[\text{\textsuperscript{9}}\text{S. D. Code (1939) §59-0114.}
for the last clause. Until recently the New York Surrogate’s Court Act\textsuperscript{10} made the holding of fiduciary assets without earmarking a misdemeanor. Some of the older banking codes also seem to have restated this duty,\textsuperscript{11} but the acts relating to banks and trust companies which have been adopted since 1900 seem to require merely a physical segregation of the securities of each account and do not mention any duty to earmark.\textsuperscript{12}

In establishing this stringent common law rule the courts were concerned with two objectives, namely, (1) securing to the beneficiary his remedy of tracing, and (2) giving to the beneficiary the protection arising from notice to the public of the trust and its terms. Illustrations of instances in which these two purposes are forwarded by the application of the earmarking rule are numerous, but the following are among the more important:

\textsuperscript{10}§231 (applying to executors, administrators, guardians, and testamentary trustees only), added by L. 1916, c. 588, which became a law May 18, 1916, and became effective Sept. 1, 1916. It was held in In re Harris’ Estate, 169 N.Y.Misc. 943, 9 N.Y.Supp. (2d) 508 (1939), that a settlor could not relieve his trustee of the duty to earmark recognized by this section. For recent changes see note 39, post.

In Matter of Union Trust Co., 219 N.Y. 514, 114 N.E. 1057 (1916), a corporate trustee had prior to 1916 held mortgages in its name, without trust label, and allotted shares in them to trusts held by it. Life beneficiaries were notified of the investments and form of holding. There were objections to investment in participations in the mortgages and also to the way in which the mortgages were held. The court held the participations were legal trust investments and that the notices to the life cestuis prevented any objection to the form of holding. The court stated the common law earmarking rule and apparently reaffirmed it, but apparently held that the beneficiaries had waived their rights to object by failure to complain after receiving notices. Willard Bartlett, C. J., concurred in a short opinion in which he approved the statements about earmarking but said “the parties objecting to the account are entitled to have those views carried into effect,” and he voted to modify the order “so as to require the respondent to alter the form of the investments so as to conform to the practice approved in the opinion of Chase, J.”

This decision seems to be a recognition of the existence in New York of the common law earmarking rule prior to 1916. Section 231 of the Surrogate’s Court Act merely restated the rule as to fiduciaries accounting in that court and added the criminal penalty.

\textsuperscript{11}In Yost’s Estate, 316 Pa. 463, 466, 175 Atl. 383, 384 (1934), the Pennsylvania Banking Act, as amended to 1925, is quoted as requiring that trust companies “shall keep all trust funds and investments separate and apart from the assets of the companies, and all investments made by the said companies as fiduciaries shall be so designated as that the trust to which such investment shall belong shall be clearly known.”

A. Dishonest trustee attempts to dump poor investments when he accounts. It is obvious that if a trustee is permitted to keep his personal assets and trust investments in a pool, with no earmarks on any of them, he will be tempted, when called to account for his trust, to allocate to the trust the securities which have turned out to be least satisfactory.

B. Trustee dies or absconds. In these cases when the beneficiary or a successor trustee seeks to save something from the wreck of an insolvent trustee's estate he will be greatly aided by labels on assets which were bought with trust funds.

C. Notice to creditors. If trust investments are not labelled as such, and are held indiscriminately with the property of the trustee, the personal creditors of the trustee may seize the trust property under execution, attachment, in bankruptcy, or otherwise, and a heavy burden will be placed on the beneficiaries of the trust to prove that the investments taken were bought with trust funds. Even if the cestuis are successful in their efforts, they will be put to expense; and if they fail, what is in fact trust property will be applied to the payment of the personal obligations of the trustee.1

D. Notice to purchasers. It is well established that one dealing with a known trustee is charged with knowledge of the trustee's powers. If trust property is clearly marked as owned by a specific trust, a third person to whom the trustee seeks to mortgage, pledge or sell the asset, will be a participant in the breach of trust, and will not be a bona fide purchaser, if in fact the trustee had no power to make the transfer, or, although he had such power, if he was transferring for an improper purpose and the third person actually knew of the improper purpose or had knowledge of facts which made his participation in the transaction "an act of bad faith."

It is sometimes argued that the rule is of little value because a dishonest trustee can always convert the trust investments into cash or bearer bonds and thus easily embezzle the trust assets; that holding cash or bearer bonds is legal and will excite no suspicion and put no one on notice of an intended breach; and hence that a trustee who decides to loot the estate will not hold stocks and mortgages, if earmarking is required as to them and if failure to mark them may to some extent handicap him.

1In School District of Greenfield v. First National Bank in Greenfield, 102 Mass. 174 (1869), a bank was successful in claiming under its lien for a debt owed it by the trustee individually trust funds which had been deposited in the bank without trust label.
It is not believed that this is a sound argument. The rule admittedly does not constitute an insurance policy against dishonesty, carelessness, or loss to the trust. No rule of trust administration does have that effect. It merely has some tendency to force a trustee into practices which are safest for the beneficiary. Many dishonest trustees are not systematic and skillful in embezzling and are caught before they have completed the job. Others are honest but unbusinesslike or ignorant and attempt to make transfers which are in fact in breach of trust and they may be deterred by the proposed transferees, if the property is earmarked. The fear of penalty liability will have some deterrent effect on both dishonest fiduciaries and honest, ignorant or unbusinesslike trustees.

Notwithstanding the clearly established rule described above, many trust institutions held mortgages, stocks, and other investments either in their own names, or in the name of a nominee of the trust institution, without reference to any trust, during the generation immediately preceding the depression of 1929. They kept complete records within their trust departments as to actual ownership, segregated the documents and securities of each trust in a separate portfolio in their vaults, and regarded these practices either as compliance with the earmarking rule, or as a satisfactory substitute therefor.

The various books kept by corporate trustees, and by many skilled individual trustees, undoubtedly show clearly from day to day what are the investments of each trust; and if the stock certificates, mortgages or other instruments representing these trust investments are not earmarked on their faces, it is customary to execute declarations of trust regarding those instruments and place them in the portfolio of the appropriate trust in the vaults. Bank examiners make a complete check to see that the assets of each trust, according to the

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14 The practice followed by the company in thus carrying these mortgages has been followed for over 40 years by trust companies generally in Allegheny County and elsewhere throughout the state, with the exception of Philadelphia County. It has been approved by the Orphans' Court of Allegheny County and by the Department of Banking of the Commonwealth. Inquiries by that department through the state have ascertained that trust mortgages aggregating $138,000,000, at least, are carried without disclosure of the trusteeship on the public record, while other mortgages amounting to over $78,000,000 are designated upon the public record as trust mortgages. Guthrie's Estate, 320 Pa. 530, 533, 182 Atl. 248, 250 (1936).

In Chapter House Circle v. Hartford National Bank & Trust Co., 121 Conn. 558, 564, 186 Atl. 543 (1936), it was stated that the trial court had found that trust companies of the highest standing in that state had been holding mortgages without trust label for at least thirty-five years prior to that litigation.
books, are in fact to be found in the envelope or box assigned to that trust in the vault. There is thus a strong argument that these records constitute for the beneficiary all the earmarking he needs to enable him to trace the investments of his trust into the hands of the trustee. Such records are, however, more subject to manipulation than earmarks placed on the investment documents at the time of the purchase of the investments and also on stock books or public records. And, furthermore, these internal records in the offices of the trustee have no effect in giving notice to third persons who may deal with the trust investments, as in the case of buyers, mortgagees, and pledgees.

As trustees' accounts were presented in the early 1930's, and shrinkage and failure of numerous trust investments were brought sharply to the attention of beneficiaries and their lawyers, in many cases the earmarking rule was seized upon as a basis for attempting to avoid the unfortunate investments. A few of these cases reached the Supreme Courts prior to the completion of the Restatement of Trusts in May, 1935.

In Keen's Estate, decided in 1932, an individual trustee held a mortgage in his name as trustee for a named trust. The mortgage was in default. "To obviate the expense of foreclosure proceedings, the trustee agreed to take title to the property, and, in order to avoid a merger, took it in his own name." After holding the property for a time, and crediting the trust with its income, he sold it and credited the estate with the sale price. As one of many objections to the trustee's account the beneficiaries contended that, because the fee was held for a time in the name of the trustee without earmarking, they could claim from the trustee the amount of the mortgage with interest. The court's entire discussion of this contention was as follows:

"This is too broad a statement. We adhere closely to the rule that where a trustee takes title for his personal benefit, whether in his own name or in that of some other person, the beneficiaries may elect as appellants now contend; but this rule has no applicability where, as here, title was taken for the benefit of the estate, which received all the money realized exactly as would have been the case had the title been taken in its name."

Thus, Keen's Estate seems to make an exception to the ordinary rule based on two factors, namely, (1) that a purpose beneficial to

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15 Pa. 363, 159 Atl. 713 (1932).
16a306 Pa. 363 at 371, 159 Atl. 713 at 715.
the estate was achieved by taking the title without trust label, *i.e.*, the prevention of merger; and (2) that at the time of the accounting in question no property was held without earmarking, since the realty had been sold and its proceeds applied for trust purposes, and thus the violation of duty had been cured by later transactions. No stress was laid on good faith, although it obviously existed. Merger could have been prevented by an expression of intent in the deed as well as by the method adopted.\(^1\)

*Yost's Estate,*\(^1\) was decided by an opinion handed down Nov. 26, 1934. In it a corporate trustee which held a mortgage in its own name, and had placed it in a mortgage pool, withdrew the mortgage and made entries on its own books to the effect that the mortgage was henceforth held for the Yost trust, but did not assign the mortgage to itself as trustee or change the county records to that effect. Later the mortgage was foreclosed and the realty purchased by the trustee on behalf of the trust for costs and taxes. The court states: "At the sheriff's sale the property was bought in by the company for costs and taxes."\(^1\)\(^2\) It seems probable that the deed ran to the trust company with trust label, but this does not clearly appear. At any rate at the time the objection was made the mortgage had been foreclosed, so that in this respect there was great similarity to *Keen's Estate.* The beneficiaries were allowed to avoid the investment and compel the trustee to restore to the trust the amount invested in the mortgage. The court cited the older authorities which applied the penalty rule, but made no reference to *Keen's Estate.* It said:

"Only by giving the beneficiary a right to make the trustee account for funds thus invested can a practice so fraught with danger be effectually prevented. Nor is the danger less where the trustee is a corporation than where the trustee is an individual."\(^1\)\(^3\)

In the *Yost* case there were apparently (1) good faith; (2) a benefit to the trust through increased facility in management of the mortgage, although this is not stressed by the court; (3) no damage caused by breach of the earmarking rule; and (4) the breach was as to a holding which had ceased before the accounting. The facts were thus very similar to *Keen's Estate,* but the decision was exactly the

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\(^1\)Woodside v. Lippold, 113 Ga. 877, 39 S.E. 400 (1901); Thauer v. Smith, 213 Wis. 91, 250 N.W. 842 (1933).

\(^2\)316 Pa. 463, 175 Atl. 383 (1934).

\(^3\)316 Pa. 463 at 466, 175 Atl. 383 at 384.

\(^4\)316 Pa. 463 at 468, 175 Atl. 383 at 385.
opposite. Although Keen's Estate was not cited by the court in Yost's Estate, it would seem that the result of the court's decree in the latter case was either in substance an implied overruling of the former case or a "confinement of it to its facts." The earmarking question was given brief and cursory treatment in Keen's Estate, but was discussed at length in Yost's Estate. The same judges decided both cases, except that Mr. Justice Linn took part in the Keen case but not in the Yost case.

In Wolk v. Stefanowicz,\(^\text{18}\) decided March 25, 1935, an individual trustee of a judgment note held it without trust label, and instead of issuing an execution against the obligor's real estate and merchandise, the trustee took a conveyance of that property in his own name, with no reference to the trust, later sold the property and did not account for the proceeds as trustee until a bill in equity was filed against him. The chancellor held the trustee liable for the face amount of the judgment note, quoting the strict common law rule as to earmarking, and citing no cases; and the Supreme Court affirmed in a per curiam opinion and merely quoted from the chancellor's opinion. While in this case there were apparently (1) some slight advantage to the trust from ease of transfer, and (2) no direct connection between the method of holding and the loss to the trust estate. There was evidently bad faith on the part of the trustee, but the court does not stress this feature or cite the Keen or Yost cases. It appears to treat the earmarking rule as an absolute rule, for the breach of which a penalty is imposed.

Another case involving an effort to secure relaxation of the common law earmarking rule was Guthrie's Estate,\(^\text{19}\) which had reached the Orphans' Court of Allegheny County in time for a decision in February, 1935. That court refused to surcharge a corporate trustee for holding mortgages in its own name. This decision constituted some slight support for Keen's Estate, although it would seem to have been in conflict with the later case of Yost's Estate.

In Connecticut, on the other hand, in the case of Chapter House Circle v. Hartford National Bank and Trust Company\(^\text{20}\) it had been held by the trial court, apparently prior to May, 1935, that failure by a corporate trustee to earmark a mortgage gave the beneficiaries the option of avoiding the investment, regardless of good faith or utility to the trust.

\(^{18}\) 18318 Pa. 197, 177 Atl. 821 (1935).  
\(^{19}\) Reported in the Supreme Court at 320 Pa. 530, 182 Atl. 248 (1936).  
\(^{20}\) Reported in the Supreme Court at 121 Conn. 558, 186 Atl. 543 (1936).
THE RESTATEMENT OF TRUSTS, 1930 TO MAY, 1935

The Restatement of Trusts was prepared by the American Law Institute during the years 1930 to 1935. The theory of the Restatement was that it was a clarification and simplification of existing common law, that if there was a conflict of authorities the rule deemed superior in theory and effect would be restated, but that if a change in the common law was deemed necessary it would be recommended as a statute to be offered to the legislatures.\(^{21}\)

The history of the statement of the earmarking rule by the Institute is interesting. In Preliminary Draft No. 16, dated April 9, 1930, there appears for the first time a treatment of the matter. In a section numbered 174 there is stated a duty on the part of the trustee to keep the trust property separate from his individual property and from other non-trust property "and so far as it is reasonable he should see that the property is designated as property of the trust." The comment to the Section states that bank deposits, titles to realty, stock certificates, and registered bonds should be taken in the name of the trustee as trustee and should ordinarily be so earmarked as to indicate that they are the property of a particular trust; but the effect of failure to earmark is not discussed.

This section was brought up by the Reporter, Professor Scott, for discussion with his advisors in a meeting at Cambridge, May 16 to 18, 1930, but the minutes contain no reference to any discussion of the earmarking rule.

In the explanatory notes to Tentative Draft No. 1, March 10, 1930, under Section 174, there appear the words:

"To the effect that it is improper for the trustee to invest trust funds in his individual name, see De Jarnette v. De Jarnette, 41 Ala. 708 (mortgage); White v. Sherman, 168 Ill. 589 (stock); Knowlton v. Bradley, 17 N.H. 458 (note); In re Hodges' Estate, 66 Vt. 70 (mortgage)."

These are all cases where the strict rule of the common law was enforced. No cases were cited which held that the trustee had discretion to earmark or not, or that he could earmark when reasonable and be excused from earmarking when a reasonably prudent man would have failed to earmark. Indeed, at this time (1930), it would seem that the only support for such a position was the small amount of case law to the effect that a trustee might hold bearer

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bonds, and that there were a large number of cases holding the direct opposite with regard to all other types of property.

No substantial change appeared in Section 174 between 1930 and October, 1934. A tentative draft containing Section 174 was submitted to the Annual Meeting of the Institute in May, 1931, but there was no discussion of that section. At this meeting, as throughout the entire course of the Institute’s consideration of the all drafts of Restatements, the reporter brought up for discussion by the meeting only those sections which had aroused controversy among his advisors or in the Council of the Institute or were for some other reason thought extraordinary. It would seem debatable whether Section 174, as it then existed, did not involve a somewhat important deviation from prevalent trust law, meriting discussion by the members.

In Preliminary Draft No. 47, dated October 16, 1934, an important change in Section 174 was made by the addition of a new paragraph to Comment d, as follows:

“If the trustee takes title to the trust property in his individual name in good faith, and no loss results from his so doing, he is not liable for breach of trust. Thus, if the trustee of a mortgage accepts a conveyance of the property from the mortgagor, and in order to prevent a merger takes the conveyance in his individual name, acting in good faith and crediting the trust estate in his accounts with all receipts from the property, and the only objection to the transaction is that he took title in his name, he is not liable merely because the property depreciates in value. The breach of trust in such a case is merely a technical breach of trust, and no loss has resulted therefrom. If, however, he took title in his own name in bad faith, intending to misappropriate the property, he is liable for the full amount of the mortgage and interest thereon. Even if he acted in good faith, if a loss resulted from the fact that he took title in his own name, as for example if his personal creditors were thereby enabled to reach the property free of the trust, he would be liable for the loss.”

This new paragraph was evidently based on Keen’s Estate,22 decided in 1932.

Another important change in Section 174 occurred in Preliminary Draft No. 49, dated Dec. 15, 1934, which was submitted to and approved by the Council of the Institute Jan. 30 to Feb. 2, 1935. The section as then presented read:

22306 Pa. 363, 159 Atl. 713 (1932).
"Duty to Keep Trust Property Separate. The trustee is under a duty to the beneficiary to keep the trust property separate from his individual property, and, so far as it is reasonable that he should do so, to keep it separate from other property not subject to the trust and to see that the property is designated as property of the trust."

This changed the duty to keep the trust property separate from non-trust property (other than that of the trustee individually) from an absolute duty to a qualified one, and permitted mingling trust property of the A trust with that of the B trust or with that of a third person, if it was reasonable to mix them.

Between October, 1934, when the new comment to Section 174, based on Keen's Estate, was drafted and December, 1934, when Section 174 with its new comment was submitted to the Council of the Institute, Yost's Estate had been decided by the Supreme Court of Pennsylvania. On November 26, 1934, this latter decision was handed down. It in effect overruled Keen's Estate on which the new comment to Section 174 was based, but no attention seems to have been paid to Yost's Estate by the Reporter for Trusts or the Council of the Institute.

Section 174, as revised in December, 1934, and with the last paragraph of Comment d as revised in October, 1934, was submitted to the Annual Meeting of the Institute in the Final Draft of the Restatement of Trusts in May, 1935, and was approved without discussion or change.

When the Restatement of Trusts was printed at some date after May, 1935, Section 174 was renumbered 179 and a slight change was made in the last paragraph of Comment d, the underlined words being inserted in the following sentence:

"If the trustee takes title to the trust property in his individual name in good faith, and for a proper purpose, and no loss results from his so doing, he is not liable for breach of trust."

Two points may be made with regard to the Restatement of Trusts, Section 179, and Comment d thereto, as finally approved by the American Law Institute. First, at the times when the section was first drawn (1930) and was finally approved (1935) there was no substantial authority in the case law for the proposition that the duty of a trustee to earmark trust assets as belonging to a particular trust was a limited or qualified duty, instead of an absolute duty, except in the case of bearer bonds. With regard to mortgages, stocks,
registered bonds, notes and bank accounts there was an abundance of case law to the effect that the trustee was under a duty to earmark them, and had no discretion to decide whether it was reasonable to mark them or not. The only authority for the position of the Restatement that the duty was to earmark "so far as it is reasonable" was the opinion of the State Banking Department in Pennsylvania, rulings of Orphans' Courts in that state outside of Philadelphia County, and the decision in Keen's Estate, all of which would seem to have been in substance overruled by Yost's Estate, decided November 26, 1934. It thus seems very questionable whether the Institute was restating the common law of earmarking in Section 179, or was instead making new law.

Secondly, Comment d to section 179, was based entirely on Keen's Estate, and yet at the time this comment was approved by the Institute in 1935 a later decision of the Supreme Court of Pennsylvania in Yost's Estate (decided Nov. 26, 1934) had in substance overruled Keen's Estate, although there was no reference to the former case in the later opinion of the court.

Evidently the Institute thought it fair and economically sound to free trustees from liability for failure to obey the common law earmarking rule, except for damages actually caused by such failure and in cases of bad faith. There were signs that considerable potential liability existed and was being pressed in the courts in the 1930's. Recommendation of a statute by the Institute would have been of prospective effect only, and considerable time would have been lost in promulgating the statute. Therefore, the Institute took the bull by the horns, based Section 179 on the slightest of judicial authorities, and ignored a large number of well considered cases to the contrary in many states.

Case Law 1936 to Date

Very soon after the promulgation of the Restatement of Trusts in May, 1935, important cases reached the Supreme Courts of several states, involving efforts to avoid investments which had been held without trust label in the individual name of a trustee or in the name of a nominee, where there had been a great shrinkage in value due to the depression.

Because of the practices of corporate trustees during the period just prior to the depression the total potential liabilities from the
application of the strict common law penalty rule were very large. During the preceding decade thousands of banks had been closed. The remaining banks were in no position to stand millions of dollars of surcharges for failure to earmark. True they had apparently in many states flouted the common law rule and taken chances for the sake of what they thought were benefits to their trusts or for their own convenience; but the pressure on the courts to save the banks from an additional enormous burden was great. The public interest in preserving intact the banking structure was an important influence.

In their argument that the banks should be relieved of this liability corporate trustees found the Restatement of Trusts, Section 179, the strongest available support. They could point to very little case law to back up their claims, except Keen's Estate. But the great prestige of the Institute and its Restatement gave the courts a basis on which to decide the cases in the way in which their views of public policy urged them to go.

The first of this line of cases was Guthrie's Estate, in which the court refused to hold a corporate trustee liable for the amount invested in mortgages which had been held without trust label for a time but which had been labelled as trust property after the decision in Yost's Estate. The court held that it ought to relieve the trustee from the penalty of the common law rule, where the trustee had acted in good faith and no damage to the trust had been caused by lack of earmarking. For authority it relied on Matter of Union Trust Company and Section 179 of the Restatement of Trusts. It states that the facts of Yost's Estate were very different from those of the Guthrie case, although it does not point out the details of difference nor are such differences apparent. Five of the Justices who decided Yost's Estate were on the court which handed down the decision in Guthrie's Estate.

In Springfield Safe Deposit & Trust Co. v. First Unitarian Society, the objections in the probate court were entirely with regard to the propriety of participating mortgages as trust investments, but the Supreme Court in approving them made some statements regarding the earmarking rule which would seem to have been dicta. In stat-

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24aThe power of the court to relieve a trustee from liability where he has committed an admitted breach of trust, but has acted "honestly and reasonably," is stated in the ENGLISH TRUSTEE ACT, 1925, sec. 61, and in sec. 19 of the UNIFORM TRUSTS ACT, adopted in six states.
ing that failure to earmark mortgages would not be a basis for sur-
charging, the court said:

"The books of the petitioner in connection with statutory provisions
[as to physical segregation, reports to the state banking department,
and inspections by it] sufficiently segregated the funds in question
to protect the beneficiaries under the trust. * * * In the case at bar
there is no contention that the petitioner did not exercise good faith
and act for a proper purpose. The loss that has resulted to the
beneficiaries is not due to conduct of the petitioner or the kind of
investment made, but to adverse general financial conditions."\textsuperscript{27a}

The Massachusetts court cited as authorities for its views \textit{First National Bank of Boston v. Truesdale Hospital},\textsuperscript{28} holding that lack of diversification was not ground for surcharge when it caused no damage; and \textit{Springfield National Bank of Springfield v. Couse},\textsuperscript{29} holding that one who acted as trustee prior to a technically sufficient
transfer to him would not be surcharged where no loss arose from
this act; and the \textit{Restatement of Trusts}, § 179, Comment \textit{d}.

In \textit{The Chapter House Circle of the King's Daughters v. Hartford National Bank & Trust Co},\textsuperscript{30} the Supreme Court of Connecticut had
before it a case where a corporate trustee which had an agency account
took a note and mortgage to itself, without fiduciary label, but de-
posited a declaration of trust in the principal's portfolio. It used this
system to facilitate transfers from one agency or trust account to
another. The court held that, although there was a breach of trust,
it would refuse to decree the common law penalty of liability for
the amount invested in the mortgage. The opinion by Maltbie, C. J.,
is the most thorough and detailed of any of the judicial discussions
which have come to the attention of the writer. The court expressed
itself strongly in favor of the maintenance of earmarking by corporate
as well as individual trustees, but it rebelled at imposing a penalty.
It cited \textit{Guthrie's Estate} and the \textit{Restatement of Trusts}, § 179 (\textit{d}).

With the backing of the strong decisions in \textit{Guthrie's Estate} and
the \textit{Chapter House} case, the \textit{dictum} in the \textit{Springfield Safe Deposit}
case, and the Restatement, trustees found it relatively easy to secure
the approval of the relaxation of the earmarking rule in other states
in the late 1930's and in the 1940's.

In Pennsylvania, following \textit{Guthrie's Estate}, there seem to have
been four cases, one of which applied the old rule, but the other three

\textsuperscript{27a}293 Mass. 480 at 488, 200 N.E. 541 at 546.
\textsuperscript{28}288 Mass. 35, 192 N.E. 150 (1934).
\textsuperscript{29}288 Mass. 262, 192 N.E. 529 (1934).
\textsuperscript{30}121 Conn. 558, 186 Atl. 543 (1936).
approved Guthrie's Estate in its relaxation of the older rule. In Fenelli's Estate, a corporate trustee was held liable for the amount invested in a mortgage which it failed to earmark, the court stating the old rule and citing Yost's Estate. While it referred to Guthrie's Estate, it did not follow it or elaborate on its effect. Dillon's Estate, Harton's Estate, and Swindell's Estate, were all mortgage cases, and all refused to impose a penalty on the trustee where there was good faith and no damage resulted from the method of holding. All relied on Guthrie's Estate.

Other decisions approving the rule as laid down in the Restatement, and following the leading cases mentioned above, appeared in 1937 in Florida and the Federal District Court for Alabama, in 1938 in Nebraska and New Jersey, in 1939 in the Circuit Court of Appeals for the Sixth Circuit and in Alabama, in 1940 in Virginia, in 1941 in Washington, in 1943 in New Hampshire, and in 1944.

31323 Pa. 49, 185 Atl. 758 (1936); 330 Pa. 499, 199 Atl. 496 (1938).
33331 Pa. 507, 1A.(2d) 292 (1938).
34332 Pa. 161, 3A.(2d) 2 (1938).
36Barker v. First National Bank of Birmingham, 20 F.Supp. 185 (mortgage; breach held technical only when no loss caused).
37Rotzin v. Miller, 134 Neb. 8, 277 N.W. 811 (1938) (mortgage and later title to land; decision based on Restatement). The court first wrote an opinion in favor of surcharge but later changed its mind. There was a vigorous and well-reasoned dissent by Justices Rose, Eberly and Day. In re Estate of Boschulte, 130 Neb. 284, 264 N.W. 881 (1936), was overruled.
39Potter v. Union & Peoples National Bank of Jackson, 105 F.(2d) 437 (corporate trustee used partnership of employees as a nominee to hold stock; good faith and no loss from method of holding; court relied entirely on the Restatement).
40First National Bank of Birmingham v. Basham, 238 Ala. 500, 191 So. 873 (1939) (corporate trustee took mortgage to itself, but indorsed note and assigned mortgage to self as trustee but assignment not recorded; earmarking sufficient or if not trustee protected by good faith and lack of loss due to method of holding).
41Buckle v. Marshall, 176 Va. 139, 10 S.E.(2d) 506 (1940) (individual administrator held registered bonds in own name for ease of transfer but wrote on each bond that it was held for the estate and kept bonds separate from own property; while recognizing the common law rule the court held the informal earmarking sufficient; strong dissent by Campbell, C. J., as to adequacy of earmarking.
42In re Lefevre, 9 Wash.(2d) 145, 113 P.(2d) 1014 (1941) (bonds held by guardian in own name; no liability where good faith and method of holding did not cause loss).
43Miller v. Pender, 93 N.H. 1, 34 A.(2d) 663 (1943) (individual trustee held securities, probably stocks, in own name; court refused to impose common law penalty, holding that it was too severe).
Thus, a large body of case law has been built up since May, 1935, to the effect that if a trustee holds any trust investment except a bank account in his own name, or in the name of a nominee, acts in good faith, and the method of holding does not cause any loss, there is no liability on the part of the trustee, even though the asset may have depreciated or become valueless. Complete records in the office of the trustee and the accomplishment of a purpose useful to the trust doubtless have weight in proving good faith.

**EASY TRANSFERABILITY OF TRUST ASSETS; NOMINEE STATUTES**

The emphasis of the Restatement, §179, and of the case law from 1936 to date seems to have been on freeing trustees from a penalty for failure to earmark and thus on protecting them from a liability which was believed to have been unwarranted.

Beginning about 1935 and continuing to date another but related movement has been gaining momentum, namely, the trend toward the adoption of statutes permitting the holding of trust investments in the names of nominees. Here the argument has not been the need to free trustees from unjustified liabilities, but rather the desirability of making trust investments more easily transferable, and the handicaps which earmarking imposes on quick disposal of trust assets.

The rules of stock exchanges provide that tender of stock which is held in the name of a fiduciary is not a "good delivery," that is, such stock cannot be made the basis of an immediate sale but has to be contracted to be sold at a future date, after proof of authority to sell has been presented. Therefore, trustees who desire to take advantage of stock market prices on a certain day are greatly handicapped, if they earmark the stock; and transfers are greatly facilitated if the stock is in the name of an individual or partnership as a nominee.

In weighing this argument one should bear in mind that discretionary investment clauses in many important trust instruments and the increasing adoption of the prudent investor rule by legislatures have resulted in the acquisition and retention of a great deal of

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44*Re Brown, [1944] 4 Dom.L.R. 419 (corporate trustee; mortgage).*

45*For excellent discussions of the whole problem of nominees and earmarking, but particularly with regard to corporate stock, see Capron, *Nominee Registration of Fiduciary Securities* (1944) 79 Trusts & Estates 309 (1944); Horn and Dixon, *Nominee Registration to the Fore*, (1939) 69 Trusts & Estates 271. See also Christy and McLean, *The Transfer of Stock* (2d ed. 1940).*
corporate stock by trustees. One well-informed writer estimates that at least a third of all trust investments in dollar value are stocks.46

While trustees are not supposed to buy and sell for speculative purposes, but rather with the object of maintaining capital and reasonable flow of income, a great many sales of stocks by trustees are required for legitimate trust purposes or are demanded by settlors who have reserved power to themselves to direct investments.

This argument from the necessity for speedy sales would not seem to apply to transfers of mortgages or fee titles, where purchasers are willing to wait a few days for proof of authority and completion of transfers, and to pay the same price as if the transaction could be completed in a single day. Nor would the element of speed seem to be important in cases where the trustee is borrowing and giving a mortgage or pledge as security.

Those favoring the use of nominees also urge that transfers by a trustee can be made by a trustee at less cost if nominees are used, since on transfer by the nominee no proof of the authority and powers of the trustee will have to be made. Transfer agents and registrars require proof of authority before they will complete a transfer from a fiduciary; and buyers, mortgagees, or pledgees of mortgages or of titles to realty or personalty which are labelled as held for a trust demand similar proof.

These expenses, however, are not great. A single copy of the trust instrument or letters of trusteeship can often be used for numerous transactions. And, furthermore, if a trustee holds stock first as trustee and then seeks to register it in the name of a nominee, proof of authority must be given to the transfer agent or registrar.

It would not seem that the argument based on economy ought to be conclusive. Admittedly if nominees are not used there will be some additional expense for proof of authority, and some increase in correspondence and paper work in some instances. But in other instances nominees cause increased labor for the trustee. If substantial protection comes to the beneficiary from earmarking, it will be worth what it costs.

With respect to stock the need for speed of transfer would seem to be a more potent argument.

Beginning in 1935 there has been a strong trend toward the adoption of statutes permitting fiduciaries to hold some or all invest-

46Stephenson, Nominee Registration of Securities Held in Trust Accounts (1944).
ments in their individual names or in the names of nominees. Bankers’ Associations have drafted and worked for statutes of this type. The National Conference of Commissioners on Uniform State Laws in 1937 approved the *Uniform Trusts Act*, section 9 of which validated the use of nominees with some qualifications.

The Pennsylvania Legislature of 1935 adopted two acts on the subject, the first, P.L. 1935, no. 200, permitting corporate fiduciaries to hold all investments in their own names or in the names of nominees, if the books of the bank clearly showed the facts as to ownership; and the second, P.L. 1935, no. 524, providing that, if a trust company had previously carried investments in real property without earmarking, a court might stay a suit to avoid the investment for a period not to exceed two years.

Section 9 of the *Uniform Trusts Act* reads as follows:

“A trustee owning stock may hold it in the name of a nominee, without mention of the trust in the stock certificate or stock registration book; provided that (1) the trust records and all reports or accounts rendered by the trustee clearly show the ownership of the stock by the trustee and the facts regarding its holding; (2) the nominee shall deposit with the trustee a signed statement showing the trust ownership, shall endorse the stock certificate in blank, and shall not have possession of the stock certificate or access thereto except under the immediate supervision of the trustee. The trustee shall personally be liable for any loss to the trust resulting from any act of such nominee in connection with such stock so held.”

This statute has been adopted, with some variations, in six states. Other nominee statutes, apparently drawn by trust men, have been adopted in twelve states. They vary to a considerable extent. Some cover corporate fiduciaries only, others both individual and corporate fiduciaries. Some apply to trustees only, some to

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51 Fla., La., Nev., N.Y. (if deposited with bank for safekeeping and bank places in name of nominee); Okl., S.D., Tex., Wisc. (same as N.Y.).

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other named fiduciaries or to all fiduciaries. Some permit the use of nominees in the holding of corporate stock only, others apply to stock or other securities, and some are broad enough to cover all investments.

The conditions precedent established by these statutes as prerequisites for the use of nominees likewise differ. It is usual to require that the records of the fiduciary shall show the facts of ownership, and that the property shall be physically separated from the assets of the fiduciary. Frequently also the power of the nominee is limited by requiring him to sign a declaration of trust, or indorse the stock certificate or give a stock power, and by prohibiting the fiduciary from giving the nominee possession of, or access to, the property. The fiduciary is commonly made liable for any breach of duty on the part of the nominee.

Some of these acts are broad enough to allow the fiduciary to hold trust property in his own name without earmarking, but most of them deal with the use of nominees only.

In 1945 the Trust Division of the American Bankers’ Association proposed to the National Conference of Commissioners on Uniform State Laws that it draft a nominee statute to take the place of section 9 of the Trusts Act of 1937 and of the various bank-sponsored nominee statutes which had been adopted since 1935. This invitation was accepted and the subject is now being considered by the Property Acts Section of the Conference, of which L. A. Howard, Esq., of Hartford, Conn., is chairman. Hon. Sherman R. Moulton, Chief Justice of the Supreme Court of Vermont, who is a member of the Section, has consented to act as draftsman. Such a substitute, revised statute might have the effect of producing uniformity in those states

53 Cal., Ky., Minn., N.Y., Wis.
55 Fla., Nev., N.C., Okl., S.D.
56 Cal., Ky., N.J., N.Y., Oh., W.Va., Wis.
57 Minn., Ore., Pa., Tex.
59 Cal., Ky., N.J., N.Y., Wis.
60 La., Okl., S.D., Tex., W.Va. (all necessary documents).
61 La., Okl., S.D., Tex.
62 Nev., Tex. (if stock certificate not indorsed).
65 Ky., Oh., Ore., Pa., W.Va.
which have indicated a willingness to permit the use of nominees, and might be helpful in persuading the thirty states which have not yet adopted nominee statutes to sanction this practice in fiduciary administration.

Another statutory approach to the objective of giving trust assets free and untrammeled transferability is the abolition of the rule that one dealing with a known trustee is charged with knowledge of the powers of the trustee.

The Oregon Legislature, in its nominee act of 1941, has made this direct approach to the problem of notice to third parties dealing with trustees. It provided:

"In acquiring, holding, satisfying and conveying of any trust asset or any investment of trust funds, it shall not be the duty of any trust company to disclose that it is acting in a fiduciary capacity or the terms or conditions of the instrument pursuant to which it acts or the nature or extent of its authority or the application of the proceeds of such transaction, nor shall any person dealing with such trust company be required or authorized or permitted to inquire into the said matters, or any of them, except to the extent or for the purposes specified in section 40-1222."

If legislatures would adopt such a statute, and stock exchanges would thereafter make tenders of stock held by a fiduciary good delivery, some delays and expense incident to transfer by trustees would be avoided, without the use of nominees, and one strong argument for the abolition of the earmarking rule would be done away with.

Something of this sort was attempted in the Uniform Fiduciaries Act (now adopted in at least 20 states) which declared that transfer agents and banks would be held to have participated in breaches of trust with regard to stock, bank accounts, and commercial paper only where they received a benefit from the breach of trust, had actual knowledge of the intended breach, or had knowledge of facts which made their acts evidence of "bad faith." This generally relieved these intermediaries who dealt with trustees from the duty to inquire into the propriety of the conduct of the trustees. But it

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67L. 1941, c. 35.
68In at least one midwestern city corporate trustees which have realty for sale convey it to another trust company under a subtrust for sale and provide in the deed to the sub-trustee that no person dealing "with said trustee be required or privileged to inquire into the necessity or expediency of any act of said trustee, or of the provisions of this instrument." The sub-trustee is in practical effect a nominee. It seems doubtful whether a term in the sub-trust instrument can abolish the common law rule that one dealing with a known trustee is charged with knowledge of the powers of that trustee.
is understood that transfer agents and registrars, notwithstanding this statute, require proof of authority from fiduciaries because of the exceptions named in the statute and the possibilities of liability coming from those excepted cases. Thus, to some extent the intent of the framers of this Uniform Act has been frustrated by the superabundant caution of the transfer agents. In any Act covering persons dealing directly with trustees for their own benefit, and attempting to relieve them from the duty to inquire, it would seem that the same exceptions would have to be made, and consequently that extreme caution might in some cases nullify such legislation, as it has done with the Fiduciaries Act.

While the statutes permitting the use of nominees in substance do away with the duty of third parties to inquire about the terms of the trust, and legislatures seem willing enough to pass such acts, it is doubted whether they would be so acquiescent in abolishing the long standing rule that one dealing with a legal entity which is generally or frequently of limited power takes the risk that the contemplated act is within the powers of the party with whom he deals.

DEVELOPMENTS IN THE NEAR FUTURE

There can be little doubt that the Restatement of Trusts, Section 179, will continue to receive the judicial approval which has been accorded to it in the cases decided since 1935 which are discussed above. How trust assets are held will be a matter for the exercise of reasonable judgment by the trustee. It may be urged that such rulings obviate the need for statutes providing for nominees, since in all probability, in most cases, holding investments in the name of a nominee will be held by the courts to be reasonably prudent and useful.

It is believed, however, that corporate trustees will not be content with probable protection under the Restatement, but will rather continue to press nominee statutes so as to obtain a clearcut definition as to the extent to which they can safely depart from the common law earmarking rule. The action of the Trust Division, American Bankers' Association, in soliciting cooperation from the Uniform Law Conference is in this direction.

In preparing a model nominee statute it might be well to consider whether such an act should be framed on the theory (1) that it treats the Restatement, Section 179, as intact and merely gives one
legislative example of reasonable conduct in holding without earmarks, leaving it open for the courts to adjudge that in other cases the conduct may also be reasonable; or (2) that the strict common law earmarking rule is in effect, except as qualified by the nominee statute. This latter idea is adopted by the New York statute.\textsuperscript{49} The first method amounts to a reaffirmation of the Restatement rule, supplemented by a declaration that one type of conduct is reasonable under the Restatement. The second method would be founded on the idea of repudiating the Restatement, Section 179, returning to the common law, but relaxing the rigor of that rule to a certain extent. Unless the rationale of the model act is made clear, the door may be left open for litigation. The doctrine \textit{expressio unius, exclusio alterius}, may be invoked.

In the opinion of the writer the model statute should sanction the use of nominees in those cases where they serve an important trust purpose, but not in the instances where the mere convenience or economy of the trustee is involved. Bearer bonds and corporate stock seem to be the only cases of real need for relaxation of the common law rule. All fiduciaries should be treated alike. The trustee deserves no special consideration. Individual fiduciaries should be allowed the same privileges as corporate fiduciaries, but the New York scheme of requiring individual fiduciaries to deposit the securities which are held in the name of a nominee with a bank or trust company should be considered.\textsuperscript{70} The rule that third persons dealing with a known trustee are charged with knowledge of his powers should not be abolished.

The importance of case and statute law with relation to nominees and earmarking may easily be exaggerated. Many trust institutions suggest inserting in trust instruments clauses which permit the use of nominees, and this advice is frequently followed by settlors. Some conservative corporate trustees rarely use nominees, except as thus authorized.

\textsuperscript{70}See notes 39 and 41 \textit{supra}. 