Contractual Limitation of Liability by the so-called "Massachusetts Trust," under the Indiana Law

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Recommended Citation
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CONTRACTUAL LIMITATION OF LIABILITY BY THE
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THE INDIANA LAW

In the recent case of McLaren v. Dawes Sign & Mfg. Co., 156 N. E. 584, the Indiana Appellate Court has expressed the opinion that contractual limitations of liability are illegal in this state, except in the case of corporations. The suit in question was brought against the trustees of a "business trust," which was organized on the model familiar in Massachusetts, and commonly known as a "Massachusetts trust." The court insisted that such an organization must have been formed for the purpose of evading the corporation laws of this state. Accordingly it was held that the contractual limitation of liability of the defendants (provided in the declaration of trust, which was recorded, and also on the printed letter-heads and similar literature used by the defendants)\(^1\) was illegal and that the trustees were liable as partners.

It is beyond the scope of this comment to treat exhaustively the question of the difference between a business trust and a partnership. The problem is really one of distinguishing between agents and trustees, for it is well known that these terms, though widely different in their legal connotation, are often used almost interchangably, or even with the deliberate purpose of confusing the meaning in the particular document—so that the users may be able to sustain whichever meaning may later prove most for their convenience.\(^2\) The test is one of control. The agent is under the control of his principals; the trustee, while bound to account to his cestuis, is not required to obey their instructions, nor to conduct the affairs of the trust in accordance with the judgment of anyone except his own. In the case of a business trust so-called, the problem as to how far the persons beneficially interested may make their wishes effective in the general conduct of the business, and still have a real trust, is obviously somewhat difficult. In Massachusetts itself

\(^1\) It is stated that "Appellee had no notice or knowledge of the existence of the declaration of trust," and that the stationery did not have the warning of the existence of the trust printed on it, as had been intended. It would seem that the plaintiff was not duly warned of the limitation of liability of the defendants, so that on this ground the result of the case may be supported.

\(^2\) See I Williston on Contracts, Section 313, where it is said "It must be remembered that what is nominally a trust may be in reality and in legal effect an unincorporated association or partnership, the so-called trustees being more properly designated as agents."
the courts have tended to apply this test somewhat rigidly, and wherever the holders of the beneficial interest have any power to initiate action, the organization will generally be held to be a partnership and the so-called trustees will be treated as mere agents.\(^3\) Other authorities have urged a somewhat broader test.\(^4\) On principle, the question would seem to be whether the holders of the beneficial interests are given such powers as will enable them to effectively interfere in the business. If so, a partnership certainly exists; if, on the other hand, the management of the ordinary business is solely in the hands of the trustees, there is a real trust, even though the cestuis may have considerable powers in unusual circumstances.\(^5\)

However, the initial fallacy of the Indiana court goes deeper. It is embodied in the theory, to which reference has already been made, that the formation of a business trust is in contravention of the corporation laws of this state, or at least inconsistent with their purpose. But trusts are probably as ancient, and certainly as respectable as private corporations.\(^6\) Furthermore,
the carrying on of business by this device and without statutory aid has no elements of novelty; certainly it has long been accomplished through testamentary trusts.\textsuperscript{7} The only novelty to which the Massachusetts trusts may seriously lay claim is the provision for transferrable beneficial interests, but this is common enough, not only in that rather strange kind of partnerships known as joint-stock associations\textsuperscript{8} but also in the case of corporate mortgages, where every transferee of bonds is also the holder of an undivided beneficial interest in the security.

Granting then that we have a business trust, the question remains whether it is possible to absolve the certificate-holders (the certificates represent the beneficial interests) from liability. The answer is clearly in the affirmative. In the first place, the certificate-holders are neither parties to, nor have they any control over, the contracts made by the trustees. There is accordingly no direct right against them. It is true that the cestuis have the duty of indemnifying the trustees against liability in connection with any contracts properly entered into in behalf of the trust and probably the creditors may take advantage of this right.\textsuperscript{9} But this is a derivative right and it seems clear that it can be given up by an arrangement between the trustees and the certificate-holders, even without consent of the creditors (except, of course, with respect to existing liabilities.) \textit{A fortiori}, where the creditor himself consents in advance to give up any right against the cestuis, there seems to be no room for any contention that the cestuis are bound.\textsuperscript{10}

But let it be assumed that the attempt to form a trust has proven a failure, because of the giving of too great powers to the certificate-holders. These unfortunate persons, who have had powers greater than they ever realized, desired, or used, are now confronted with an equally greater and an even more

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\textsuperscript{7}Ex parte Garland, 10 Ves. Jr. 111.  \\
\textsuperscript{8}See Carter v. McClure, 98 Tenn. 109, 38 S. W. 585.  \\
\textsuperscript{9}Hardoon v. Belilios (1901), A. C. 118. See also I Williston on Contracts, Section 313.  \\
\end{flushleft}
unexpected liability—that of partners. Still, the creditor has agreed not to proceed against the certificate-holders (or has contracted with the association with notice of the inability, or at least impropriety, of the so-called trustees binding the certificate-holders personally, which would seem to amount to the same thing) and there seems to be no reason why he should be given this additional advantage against the certificate-holders, even if they are partners. The only answer that can be given to this is "public policy," and it is submitted that this is no answer at all. Why a number of individuals carrying on business together—or a single individual, for that matter—should not be able, with the consent of the creditor, to limit his or their liability to the amount invested in the business, is something which business men, at least, cannot see, and it is believed that the law itself has not been successful in devising any justification for a negative answer to this inquiry.\textsuperscript{11} It is often urged that this results in no one being liable. Assuming that this would be a fatal objection,\textsuperscript{12} the obvious answer is that it is not true in fact—all the individuals are liable, but in an amount limited by their contribution to the business. A more serious objection is the possible unfairness to the creditor. But he has agreed to this, and if he was unwilling to consent, he should not have entered into the transaction. This objection has a certainly validity in that it emphasizes the importance of full notice to the creditor, in order that his consent to the arrangement shall be actual and well-considered. Undoubtedly the burden should be on the certificate-holders to show that the creditor has actually consented to give up any recourse against them;\textsuperscript{13} but when this has been shown, there is no reason in theory or justice why the creditor should be permitted to disregard his own agreement not to proceed against them. The few authorities against this view should not be followed.\textsuperscript{14}

\begin{itemize}
\item \textsuperscript{11} To the effect that the liability may be so limited, see \textit{Hibbs v. Brown}, 190 N. Y. 167, 82 N. E. 1108; \textit{McCarthy v. Parker}, 243 Mass. 464, 138 N. E. 8; \textit{Ex Parte Garland}, supra, and \textit{Halket v. Merchant's etc. Ass'n.}, 13 Q. B. 960. In the case last mentioned, policies issued by the defendant provided that the shareholders were not to be liable and that the only recourse of the policy-holders was against the "capital stock and funds." This provision was upheld.
\item \textsuperscript{12} But see to the effect that it is not, \textit{Shoe & Leather National Bank v. Dix}, 123 Mass. 148, 151.
\item \textsuperscript{13} \textit{Hayes Motor etc. Co. v. Wolff}, 175 Wis. 501, 185 N. W. 512; \textit{Neville v. Gifford}, supra; \textit{Rand v. Morse}, 289 Fed. 839.
\item \textsuperscript{14} The clearest contrary authority is \textit{Thompson v. Schmitt}, 274 S. W. 554, where the Texas Supreme Court reached the astounding conclusion
\end{itemize}
But the Indiana court might admit all this and still insist that the principle case was rightly decided. The court would undoubtedly point out that all the defendants in this case were trustees and that the above reasoning has no bearing on their liability. It must be admitted that the problem of devising a scheme for relieving the trustees from liability, is somewhat more troublesome. In a real trust, the right of the creditor against the trustees is direct, and not merely derivative as in the case of the cestuis. Accordingly, there is no possibility of claiming that the trustees should be exempt, unless by reason of an express agreement to that effect. The matter of notice to the creditor is vital here, and it would not seem that a provision in the trust agreement limiting the liability of the trustees would be sufficient, unless actually brought to the attention of the creditor. But there is no more objection to the limitation of the liability of trustees that to a similar limitation in the case of partners. If it be urged that the usual result is to take away the personal liability of both trustees and cestuis, the answer is not only that the creditor has agreed to this, but that he has in fact recourse to the trust fund, which will ordinarily be sufficient.

That a business trust is a partnership because the trustees are the agents of the so-called cestuis, although the cestuis have no control whatever over the trustees, and also that both cestuis and trustees are personally liable upon all contracts even though it is specifically provided in the contract that they shall not be. This mere statement of the holding of the court is believed to be sufficient to demonstrate that it cannot be characterized as other than "grotesque." Indeed the decision—or at least the last part of it—is vigorously and effectively criticized by Professor Hildebrand in 4 Texas Law Rev. 57. The Texas Commission of Appeals has in effect declined to follow the authority of the Thompson case in Shelton v. Montaya Oil and Gas Co., 292 S. W. 165, holding that the trustees and cestuis in a business trust may limit their liability by contract. Such cases as People v. Hinkle, 126 Wash. 581, 219 Pac. 41, holding that a "common-law trust" is an illegal organization would probably lead to the same result, so far as personal liability of cestuis is concerned.

15 Neville v. Gifford, supra; Mitchell v. Whitlock, 121 N. C. 166, 23 S. E. 292.

16 Taylor v. Davis, 110 U. S. 330; Rand v. Morse, supra; Bank of Topeka v. Eaton, 100 Fed. 8, affd. 107 Fed. 1003; Adams v. Swig, 224 Mass. 584, 125 N. E. 857; Shoe and Leather National Bank v. Dix, supra; Rand v. Farquhar, 226 Mass. 91, 115 N. E. 286. The case of Betts v. Hackathorn, supra, reaches the opposite result on the assumed authority of Taylor v. Davis, supra, but the court was misled by its failure to quote the entire governing portion of the opinion in the Taylor case. Of course the mere signature by the trustees as such will not limit their liability. Roger Williams National Bank v. Groton Manufacturing Co., 16 R. I. 504, 17
If the so-called trustees claim exemption where the assumed trust has been declared a partnership, they are actually agents claiming exemption from personal liability on contracts made in behalf of their principals, the certificate-holders. Such a claim is reasonable and quite usual; indeed there would be good grounds for contending that the agents should not be bound even in the absence of an express agreement to that effect. However, since the certificate-holders, the principals, are themselves generally not bound, the presumption would arise that the agents (the so-called trustees) would be bound. This presumption could only be rebutted by showing an express agreement, as before, but there would appear to be even less chance for maintaining that such an agreement contravened public policy.

The foregoing discussion relates, of course, solely to contractual liability. The possibility of limiting tort liability is much more restricted. It would seem impossible to limit the liability of the trustees, whether or not the organization is held to constitute a pure trust, since such limitation of liability can only be secured by contract. There are some authorities to the effect that the cestuis of a pure trust are not liable for torts of the trustees, on the ground that the trustees are not the agents of the cestuis and that they have no right of indemnity of which the creditors may take advantage. There seems to be no logical answer to this position, but it is suggested that this may inflict a distinct hardship upon the victim of the misdoings of the trustees, and that here there is a legitimate ground for the courts to interfere on grounds of public policy.

It is believed that the reasoning of the court in the McLaren case is erroneous both in denying the possibility of the formation of a business trust in this state and also in the assumption

Atl. 170. In Hess v. Werts, 4 Searg. & R. (Pa.) 355 and in Greenwood's Case, 3 DeG. M. & G. 459, there are well-considered dicta that even individuals may limit their personal liability by contract.


19 Falardeau v. Boston Art Students Ass'n., 182 Mass. 405, 65 N. E. 797; Curry v. Dorr, 210 Mass. 430, 97 N. E. 87. In Fisheries Co. v. McCoy, 202 S. W. 343 (Texas Civil Appeals) it is held that a contract between the trustees and an employee limiting the liability of the former for injuries to the employee is void as contrary to public policy.


21 The Supreme Court in Ridge v. State, 192 Ind. 639, 137 N. E. 759, seems to approve the formation of a business trust in this state.
that the liability of cestuis or even partners cannot be limited by agreement. As already pointed out, the actual decision may have been correct, but the reasons given by the court are erroneous and should not be followed. The court itself weakens its position with respect to business trusts, since, after the condemnation of such organizations which has already been summarized, it adds:

"Such associations, even in this state, may be trust organizations or they may be partnerships, depending entirely on the provisions of the instrument under which they are organized."

This seems to be an admission by the court that business trusts may be organized in Indiana, notwithstanding all alleged reasons of public policy to the contrary. It is submitted that the court should—and it is believed that it will in a proper case—likewise change its opinion that cestuis and trustees—and also partners and their agents—cannot limit their personal liability by contract. Both views rest upon theories of public policy which are not in fact sustainable.

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