

FULTON IRON WORKS CO., PLAINTIFF AND APPELLEE, VS. CHINA BANKING CORPORATION ET AL., DEFENDANTS. CHINA BANKING CORPORATION, APPELLANT.*G.R. No. 32576. November 06, 1930*

Ponente: STREET, J.

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This action was instituted on June (23, 1926, in the Court of First Instance of the City of Manila by the Fulton Iron Works Co., a Delaware corporation having its principal place of business in St. Louis, Missouri, and duly authorized under the laws of the Philippine Islands to engage in business in this country. The defendants named in the complaint are the China Banking Corporation, a domestic corporation having its principal place of business in the City of Manila, and one S. C. Schwarzkopf. In the petitory part of the complaint judgment is sought against the two defendants jointly and severally for the sum of P131,197.10, with interest. As a ground of action against the two defendants it is asserted in the complaint that the amount claimed by the plaintiff is, part of a larger sum of money (P176,197.10) belonging to the plaintiff which had been deposited in the defendant bank by Schwarzkopf during the year 1922, and which had been misappropriated and embezzled by him, with the full knowledge and consent of the defendant bank. The idea underlying the action, as against the bank, is that it has been guilty of what may perhaps be styled a civil complicity in the misappropriation of the money for which recovery is sought.

Upon hearing the cause, upon the separate answers of the two defendants, the trial court absolved Schwarzkopf from the complaint, for the reason that in two prior criminal proceedings he had been convicted of the offense of estafa, based upon his misappropriation of the same money, and in said proceedings the obligation to indemnify the plaintiff had been imposed upon him in the amount of P146,197.40. His Honor, however, gave judgment in favor of the plaintiff, the Fulton Iron Works Co., to recover of the defendant bank the sum of P127,200.36, with lawful interest from June 23, 1926, the date of the filing of the complaint, and with costs. From this judgment the defendant bank appealed.

It appears that in the month of March, 1921, the plaintiff, the Fulton Iron Works Co., of St. Louis, Missouri, sold to the Binalbagan Estate, Inc., a Philippine corporation, machinery for a sugar mill, for which the purchaser executed three notes amounting to about \$80,000. The first of these notes became due October 1, 1921, and the other two on April 1, 1922. Neither of the three notes was paid at maturity, owing to the fact that, before the notes fell due, the Binalbagan Estate, Inc. suspended payments and passed into the hands of the Philippine National Bank, its principal creditor, for administration.

The consequent delay in the payments of the notes caused the plaintiff to employ a firm of lawyers in Manila, of which S. C. Schwarzkopf was then a member, to represent the plaintiff in an effort to obtain security for the indebtedness, with a view to its later collection. At the time this retainer was effected, Schwarzkopf was in St. Louis, on a visit to the United States, and in order that the plaintiff might comply with the laws of the Philippine

Islands in the matter of obtaining a license to transact business here, the plaintiff executed a formal power of attorney authorizing the members of Schwarzkopf's firm jointly and severally to accept service in actions and to do other things necessary to enable the plaintiff to secure the contemplated license. It is noteworthy that the authority of Schwarzkopf's firm to represent the plaintiff in the collection of the claims above mentioned did not proceed from this power, but had its origin in the employment of said firm as attorneys in the matter.

Schwarzkopf returned to Manila in the early part of November, 1921, and the law firm to which he pertained was dissolved on November 15, 1921. Under the dissolution agreement the matter of handling this collection devolved upon Schwarzkopf, and he alone was thereafter concerned in the matter.

On December 13, 1921, Schwarzkopf opened a personal account, as a depositor, in the China Banking Corporation by making a deposit, on that date, of the sum of P578. This account was at all times modest in size, and on January 1, 1922, the credit balance therein was P543.35. This account has little or no significance in the case, and it became defunct by September 1, 1922. It may be observed, however, that a few of the deposits in this account appear to have been taken from account No. 2 to which reference will presently be made.

In the early part of the year 1922, the financial condition of the Binalbagan Estate, Inc. began to improve; and on January 13, 1922, D. M. Semple, manager of the Philippine Sugar Centrals Agency, a department of the Philippine National Bank, drew check No. 574 for the sum of P10,000, payable to the order of Sydney C. Schwarzkopf, and delivered the same to him in part payment of the indebtedness owing to the plaintiff from the Binalbagan Estate, Inc. Upon receiving this check Schwarzkopf signed a receipt as "attorney-in-fact of Fulton Iron Works Co." The character of attorney-in-fact, thus assumed by Schwarzkopf, was of course a mere fiction, as the power of attorney which he really possessed was limited to other matters. The point, however, is really of no moment.

The check for P10,000 above mentioned was duly indorsed by Schwarzkopf and deposited by him in a new account with the defendant bank, known as "No. 2 account." This money was thereafter withdrawn from the bank from time to time by Schwarzkopf, upon his personal checks, and used for his individual purposes. In the appealed judgment the defendant is held liable for this money, a mere oversight resulting, apparently, from a confusion of this matter with the more important issues involved in other parts of the case. There is no proof that the defendant bank had any knowledge, or was chargeable with notice, that the P10,000 thus deposited and drawn out belonged to any person other than Schwarzkopf himself; and, as depositor, Schwarzkopf of course had absolute control of the account. A depositor is presumed to be the owner of funds standing in his name in a bank deposit; and where a bank is not chargeable with notice that the money deposited in such account is the property of some other person than the depositor, the bank is justified in paying out the money to the depositor or upon his order, and cannot be liable to any other person as the true owner. It is hardly necessary to cite authority upon a proposition so manifestly in accord with the usage and the common sense of the commercial community. The proposition stated is implicit in all the cases concerned with the question of the liability of a bank to its depositors and other persons claiming an interest in the deposits.

Proceeding to the next collection effected by Schwarzkopf upon account of the plaintiff's claim against the Binalbagan Estate, Inc., we find that on April 11, 1922, Schwarzkopf received, from the manager of the Philippine Sugar Centrals Agency, a check for the sum of P61,237.50. This check was made payable on its face to, "S. C. Schwarzkopf, Attorney-in-Fact, Fulton Iron Works Co., or order." After indorsing this check in the form in which it was drawn, Schwarzkopf opened a new account with the defendant bank, entitled "S. C. Schwarzkopf, Attorney-in-Fact, Fulton Iron Works Co.," and deposited said check therein. This account remained undisturbed on the books of the bank for some two months, during which period it had an accretion of about P130.

Meanwhile, the No. 2 account, which had been established back in January, became depleted, but the manager of the bank, in view, no doubt, of the funds to Schwarzkopf's credit in the third account, conceded to him a credit in No. 2 account of P25,000. By June 15, 1922, said account became overdrawn to the extent of P22,144.39, and it was obvious that the limit of the conceded credit would soon be reached. The manager of the bank then intervened and requested Schwarzkopf to settle the overdraft. To accomplish this Schwarzkopf merely transferred, by check, the money to his credit in his special account as plaintiff's attorney-in-fact to the No. 2 account. The amount thus transferred was P61,360.81, and the effect of the transfer was to absorb the overdraft and place a credit balance of nearly P40,000 in No. 2 account. Schwarzkopf then purchased a draft on New York in the amount of \$15,000, and after some delay transmitted the same by mail to the plaintiff. This draft cost Schwarzkopf the sum of P30,375.02, and it was the only remittance ever made by him to his client.

The principal question that arises upon the facts above stated is, whether the defendant bank is liable to the plaintiff for the sum of P22,144.39 which was thus applied to the payment of Schwarzkopf's personal indebtedness resulting from his overdraft in the No. 2 account. Upon this point the first thing to be noted is that the very form in which the third account was carried on the books of the defendant bank was sufficient to charge the bank with notice of the fact that the money deposited in said account belonged to the Fulton Iron Works Co. and not to Schwarzkopf. It is commonly said, and truly said in a legal sense, that money has no earmarks. But bank accounts and commercial paper can have earmarks, and these earmarks consist of the word or words which infallibly convey to the mind notice that the money or credit represented by the account with which they are associated or the instrument upon which they are written rightfully belongs to some other person than the one having control thereof. A bank cannot permit, much less require, a depositor who is in control of a trust fund to apply any part of the same to his individual indebtedness to the bank. The decisions to this effect are uniformly accordant, and it is believed no creditable authority to the contrary can be produced from any source. The expression "trust fund," in this connection, is not a technical term, and is applied in a loose sense to indicate the situation where a bank account or negotiable securities of any sort are under the control of a person other than the true owner. The following decisions are instructive as illustrating different phases of the rule above stated, the selection having been made with a view to the fact that the cases cited are for the most part accessible in one or more series of annotated reports: *Central Nat. Bank of Baltimore vs. Conn. Mut. Life Ins. Co.*, 104 U. S., 54; 26 Law. ed., 693; *Union Stock Yards Nat. Bank vs. Moore*, 25 C. C. A., 150; 79 Fed., 705; *Sayre vs. Weil*, 94 Ala., 466; 15 L. R. A., 544; *Am. Trust & Banking Co. vs. Boons*, 102 Ga., 202; 40 L. R. A., 250; 66 Am. St. Rep., 167; *First Denton Nat. Bank vs. Kenney*, 116 Md., 24; Ann. Cas. 1913B, 1837; *Allen vs. Puritan Trust Co.*, 211 Mass., 409; L. R. A. 1915C, 518 (and note); *Emerado Farmers' El. Co. vs. Farmers' Bank*, 20 N. D., 270; 29 L. R. A. (N. S.), 567; *Baird vs. Lorenz* (N. D.), 61 L. R. A., 1385, 1389 (note); *Walters Nat. Bank vs. Bantock*, 41 Okla., 153; L. R. A. 1915C, 531; *Interstate Nat. Bank vs. Claxton*, 97 Tex., 569; 65 L. R. A., 820; 104 Ani. St. Rep., 885; *Boyle vs. Northwestern Nat. Bank of Superior*, 125 Wis., 498; 1 L. R. A. (N. S.), 1110; 110 Am. St. Rep., 851; *United States Fidelity & Gy. Co. vs. Adoue*, 104 Tex., 379; 37 L. R. A. (N. S.), 409; Ann. Cas. 1914B, 667; *Underwood Ltd. vs. Bank of Liverpool* (1924), 1 K. B., 755.

Upon the facts before us it is evident that when credit to the extent of P25,000 was conceded to Schwarzkopf in his personal account No. 2, the eye of the banker was fixed upon the large amount then upon deposit to Schwarzkopf's credit in his account as attorney-in-fact; but of course, if a bank cannot apply the money in such an account, or even permit it to be applied, to the personal indebtedness of the fiduciary depositor, it is not permissible for the bank to extend personal credit to such depositor upon the faith of the trust account. From any point that the matter be viewed, the liability of the bank is clear to the extent of P22,144.39, this being the amount derived from Schwarzkopf's account as attorney-in-fact which was absorbed by his overdraft in account No. 2 when the transfer of the balance in the former account to the latter account was effected, in the manner already

stated.

We next proceed to consider the disposition made of the proceeds of the third check collected by Schwarzkopf upon account of plaintiff's claim against the Binalbagan Estate, Inc., from the Philippine National Bank. The amount of this collection was P104,959.60, and it was paid, on October 11, 1922, by a cashier's check on the Philippine National Bank, payable "to the order of S. C. Schwarzkopf, attorney-in-fact, Fulton Iron Works Co." Upon receiving this check, Schwarzkopf indorsed it in proper form, by writing thereon the words "S. C. Schwarzkopf, attorney-in-fact, Fultort Iron Works Co.," to which he added another endorsement consisting of his own name alone, and deposited the check in his personal account No. 2 with the defendant bank. The check thus delivered to the bank was collected by it from the Philippine National Bank in ordinary course. Thereafter, in the course of the next few months, Schwarzkopf withdrew, upon checks written by himself, the entire amount of the money to his credit in account No. 2, thus misappropriating the money in said account to his own use.

It will be noted that the money thus squandered comprised not only the proceeds of the check last mentioned but the residue, consisting of a few thousand pesos, which had been left in No. 2 account after the overdraft had been paid and Schwarzkopf had remitted the draft of \$15,000 to his principal in the United States. We consider that, from a legal point of view, the situation with respect to this money is precisely the same as that presented with respect to the money which came into the account later by deposit of the check for P104,959.60 above mentioned, because, as to both funds, liability is sought to be fixed upon the bank by reason of its knowledge of the source from which said funds were derived; and in this connection it should be noted that there is no proof showing that the defendant bank had any knowledge of the misappropriation of this money by Schwarzkopf other than such as might have been derived from an inspection of its own books and the checks by which the money was paid in and paid out.

The feature of the case now under consideration brings us, it must be admitted, into debatable territory, but a discriminating analysis of the legal principles involved leads to the conclusion that the defendant cannot be held liable for money paid out by it in ordinary course on checks, in regular form, drawn by Schwarzkopf on the No. 2 account.

The specialized function of a bank is to serve as a place of deposit for money, to keep it safely while on deposit, and to pay it out, upon demand, to the person who effected the deposit or upon his order. A bank is not a guardian of trust funds deposited with it in the sense that it must see to their proper application, nor is it its business to pry into the uses to which moneys on deposit in its vault are being put; and so long as it serves its function and pays the money out in good faith to the person who deposited it, or upon his order, without knowledge or notice that it is in fact assisting in the misappropriation of the fund, the bank will be protected. As is well said by the author of the monographic article on Banks and Banking in *Ruling Case Law*, it would seriously interfere with commercial transactions to charge banks with the duty of supervising the administration of trust funds, when, in due course of business, they receive checks and drafts in proper form drawn upon such funds in their custody. The law imposes no such duty upon them (3 R. C. L., 549; see also cases cited in C. J., 644, 645, note 25).

There are, it is true, decisions from a few courts, deservedly held in high esteem, to the effect that a bank makes itself an effective accomplice in the conversion of a trust fund when, with notice of the character of such fund, it permits the person in control thereof to deposit it in his personal account. But the decided weight of judicial authority is to the contrary; and it is generally held that the mere act of a bank in entering a trust fund to the personal account of the fiduciary, knowing it to be a trust fund, will not make the bank liable in case of the subsequent misappropriation of the money by the fiduciary. (*United States Fidelity & Gy. Co. vs. First Nat. Bank*, 18 Cal. App., 437; *Goodwin vs. Am. Nat. Bank*, 48 Conn., 550; *Batchelder vs. Cen. Nat. Bank of Boston*, 188 Mass., 25; *Allen vs. Puritan Trust Co.*, 211 Mass., 409; *L. R. A.* 1915C, 518; *Gate City Bldg. & Loan Assoc. vs.*

National Bank of Commerce, 126 Mo., 82; 27 L. R. A., 401; 47 Am. St. Rep., 630; Bischoff vs. Yorkville Bank, 218 N. Y., 106; Havana C. R. Co. vs. Knickerbocker Trust Co., 198 N. Y., 422; L. R. A. 1915B, 720.) The bank has the right to presume that the fiduciary will apply a trust fund to its proper purpose, and at any rate the bank is not required to send a courier with the money to see that it reaches a proper destination.

In the case before us an intimate study of the checks which came into the defendant bank against account No. 2, over a series of months, would have led a discerning person to the conclusion that the plaintiff's money was being squandered, but such an inference could not legitimately have been drawn from the first few checks which were drawn upon the fund, and it would be hard to say just where the bank, supposing its suspicions to have been aroused, should have intervened. No such a duty is imposed. Of course, when the bank became a party to the application of part of the plaintiff's money to the satisfaction of the overdraft in No. 2 account, it "Was directly chargeable with knowledge of the misappropriation of the fund to the extent of the overdraft, and that fact, as we have already said, made the bank liable. But this rule cannot be extended to subsequent acts of malversation and misappropriation committed by the fiduciary against the real owner of the fund.

Furthermore, it is undeniable that a bank may incur liability by assisting the fiduciary to accomplish a misappropriation, although the bank does not actually profit by the misappropriation. A decision illustrating this aspect of the law is found in Washborn vs. Linscott State Bank (87 Kan., 698), where a bank, to help the treasurer of a lodge to conceal his defalcations, permitted him to overdraw, and when his accounts were to be audited, issued to him a deposit certificate for the shortage, payable to the lodge. After the audit was made, the certificate was returned and cancelled, and the shortage reappeared. The court held that a loan had been made to the treasurer personally, and that the bank became liable to the lodge upon cancelling the deposit certificate.

Our discussion of this phase of the case should not be concluded without reference to Bischoff vs. Yorkville Bank (218 N. Y., 106), which undoubtedly affords some support to the contention of the appellee that the defendant bank is liable not only for the proceeds of the last check collected by Schwarzkopf, but for all of the money which was transferred to account No. 2 from the account of Schwarzkopf as attorney-in-fact. This decision comes, it must be admitted, from a court of high repute. But we are unable to accept the court's conclusion, as applicable to the facts before us. In the case mentioned it appeared that an executor, named Poggenburg, having money on deposit in a certain bank to his credit as executor, gradually withdrew about \$13,000 from said deposit by checks drawn by him, over a long period of time, in the character of executor. These checks were indorsed by Poggenburg in his own name simply and deposited in the defendant Yorkville Bank to his personal credit. At the inception of this series of transactions Poggenburg was indebted by note to the defendant, and payments were made on this note and other notes thereafter executed in favor of the bank, out of the funds transferred as above stated. The court held, upon the facts before it, that the defendant knew at all times that the credits created by the various deposits, through checks of the executor, were assets pertaining to the estate of which Poggenburg was executor; and from this fact, in connection with the misapplication of part of the money to the payment of the personal notes of Poggenburg, the court held that the defendant bank was liable to the extent of the whole amount misappropriated by means of the personal account.

It will be noted that this decision was made in third instance, after a trial in first instance, possibly before a jury, and after the judgment against the bank had been affirmed upon appeal in the appellate division of the Supreme Court. The prior history of the case was therefore such as to entitle the findings of fact of the two prior courts to great weight, and these courts had found in effect that the defendant bank had acted in bad faith. If not explicable upon this ground, the decision in the Court of Appeals must be considered a unique variant from accepted doctrine, in this, that while repudiating the idea, favored by a few courts, that the act of depositing a trust fund in the personal account of the fiduciary is an effective act of conversion on the part both of bank and fiduciary, the

court nevertheless held that the act of the bank in permitting the application of part of the money to the personal indebtedness of the fiduciary afforded a sufficient basis for finding the bank to have been an accomplice in the subsequent misapplication, by the fiduciary, of other portions of the deposit. We can accede to the first of these propositions but not to the second. In this connection we refer to the Annotation appended to *Allen vs. Puritan Trust Co.* (L. R. A. 1915C, 518, 529), where the pertinent cases are analyzed and the conclusion stated^[1] that, by the weight of authority, the placing of a trust fund in the personal account of the fiduciary does not make the bank liable for a subsequent misappropriation of the money by the former. For the rest it is enough to say that there is no proof in this case that the defendant bank had any guilty connection in fact with the dishonest acts of Schwarzkopf, in squandering the contents of the No. 2 account after he had made his remittance of \$15,000 to his principal.

In conclusion we ought to add that the legal principles involved in this decision are not directly deducible from the provisions of the Negotiable Instruments Law, which is in force in this jurisdiction (Act No. 2031) ; and there is no provision of the Civil Code or Code of Commerce directly bearing upon the point under consideration. The liability of the defendant bank, to the extent recognized in this decision, proceeds upon the fundamental idea that a creditor cannot apply to the obligation of his debtor money which, as he knows, belongs to another, without the consent of the latter,—a principle implicit in all law. We note that the attorneys for the appellant bank have suggested in their brief that, supposing the bank to have been an accomplice of Schwarzkopf in the misappropriation of the plaintiff's money, its subsidiary liability was extinguished as a result of the criminal proceedings against Schwarzkopf. This suggestion is clearly untenable, with respect to the liability which is fixed upon the bank by this decision. From what has been said it follows that the appealed judgment must be modified, and the same is hereby modified, by reducing the amount of the judgment against the bank to the sum of P22,144.39, with lawful interest from June 23, 1926, until date of payment,^[1] without pronouncement as to costs. So ordered.

Malcolm, Villamor, Ostrand, Johns, Romualdez, and VillaReal, JJ., concur.

Judgment modified.

[1] As amended by order of the Court of January 14, 1931.

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