69TH CONGRESS } HOUSE OF REPRESENTATIVES { REPORT
2d Session } { No. 2000

CONCERNING LIABILITY FOR PARTICIPATION IN BREACHES OF FIDUCIARY OBLIGATIONS AND MAKE UNIFORM THE LAW THERETO

FEBRUARY 7, 1927.—Referred to the House Calendar and ordered to be printed

Mr. MCLEOD, from the Committee on the District of Columbia, submitted the following

REPORT

[To accompany H. R. 16213]

The Committee on the District of Columbia, to which was referred the bill H. R. 16213 concerning liability for participation in breaches of fiduciary obligations and to make uniform the law with reference thereto, recommend that the bill be amended in the particular following, and as amended that it be passed.

The amendment recommended is the following:

Strike out lines 3 and 4, page 1, and substitute therefor the following:

> That the following provisions concerning liability for participation in breaches of fiduciary obligations and to make uniform the law with reference thereto shall be in force in the District of Columbia, namely:

The amendment is to correct a clerical error in the drafting of the bill. As originally drawn the bill appeared to propose a substitute for sections 1 to 16 of the Code of Law for the District of Columbia, whereas there was no intention to affect these sections of the code which do not relate to the subject matter of the bill.

The form of the enacting clause proposed by this committee amendment conforms to that used in enacting for the District of Columbia the uniform warehouse receipts act (approved April 15, 1910, 36 Stat. 301), and accomplishes the intention of the framers of the bill.

The several sections of the bill subsequent to the enacting clause are in the precise form drafted to be pressed for enactment in all the States and Territories. The purpose of the bill is to establish uniform and definite rules in the place of the diverse and indefinite rules now prevailing as to "constructive notice" of breaches of fiduciary obligations. Liabilities of fiduciaries are not dealt with nor affected, but only the liabilities of persons dealing with fiduciaries. At present the law in the several States as to the liability of persons dealing with fiduciaries is uncertain. It is not clear under what circumstances such persons are charged with "constructive notice" of breaches of trust by fiduciaries. The usual result if a third person dealing with a fiduciary is charged with constructive notice of a breach of trust by a fiduciary, is that the person so dealing is held liable along with the fiduciary for the breach of trust.

There are in the District of Columbia no direct or controlling decisions of the courts upon the field of law covered by the bill. In the several States, however, the decisions are so diverse that the result is that it is not clear to what extent persons dealing with fiduciaries are bound to supervise them in the performance of their duties. In practice, in the ordinary course of banking and commercial transactions, it is impracticable for banks and other persons dealing with fiduciaries to make effective inquiries into their conduct. Transfers by fiduciaries of property in their charge as such, to themselves in their individual capacity, are often held to constitute such constructive notice of a breach of the fiduciary's duty as to make third persons who participate in such a transfer liable for the property or funds so transferred if it is in fact a breach of the fiduciary's trust. Yet in actual practice such transfers need frequently to be made by honest fiduciaries, as, for example, in the payment to the fiduciary of his compensation, and rigid inquiry by persons dealing with honest fiduciaries into every such transaction, and hesitation to act without inquiry, would impede and obstruct the ordinary transaction of business, with no substantial benefit.

A dishonest fiduciary can easily cover his tracks by transferring property he intends to convert to his own use first to a straw man and afterwards to himself, so that no reasonable inquiry would reveal his dishonesty. As a practical matter, the delay and expense incident to the inquiry which needs to be made under the existing unsettled state of the law by banks and other persons dealing with fiduciaries would fall in the first instance upon the trust estates, the great majority of which are honestly administered, and falls ultimately upon the beneficiaries for whom the fiduciaries are acting.

Much of the proposed act is merely declaratory of existing law as established in many jurisdictions. Which of the diverse rules established in the several States would be followed in the District of Columbia, if this branch of the law were left to judicial development, can not with certainty be stated; but some of the decisions in the States set up as a test of the liability of a person dealing with a fiduciary, such as the payee or indorsee of a check drawn or indorsed by a fiduciary, the question whether such person was negligent. The proposed act makes such a person liable only if he takes the negotiable instrument with knowledge of such facts as makes his action amount to bad faith.

In the case of banks which are depositaries of fiduciary funds subject to the order of fiduciaries, if a check of the fiduciary is in fact a breach of his obligation, the bank is made by the act liable to the beneficiary if it receives such a check in payment of the personal debt of the fiduciary, or if the check is payable to the bank itself, and in other cases if it has such knoweldge of the facts as amount to bad faith on its part in honoring the check. Under other circumstances, a claim of negligence on the part of the bank can not be made the basis of liability on its part under the provisions of this act, though in some jurisdictions banks have been held liable as for a participation in the breach of a fiduciary's obligation where the bank acted in good faith and did not profit by nor participate in the breach of the fiduciary's obligations, upon the ground that it was negligent in supervising the fiduciary in the performance of his duties. These are illustrations of the substitution made by the bill of definite rules of liability for the test of "due care" or "negligence" which has produced the diversity of decisions among the States.

The bill was drafted by the National Conference of Commissioners on Uniform State Laws which had its origin in the appointment of a special committee by the American Bar Association in 1889 and the authorization in 1890 by an act of the Legislature of the State of New York of the appointment of commissioners for the promotion of uniformity of legislation in the United States. By successive actions in the several States, the District of Columbia and the Territories, all of these jurisdictions are now represented in the national conference by two or three representatives each. These conferences are held during the week immediately preceding the annual meeting of the American Bar Association, and its actions are reviewed by the American Bar Association. Of the uniform acts proposed by this conference, the negotiable instruments act has been adopted in all jurisdictions, including the District of Columbia, excepting Porto Rico, though with modifications in Illinois and Vermont. The warehouse receipts act has been adopted in 48 jurisdictions, including the District of Columbia, uniform sales act adopted in 25 jurisdictions, uniform bills of lading act adopted in 25 jurisdictions, and uniform partnership act adopted in 14 jurisdictions.

Sections 4, 5, and 6 of the present bill are in supplement of and to carry out the intention of the negotiable instruments act, section 56 (sec. 1360, D. C. Code).

The matter of a uniform act covering the liabilities of persons dealing with trustees and other fiduciaries was referred to a committee of the conference in 1919, and drafts of the present act were considered by the conference in 1921 and 1922 and were then unanimously approved. Since 1922 it has been adopted verbatim in Colorado, Idaho, Louisiana, Nevada, New Mexico, North Carolina, Pennsylvania, Utah, and Wisconsin. It is being pressed for enactment at the present sessions of the legislatures of other States.

The bill was introduced at the request of the Bar Association of the District of Columbia. At the hearings before your committee, it was considered section by section and its passage was advocated by representatives of the Bar Association of the District, of the American Bar Association, of the National Conference of Commissioners on Uniform State Laws, of the Clearing House Association of the District of Columbia, of the American Bankers Association, and of the District of Columbia Bankers Association. No opposition to the passage of the bill has been made known to the committee. The Commissioners of the District of Columbia (who appoint the commissioners for the District of Columbia on uniform State laws) have signified their approval by letter addressed to their appointees to the conference and filed with this committee.

The act is compact and can not be well summarized. The topics treated in the several sections are as follows:

Section 1 deals with definitions. The definition of "bank" is identical with that in the negotiable instruments law, section 1 (D. C. Code, sec. 1304). The definition of "person" is a combination of the definitions in the negotiable instruments law and the warehouse receipts act (D. C. Code, sec. 1304; 36 Stat. 301, sec. 58). The definition of "good faith" is identical with that of the warehouse receipts act (36 Stat. 301, sec. 58).

Section 2 deals with the misapplication by the fiduciary of payments and transfers of money and property to the fiduciary which he is authorized to receive. The contrary doctrine and the inconvenience of the common law on this point is often avoided by careful counsel drawing trust instruments by the insertion of an express provision to the effect of this proposed statute. The language of the section is based upon statutes already existing in England and in Alabama, California, Delaware, Kansas, Massachusetts, Michigan, Minnesota, Missouri, Montana, New Jersey, New York, North Dakota, Ohio, Rhode Island, South Dakota, and Wisconsin.

Section 3 deals with the transfer of stock which has been legally registered in the name of fiduciaries. It commends itself to persons having practical experience with the transfer of stock. It is based on a Massachusetts statute (St. 1918, ch. 68, sec. 3), and there are somewhat similar provisions in Delaware (Rev. Code 1915, sec. 3396), Kentucky (Stats. 1909, sec. 4169), and Pennsylvania (Purdon's Dig. 13th ed. 4850, sec. 7). Recently Illinois passed a similar statute. There is a similar statute in England (company's consolidation act (1908), sec. 27).

Sections 4, 5, and 6 deal with holders of negotiable paper drawn or indorsed by fiduciaries. These are the sections which are supplemental to and consistent with section 56 of the negotiable instruments act (D. C. Code 1360), and deal with the question whether such holders get good title to the instrument or are liable for using the proceeds of it if in fact the fiduciary has committed a breach of his trust. Under sections 4 and 5 the liability of such a holder is made definite if he acted in bad faith, or if he took the instrument in payment or in security for a personal debt of the fiduciary, or in a transaction known to be for the personal benefit of the fiduciary. The distinction between cases covered by sections 4 and 5 and that covered by section 6 is in accordance with Massachusetts cases cited in review of the subject in 34 Harvard Law Review 454, note 26.

Sections 7, 8, and 9 deal with the liabilities of banks and other depositaries of fiduciary funds. In the several different cases dealt with in these sections, liability of the bank is declared where the bank has knowledge of such facts as amounted to bad faith or knowledge that the fiduciary was committing a breach of his obligation, or in the case of deposits in the name of the principal or in the name of the fiduciary as such, where the check in question is payable to the bank itself and in payment or security for a personal debt of the fiduciary.

Section 10 applies ordinary business principles to deposits in the name of two or more persons as trustees. This section is made desirable because of a doctrine that trustees may not delegate their duties excepting as to merely ministerial acts, and it remains doubtful as to whether the drawing of a check is a ministerial act in the eyes of the law.

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