

# Following Misappropriated Funds into Life Insurance Policies

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## NOTES AND COMMENT

Editor—JAMES F. KELLY

### FOLLOWING MISAPPROPRIATED FUNDS INTO LIFE INSURANCE POLICIES.

In aiding a *cestui que trust* to follow trust funds which have been misapplied by a trustee, and in recognizing the right of the *cestui que trust* to reclaim the funds in their original state, or in whatever form they have since been changed by alteration, courts of equity have never restricted the granting of such relief to those cases alone where an actual trustee is involved, but have allowed recovery in all cases where the dishonest actor has occupied the position of a fiduciary.<sup>1</sup> Fundamentally necessary as a prerequisite in any case is the requirement that the trust funds be clearly ascertained, traced and identified, and that the rights of *bona fide* purchasers for value do not intervene.<sup>2</sup> Where investments have been made by a trustee with trust funds wrongfully taken to his own use they may, at the option of the *cestui que trust*, be treated as having been invested for his benefit.<sup>3</sup> This right is a property right, not one created by any preference or favoritism of a court of equity.<sup>4</sup>

Holmes v. Gilman,<sup>5</sup> a leading case on the right of the *cestui que trust* to follow trust funds, though changed by investment from their original state, was an action by a partner of the assured brought against the assured's wife to have a trust impressed upon insurance moneys collected from policies issued on the life of this deceased partner, all the premiums having been paid from partnership funds, wrongfully extracted by the assured during the course of his activity as a trusted partner of the firm. The policies had been issued on the application of the assured, made in the name of his wife and payable to her, but none of the premiums had been paid by the wife or from her funds. It was held upon these facts that the life insurance was a trust fund for the benefit of the firm. The sum accruing to the plaintiff as a result of this decision did not, however, equal the amount

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<sup>1</sup> Story, Eq. Jur., 14th Ed., Sec. 1669; *In re Hallett's Estate*, 13 Ch. Div. 709, per Jessel, M. R. (1879).

<sup>2</sup> Thompson's Appeal, 22 Pa. St. 16 (1853); *Wells-Fargo v. Robinson*, 13 Cal. 134 (1859); *Cavin v. Gleason*, 105 N. Y. 256, 11 N. E. 504 (1887); *Holmes v. Gilman*, 138 N. Y. 369, 34 N. E. 205, 20 L. R. A. 566 (1893); *Perry, Trusts*, 7th Ed., Sec. 828.

<sup>3</sup> *Bank v. Russell*, 50 Neb. 277, 69 N. W. 763 (1897); *Pierce v. Holzer*, 65 Mich. 263, 32 N. W. 431 (1887); *Shaler v. Trowbridge*, 28 N. J. Eq. 595 (1877); Story, Eq. Jur., 14th Ed., Sec. 1670.

<sup>4</sup> *Massachusetts Bonding Co. v. Josslyn*, *infra* Note 7.

<sup>5</sup> *Supra* Note 2.

of the losses which it suffered during the lifetime of the assured as a result of the wrongful extractions of firm funds by this deceased partner. It was pointed out by the Court that by its judgment the *cestui que trust* received only a little more than one-fourth of the amount of loss to which it had previously been subjected. Commenting upon this feature it was said:

"If the proceeds of these policies had been greater than the whole of the indebtedness of the husband to the *cestui que trust* arising out of the husband's breach of trust, we do not decide what might in equity be the different rights of the wife and such *cestui que trust* in the balance, or whether any different rule could be logically applied."<sup>6</sup>

Appearing in the briefs of counsel in numerous cases from the time of its decision to the present, in this and many outside jurisdictions, *Holmes v. Gilman* has been cited by the courts, with continual approval. Departures from its result are explained where dissimilar facts are presented, but the soundness of its rule is reaffirmed.<sup>7</sup> If the paragraph quoted above<sup>8</sup> had been omitted from Judge Peckham's opinion, it appears quite probable that the question which the Court in those words chose to leave undecided would have been considered to be settled by the very decision itself—and in favor of the *cestui que trust*—for in deciding that the right in the *cestui que trust* to recover the insurance money in that case included the entire proceeds of the policy (it being less than the original losses due to the acts of the assured), the Court reached its result on reasoning which does not seem capable of establishing a different conclusion in the event that the amount of the judgment might surpass an ascertained figure; nowhere else in the decision did the Court indicate that its view was in any way influenced by the amount involved and the result certainly was based on the well recognized view that the *cestui que trust* has the right to claim the profits of investment made by the trustee with trust funds.

If the beneficiary named in the policy can assert any claim to proceeds it must be found in some property right which it enjoys, not measured by the extent to which the assured has succeeded in appropriating to his use or for the benefit of others to whom he is under social or moral obligation, moneys which are not his but are the property of some other person. It is not altogether clear from a reading of the cases just what legal or equitable right is urged as a

<sup>6</sup> *Holmes v. Gilman*, *supra*, at 385, 34 N. E. at 209.

<sup>7</sup> *Massachusetts Bonding Co. v. Josslyn*, 224 Mich. 159, 194 N. W. 548 (1923); *Vorlander v. Keyes*, 1 Fed. (2nd) 67 (C. C. A. 8th, 1924); *Dayton v. Claffin*, 19 App. Div. 120, 45 N. Y. Supp. 1005 (1st Dept. 1897); *Truelsch v. Northwestern Mutual Life Insurance Co.*, *infra* Note 13; *Thum v. Wolstenhome*, *infra* Note 14.

<sup>8</sup> *Supra* Note 6.

satisfactory basis for a claim by the wife or other beneficiary in the proceeds of the policy purchased under these circumstances, but it is apparent that the argument in its support is influenced tremendously by a tendency to regard a policy of life insurance purchased by a husband for the protection of his wife and family as something apart from an ordinary investment, demanding more discriminating exercise of equitable conscience in the adjudication of the parties' rights.<sup>9</sup> Quite probably this consideration influenced the Court in the Gilman case, when it said that a different situation might exist if it had been called upon to award to the *cestui que trust* insurance moneys in excess of the amount of its claim against the assured's estate for its losses, where the well-being of a widow and fatherless children was weighed in the balance.<sup>10</sup>

If there is a valid reason for restricting the recovery of the *cestui que trust* to the total amount of his loss through the misappropriations of the trustee, there must necessarily be some right accruing to the beneficiary of the policy in the funds which exceed that figure, which right does not exist in situations such as the Gilman case, where the insurance money does not surpass the losses of the *cestui que trust*. An examination of the problem reveals that the right of the *cestui* is superior in either case.

In spite of the extensive use of life insurance at the present time and the too frequent cases of persons occupying positions of trust and fiduciary relationships, who have become involved in proceedings arising from errors in the conduct of their duties, the specific question left unanswered<sup>11</sup> by the Gilman case seems even at this date to be without definite adjudication in our Court of Appeals.<sup>12</sup> Decisions in other jurisdictions are not in entire harmony. In Truelsch v. Northwestern Mutual Life Insurance Co.<sup>13</sup> an employee embezzled his employer's money and used part thereof for the payment of

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<sup>9</sup> This is the inevitable conclusion from the cases though the courts have not admittedly taken this view.

<sup>10</sup> Cases cited, *supra* Note 7.

<sup>11</sup> Compare Ames, Following Misappropriated Property Into Its Product, (1909) 19 Harv. L. Rev. 1911. Commenting on the right of the *cestui que trust* to the proceeds of life insurance purchased by the trustee out of trust funds, the author states: "The *cestui que trust* takes the whole of the insurance money, although ten times as much as the trust money appropriated," citing among other cases, Holmes v. Gilman, *supra* Note 2, and Shaler v. Trowbridge, *supra* Note 3. The necessary conclusion to be drawn from the statement overlooks the point with which this paper is concerned, and which was specifically left unanswered in the Gilman case and not raised in the New Jersey decision.

<sup>12</sup> In Dayton v. Clafin, *supra* Note 7, all of the premiums except the last one, amounting to seventy-five dollars, were paid with firm funds embezzled by the insured, a firm employee. The Court awarded all of the proceeds to the firm, except a small portion thereof which was calculated to be that part of the total which was purchased with the last premium contributed by the insured. Although the case informs us that the insured "had embezzled large sums of money" from his firm, the amount is nowhere mentioned, leaving the relation between that sum and the amount of insurance uncertain.

<sup>13</sup> 186 Wis. 239, 202 N. W. 352, 38 A. L. R. 914 (1925).

premiums on life insurance policies payable to his wife. In recognizing the right of the employer to recover the proceeds of the policies in contradiction to the claim asserted by the beneficiary of the policies, the Court did not limit the recovery to the amount of premiums paid out of the embezzled money, but, following the theory of the Gilman case, imposed a trust on two-thirds of the amount of the proceeds of the policies, two-thirds of the premiums having been paid with embezzled funds. As in *Holmes v. Gilman*, the amount of the recovery which the *cestui que trust* was allowed was not as great as the total sum of the employee's misappropriations, and the rights of the *cestui que trust* to participate in the excess funds was not before the Court, yet it considered the point by way of dicta, citing with approval the dissenting opinion in *Thum v. Wolstenhome*,<sup>14</sup> which favored the right of the *cestui que trust* to be awarded the insurance moneys, irrespective of the amount of its previous loss by the acts of the defaulting trustee. The Court commented on the scarcity of authority on the question, in cases where life insurance has been the form of investment for the trust funds illegally abstracted by the trustee, in spite of the fact that the rule seems well settled with respect to investments of other kinds, *i.e.*, stocks, real estate, etc., the beneficiary receiving the benefit of any increase in value, on the theory that to hold otherwise would be contrary to the rule which prohibits a trustee from making any profit whatsoever with funds belonging to his *cestui que trust*.<sup>15</sup>

*Thum v. Wolstenhome*<sup>16</sup> is quite comparable to the situation in the *Gilman* case. It was an action by the receiver of a banking house to have a trust impressed on a policy of life insurance issued on the life of its general manager and payable to his estate. It was alleged that the deceased had used approximately five thousand dollars of the funds of the bank in the purchase of this insurance, which was payable in the sum of fifty thousand dollars. It appears that the firm suffered losses considerably higher than this amount, due to the wrongful activities of the assured, yet by its judgment the Court allowed recovery only to the extent of the premiums actually paid with firm funds. The Court distinguished the case from *Holmes v. Gilman*, because the first premium in this case had been paid with the personal note of the assured, and it was said that by such act, title to the policy immediately vested in the assured, and the best the plaintiffs could claim was a lien for their funds which had been used in the payment of premiums. This theory appears untenable, especially as it further appears from a reading of the case that the note was discounted by the plaintiff bank itself, and no funds of the assured actually went into the purchase of the policy. In any event, however, the Court might well have separated the amount of the policies purchased with firm funds from those purchased with the note of

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<sup>14</sup> 21 Utah 467, 61 Pac. 540 (1900).

<sup>15</sup> Perry, *Trusts*, 7th Ed., Sec. 429.

<sup>16</sup> *Supra* Note 14.

the deceased and then prorated the proceeds of the policy in that proportion. That was the result reached by the Wisconsin court in the Truelsch case cited above.<sup>17</sup> It was the opinion of a majority of the Supreme Court of Utah that to declare a trust to exist in such a case, where the amount sought to be recovered so far exceeded the sum of the premiums paid with the plaintiff's funds, would be an extremely inequitable act, invoking in its behalf the maxim that "courts of equity are not required to do injustice."<sup>18</sup> The injustice contemplated by the plaintiff's prayer is a bit difficult to appreciate. The dissenting opinion of the Chief Justice,<sup>19</sup> with considerable force in its reasoning, holds that on the facts presented the Court was bound to declare a constructive trust with respect to the policy, on the theory that the plaintiffs should receive all of their money which had been wrongfully appropriated to the payment of the premiums and in addition any profits resulting from the investment, without limit as to amount.

Massachusetts Bonding Co. v. Josslyn<sup>20</sup> is directly in point. There the administrator of two estates insured his life in favor of his wife, the premiums being paid with the funds of the estates which were committed to his care. In deciding the respective claims of the parties, the Court permitted the plaintiff (assignee of the estates whose funds were used), to share in the proceeds of the policies in proportion to the amount of money which had been used in paying the premiums. The total amount awarded to the plaintiff in that decision exceeded by several thousand dollars the sum of the administrator's abstractions, yet the Court seemed to have no hesitancy in reaching its result.<sup>21</sup> The decision is concluded with an excerpt from Shaler v. Trowbridge, a leading case, decided by the Court of Error and Appeals of New Jersey,<sup>22</sup> the clarity of which makes comment thereon unnecessary:

"It is urged that a life policy should be exempt from the equitable rule which applies to other transactions, because it differs in its character from ordinary investments, and is a beneficent provision for the family, which should be favored.

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<sup>17</sup> *Supra* Note 13.

<sup>18</sup> *Supra* Note 14 at 471, 61 Pac. at 542.

<sup>19</sup> *Ibid.* at 475, 61 Pac. at 545.

<sup>20</sup> *Supra* Note 7.

<sup>21</sup> *Vorlander v. Keyes*, *supra* Note 7, was a contest between the receiver of a bank and the wife and children of its deceased president, who were beneficiaries of two life insurance policies on his life. One-quarter of the premiums were paid with his funds, the balance with funds embezzled by him from the bank. The Court distributed the insurance one-fourth to the beneficiaries and three-fourths to the receiver. Stating that the deceased "was heavily indebted to the bank," the report of the case does not tell definitely whether his misappropriations exceeded the sum which he had embezzled for the payment of the premiums.

<sup>22</sup> *Shaler v. Trowbridge*, *supra* Note 3.

Public policy clearly forbids the adoption of this suggestion: it would invite the commission of the wrong by assuring the wrongdoer that there is one mode in which he could surely profit by his turpitude, in securing a provision for his family. The policy is the thing which the partnership money purchased and it stands in the place of which was corruptly abstracted. Whether the policy would be productive, when terminated by death, of more or less than the premiums paid upon it, would depend upon the length of the life insured. The fact that it has a contingent value does not distinguish it, in principle, from an investment in the purchase of stock, or of an annuity, and can give no support to the claim of the widow that nothing should be exacted of her beyond the amount of premiums paid upon it out of firm funds. If this suit had been prosecuted in the lifetime of the husband, and the policy had been disposed of to the company for its surrender value, it would hardly have been insisted that he could claim, in a court of conscience, a right to any excess of the proceeds after refunding to his firm the amount of the premiums."<sup>23</sup>

In *Holmes v. Gilman*<sup>24</sup> counsel for the wife urged that it was impossible to trace the trust funds in the insurance policies because their identity was lost when they became intermingled with the property of the wife—her insurable interest in the life of her husband, but it was held that there was not such an intermingling of trust funds with other moneys as to preclude the *cestui que trust* from following and reclaiming them in their altered state, the defendant's argument being grounded on a misconception of the legal nature of an insurable interest in human life. What was in contemplation of law a mere status the wife had urged as a property right belonging to her.<sup>25</sup> However, if we assume a case where the proceeds of the

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<sup>23</sup> *Ibid.* at 604. (As in *Holmes v. Gilman*, the specific point dealt with in this note was not raised in the New Jersey case, the amount of the insurance recovered being less than the losses resulting from the assured's breach of trust. The vigorous language of the opinion, however, indicates that the result would have been the same regardless of the sum involved.)

<sup>24</sup> *Supra* Note 2.

<sup>25</sup> *Supra* Note 2 at 379, 34 N. E. at 207. At this point in its discussion the Court of Appeals declared that an insurable interest was not a "property right" but a mere "status," by law a necessary element for a valid contract of insurance; not an individual's contribution to the formation of the contract, but rather a legal qualification on his right to make this type of contract. The view is interesting and suggests further discussion: A having the right to insure his own life in favor of B, has an interest which he enjoys to the exclusion of others—not *all* others, it is true. Yet the privilege which it gives him to enjoy to the exclusion of those others who by law are barred from exercising a similar right with respect to *his* life, approaches so nearly to our conception of a property right as to make a distinction difficult. However, even if we assume that this right is some form of property, it does not appear to be property in the sense that it could be so mingled with trust property as to prevent identifica-

insurance will surpass in amount the total of the original losses of the *cestui que trust*, some question may arise as to whether or not there must be an insurable interest in favor of the *cestui que trust* up to the amount of the judgment in order that he may have a valid claim to all of this money. In other words, will the Court say that the *cestui que trust* must prove his insurable interest up to the amount of his recovery because in such a situation we are in fact saying that the *cestui que trust* insured the life of the deceased? Admitting his right to recover based on an insurable interest to the actual extent of the loss suffered, is that insurable interest restricted to the latter amount, so as to bar a right to share in any proceeds above that figure? The objection seems to be without force. Despite the fact that it is the funds of the *cestui que trust* which have provided the premiums for the policy, he cannot be deemed to be the procurer of the insurance, for such was never his intention and his claim in the proceeds is not a consequence of the exercise of whatever right he may have had to insure the life of his trustee, but is merely an insistence on the right to follow and reclaim trust funds. Further than this, it seems that the insurable interest of the *cestui que trust* is an irrelevant consideration.<sup>26</sup> In these situations the contract is between the insurance company and the deceased fiduciary. His insurable interest in his own life is sufficient to satisfy that element in the contract.<sup>27</sup> Though the necessity for this element seems to exist with respect to every contract of life insurance, it is sufficient that the individual who insures his own life "contribute" his insurable interest, it being unnecessary that we approach the problem with the inquiry whether or not the beneficiary's interest in the life of the insured is sufficiently made out. It seems established in the law of insurance that an individual may insure his own life for the benefit of any one whom he may choose, the risk being acceptable, of course, to the insurance carrier, for the insurable interest of the deceased in his own life validates the policy.<sup>28</sup> The correct result, therefore, seems to be that the trustee should be considered as the insurer of his

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tion after it has been joined with trust funds in the purchase of the insurance. When courts of equity insist that trust funds which have been mingled with other money be clearly identified, the basis for the rule is that rights of third parties are just as sacred in the law as those of the *cestui que trust*. In this situation the reason seems to fail. After the insurance has been purchased the insurable interest remains undiminished by its appearance as an element in the contract. It seems, therefore, that whatever view is taken of the nature of the insurable interest, the result reached by the Gilman case is correct.

<sup>26</sup> Insurable interest is universally stated as being the bar which the law demands for the safety and protection of the public against wagering contracts. *Connecticut Mutual Life Insurance Co. v. Schaefer*, 94 U. S. 457, 24 Sup. Ct. 251 (1876); *Loomis v. Eagle Insurance Co.*, 6 Gray 399 (Mass. 1856).

<sup>27</sup> *Allen v. Hartford Life Insurance Co.*, 72 Conn. 693, 45 Atl. 955 (1900); *Union Fraternal League v. Walton*, 109 Ga. 1, 34 S. E. 317 (1899); *Reed v. Prov. Life Insurance Co.*, 190 N. Y. 111, 82 N. E. 734 (1907); *Olmstead v. Keyes*, 85 N. Y. 593 (1883); *Richards, Insurance* (1900), p. 40.

<sup>28</sup> *Supra* Note 27, cases cited therein.

life for the benefit of his *cestui que trust*, who is entitled to claim all of the insurance money.<sup>29</sup>

These considerations lead to the conclusion that the rule which allows the *cestui que trust* to claim the proceeds of the policy, regardless of the amount, is the result most consonant with the principles of the law of trusts and general equitable standards. Views of courts which have considered the result to be clothed with some doubt, or which have favored the opposite conclusion as the better rule, appear to be based on an apparent failure to appreciate the actual problem which the situation presents, together with a not unnatural leaning towards the aid of widows and children, which, though commendable for its humane spirit, forces the recognition as standards of conduct for a court of equity, principles for which we will search in vain both in the authoritative cases and in the books of those writers who command our respect. Undoubtedly the strongest consideration, both from the practical viewpoint and from the viewpoint of legalistic reasoning, is that a holding contrary to that which we have developed as the correct rule would put a premium on dishonesty and provide for the unscrupulous a method of protection for wives and dependents by wrongdoing which would have the sanction and approval of the law.

JAMES F. KELLY.

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THE CONFLICT OF LAWS WITH RESPECT TO THE BURDEN OF  
PROVING CONTRIBUTORY NEGLIGENCE.

As a general proposition, the laws created by one state cannot have any binding force beyond the confines of its jurisdiction.<sup>1</sup> While this principle is easily discerned, nevertheless, we see many instances where the courts of one state, under certain circumstances, give effect

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<sup>29</sup> It should be noted in this connection that the "insurable interest" which the Court considered in *Holmes v. Gilman* was not that of the insured in his own life, but that of his wife in her husband's life. However, the Court spoke of that insurable interest only because it was urged upon them by counsel as the "property" with which the trust funds had been mingled. As a practical matter it seems that to say the wife's insurable interest was involved is a gross fiction. She knew nothing of the insurance contract until after the death of insured and had no participation whatsoever in the transaction. At any time after the issuance of the policy she could have exercised her privilege to insure her husband's life, her insurable interest remaining unaffected. It seems a better view that the husband's insurable interest was present in the policy.

<sup>1</sup> *Petersen v. Chemical Bank*, 32 N. Y. 21, 42, 88 Am. Dec. 298 (1865); *Pennoyer v. Neff*, 95 U. S. 714, 720, 722, 731 (1877); *Hervey et al. v. R. I. Locomotive Works*, 93 U. S. 664, 671 (1876); *Hubbard v. Hubbard*, 228 N. Y. 81, 85, 126 N. E. 508 (1920); *Marshall v. Sherman*, 148 N. Y. 9, 24, 42 N. E. 419, 34 L. R. A. 757, 51 Am. S. R. 654 (1895); 2 Kent Comm. 457; Story, *Conflict of Laws* (7th Ed.), Secs. 7, 8, p. 7.