REAL ESTATE MORTGAGE BONDS AS TRUST INVESTMENTS

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Recent audits of fiduciaries' accounts have shown the great extent to which the phenomenal rise in large commercial and multiple unit dwelling construction witnessed in the past decade was financed by monies held in trust. In many instances, there were departures from the time honored investments in small mortgages purchased outright, the legality of which as trust investments cannot be questioned,¹ into a field comparatively new—bonds secured by a single mortgage or by groups of mortgages, usually given to a trustee.²

Most of the investments in mortgage bonds, or certificates as they are sometimes called, were purchased from or through the medium of a guaranty company, which would under-write or finance the particular transaction, and have the mortgage made either to itself as trustee, or to a subsidiary or affiliated corporation. The trustee would thereupon issue bonds or certificates of participation, which were usually accompanied by the guaranty company's policy guaranteeing the payment of the principal and interest. By this means, it became possible for fiduciaries to invest comparatively small sums at a higher rate of interest than could ordinarily be obtained.³ In many such cases, the enforcement of the terms of the mortgage was supervised by the house of issue or by the guarantor of the bonds.

There were some instances in which the mortgage was taken directly by the fiduciary in its name as trustee, and shares or participations were allotted by it to its various trust accounts. In such cases, the mortgaged property was examined by the fiduciary's own appraisers, passed upon by its investment committee and thereafter supervised by it. This, in the opinion of the writer, was a more satisfactory form of investment for the reason that it placed the control of the security directly in the hands of the fiduciary. With the exception of possible objection to the particular type

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1. Mortgages have long been legal investments, even in the absence of statute, in both the United States and England. *White v. Sherman*, 168 Ill. 589, 48 N. E. 128 (1897); *Gray v. Fox*, 1 N. J. Eq. 259 (Ch. 1831); *King v. Talbot*, 40 N. Y. 75 (1869); *Hemphill's Appeal*, 18 Pa. 303 (1852); *Trafford v. Boehm*, 3 Atk. 444 (Ch. 1746); *Howe v. Earl of Dartmouth*, 7 Ves. 137 (Ch. 1802). In at least twenty-seven states, statutes declare their legality.

2. "I would say that mortgage certificates and participation certificates have brought about speculative buying under the authority of the state. . . . Trusts arising under wills in small and very large amounts have been invested entirely in such form of investment. . . ." Address by Surrogate George A. Slater, of Westchester County, N. Y., before the Bar of the City of New York on January 27, 1934.

3. See *Matter of Frazer*, 150 Misc. 43, 48, 268 N. Y. Supp. 477, 482 (Surr. Ct. 1933), in which Surrogate Delehanty stated: "The economic development which substituted large units in corporate or multiple ownership for the small project individually owned required as a corollary multiple contribution to the financing necessary for these larger projects."

of property secured by the mortgage, there can be little criticism of this means of investing trust funds.⁴

Many of the bonds were secured by mortgages upon huge projects, including hotels, factories, loft or commercial buildings, motion picture theatres, department stores, office buildings and apartment houses. The importance of their legality for trust investments is consequently far-reaching in the commercial world. As yet, the issue cannot be said to have received judicial determination. Despite the large amounts of trust funds which have been rendered non-liquid or have actually been lost in these investments, few attacks have been made on either the legality or feasibility of bonds or guaranteed certificates⁵ as investments for fiduciaries. In many states, investment of trust funds in certificates of participation or in bonds secured by mortgages has been authorized by statute.⁶ Where so sanctioned, the validity of particular investments of that type has been questioned in only a few jurisdictions.

In New York, the objections raised have centered mainly upon the non-liquidity of the investments and the fact that the maturity date of the mortgages was, in some instances, later than the time for distribution. One of the earliest decisions on the combining of trust funds for investment purposes was *Barry v. Lambert*,⁷ in which the principle was held sound. In *Re Union Trust Co. of New York*,⁸ the advantage so to be gained where the funds were small was stressed. Since that case, a number of New York decisions have assumed the validity of specific mortgage bond investments, because of the legislation authorizing investment in such securities. In

4. Cf. *In re Flint's Will*, 240 App. Div. 217, 269 N. Y. Supp. 470 (2d Dep't 1934).

5. These are to be distinguished from the "participations" which are allocated by a corporate fiduciary to its various trust accounts in mortgages taken by it as "trustee for sundry trusts". In the latter instance, the fiduciary makes its own examination and appraisal of the security and exercises its own supervision over the investment.

6. COLO. ANN. STAT. (Courtright's Mills, 1930) § 7946; DEL. LAWS (1931) c. 259, § 1; ILL. REV. STAT. (Cahill, 1933) c. 3, § 144 ("first mortgage bonds of any corporation"); IND. STAT. ANN. (Baldwin, 1934) § 7908 (applicable only to bank or trust company fiduciaries); IOWA, Acts of 43d Assembly, c. 259, § 1 (1929); KY. STAT. (Carroll, 1930) c. 128, § 4706, as amended by Acts of 1932, c. 91, p. 433; MINN. STAT. (Mason, 1927) c. 58, § 7714; N. H. PUBLIC LAWS (1926) c. 290, § 22, which deals with "notes secured by mortgages", and whose application to mortgage bonds or participations is questionable; N. J. COMP. STAT. (Supp. 1931) § 72-37a; N. Y. DECEDENT ESTATE LAW (1916) § 111; N. Y. PERSONAL PROPERTY LAW (Supp. 1934) § 21; OHIO CODE (Baldwin's Supp., Jan. 1935) § 10506-41; ORE. CODE ANN. (1930) c. 32, § 803, which may contemplate only specific whole mortgages as collateral for the bond; PA. STAT. ANN. (Purdon, 1930) tit. 20, § 801; R. I. GEN. LAWS (1923) tit. 36, c. 372, § 5685 ("Notes secured by mortgage"); S. C. CODE (1932) c. 177, § 9051; TENN. CODE (Michie, 1932) c. 16A, §§ 9596.1 (F), 9596.3; VT. GEN. LAWS (1917) § 5363; VA. CODE (1930) § 5431, as amended by Laws of 1934, c. 46, § 5431; W. VA. CODE (1931) c. 44, art. 6, § 2; WIS. STAT. (1931) § 231.32. The Idaho Act, CODE (1932) § 25-1502, provides for bonds and mortgages on unencumbered real property, and there would seem some doubt whether this authorizes investments in participation certificates, especially since the act relating to investments by savings banks specifically authorizes investments in bonds secured by mortgages to trustees.

7. 98 N. Y. 300 (1885).

8. 219 N. Y. 514, 114 N. E. 1057 (1916).

Sarah Blake's Estate,⁹ *John Blake's Estate*¹⁰ and *Guernard's Estate*,¹¹ the principal objection voiced and sustained was that against investment in "securities maturing at a distant date" and "having no ready and established market" in a "very brief space of time" before the date of the termination of the trusts, when by the terms of the will the bequests were to be paid in cash. *Thompson's Estate*,¹² dealt only with an objection alleging the purchase of the security by the fiduciary from itself. The criticisms voiced in *Adriance's Estate*¹³ were directed at investment in bonds secured by a mortgage on an unbuilt, subsequently completed, structure, and at the failure to diversify investments in placing two-fifths of the fund in one issue. In this case, the property was a twenty-four story apartment building housing also the Roerich Museum, the wealthy supporters of which, the Surrogate held, tended to enhance the attractiveness of the investment. A broader issue was raised in *Matter of Frazer*,¹⁴ where it was alleged that guaranteed certificates were not, as investments, (1) reasonable, proper and prudent; (2) legal; (3) readily convertible and having an immediate market; (4) sufficiently diversified. Surrogate Delehanty dismissed these objections in an elaborate opinion, by referring to the various statutes permitting the purchase of shares of mortgages and also to the fact that because of general economic conditions the holders of individual whole mortgages were equally distressed. The complaint as to non-liquidity was deemed "insufficient in law." *Flint's Will*¹⁵ involved a different type of security,¹⁶ and under the particular circumstances the general objections that the fiduciary was a guarantor of the investment and its conduct improper and negligent were not well taken, and in any event, not sufficiently specific.

In Pennsylvania, in *Curran's Estate*,¹⁷ the statement of the question involved, as set forth in the appellant's paper book, was that the investment (bonds secured by a mortgage on a theatre) was not in the form permitted by the Fiduciaries Act of 1923.¹⁸ In support of this contention, mention was made of the form of mortgage as not containing the ordinary form of foreclosure by *scire facias*, of the exonerations and immunities of the corporate mortgage trustee, and of the bondholders' lack of control of the investment. At the argument before the Supreme Court, however, the ap-

9. 146 Misc. 780, 263 N. Y. Supp. 310 (Surr. Ct. 1933).

10. 146 Misc. 776, 263 N. Y. Supp. 317 (Surr. Ct. 1933).

11. 149 Misc. 182, 266 N. Y. Supp. 771 (Surr. Ct. 1933).

12. 135 Misc. 62, 237 N. Y. Supp. 622 (Surr. Ct. 1929).

13. 145 Misc. 345, 260 N. Y. Supp. 173 (Surr. Ct. 1932).

14. 150 Misc. 43, 268 N. Y. Supp. 477, 482 (Surr. Ct. 1933).

15. 240 App. Div. 217, 269 N. Y. Supp. 470 (2d Dep't 1934).

16. See note 5 *supra*.

17. 312 Pa. 416, 167 Atl. 597 (1933).

18. PA. STAT. ANN. (Purdon, 1930) tit. 20, § 801: ". . . such fiduciary may invest . . . in bonds of one or more individuals secured by mortgage or real estate in this Commonwealth, which may be either a single bond secured by a mortgage or one or more bonds of an issue of bonds secured by mortgage or deed of trust to a trustee for the benefit of all bondholders. . . ."

pellant's case rested almost entirely upon another objection: that as the mortgage and the bonds secured by it were signed by a straw man for a corporation which was the actual owner of the property, the bonds were, in effect, those of a private corporation and therefore were, under the Pennsylvania Constitution,¹⁹ illegal investments for fiduciaries. In fact, the court stated specifically that neither the propriety of the investment nor the constitutionality of the Act of 1923 were before it. Another Pennsylvania case,²⁰ merely decided that the status of a mortgage as an investment does not come within the purview of the Constitutional limitation, merely by reason of its execution by a corporation, and that as a security it is distinct from the bond for which it is collateral.

Finally, the Kentucky court, in *Bishop v. Peoples Bank & Trust Co.*,²¹ approved of mortgage bonds as an investment for a trust company fiduciary, but only by *obiter*.

In seeking to determine whether mortgage bonds are legal investments for fiduciaries, problems created by the particular circumstances will arise in each case. There are, however, some which are the most fundamental and most frequently recurring, and which are capable of generalized treatment.

I. *Delegation of Duty to Make Investments*

This problem arises where the trustee purchases the bonds or guaranteed certificates from a mortgage guaranty company or other house of issue, and usually in reliance upon the information set forth in the printed prospectus furnished by the underwriter.

A trustee's duties can be placed in two classes: (1) discretionary or personal; (2) administrative or ministerial. The first class include those duties upon the performance of which depend the income to be received by the beneficiaries and the safety of the corpus. One of those duties is the making of investments, and requires the exercise of that caution, prudence and skill which the testator is presumed to have thought existed in the person whom he selected to act as the trustee of his estate. Duties of the second class include such routine matters as the receiving of income, paying of taxes, checking of fire insurance, collection of rents, inspecting of repairs and distribution of income.²² Duties of the first class cannot be delegated

19. Art. III, § 22: "No act of the General Assembly shall authorize the investment of trust funds . . . in the bonds or stock of any private corporation."

20. *Maroney's Estate*, 311 Pa. 336, 166 Atl. 914 (1933). In *Crick's Estate*, 315 Pa. 581, 173 Atl. 327 (1934), a case sustaining investments in participations in a mortgage pool, the purchases were made at the request of the donor.

21. 218 Ky. 508, 514, 291 S. W. 718, 720 (1927).

22. *Dodge v. Stickney*, 62 N. H. 330 (1882); *Klein's Estate*, 26 Berks Co. 189 (Pa. 1934).

to third persons, as can the purely ministerial functions of the second.²³ The making of investments is a duty involving the use of discretion and must be performed by the fiduciary personally.²⁴ Naturally, if the trustee be a corporation, it must function through its officers and agents,²⁵ but its agents must be distinguished from third persons, such as officers and agents of the mortgage guaranty and investment companies. Where the fiduciary makes the investment upon the strength of a prospectus furnished by the house of issue, and does not examine the mortgaged property or the neighborhood in which it is located, nor ascertain the type of occupancy, can it be said that he has exercised the necessary caution and prudence?

In certain cases where investments so purchased, have been questioned, accountants have offered the valuations made by appraisers employed by the mortgage companies. It is to be expected, however, that such appraisers, no matter what their standing and reputation in the community, are influenced in their opinions, to some degree, by the expectations of their employers. There are, furthermore, factors other than values of ground and buildings which must be taken into consideration by the fiduciary, such as the uses and availability of the property in the event of foreclosure.²⁶ These factors can not be properly considered by a perusal of the cold type of a prospectus written with an eye directed solely to the sale of the security.

It is the writer's contention that the mortgage company acts as the agent of the mortgagor, in disposing of the issue of bonds, and that as it is equally interested in their sale, its appraisers are those of the mortgagor. In England, it has always been the rule that trustees relying upon the mortgagor's valuations rather than upon their own, are liable for any loss.²⁷ There are American cases to the same effect.²⁸

II. *Exercise of Diligence After the Making of the Investments*

It has long been recognized that a trustee's duty does not end with the making of a proper investment. He must continue to exercise the sound

23. *Hawley & King v. James*, 5 Paige 318, 487 (N. Y. Ch. 1835): "A trustee who has only a delegated discretionary power can not give general authority to another to execute the same, unless he is specially authorized so to do by the deed or will creating such power"; *Markel v. Peck*, 144 Mo. App. 701, 702, 129 S. W. 243, 244 (1910); *Gaines v. Dahlin*, 228 Ala. 484, 154 So. 101 (1934).

24. 1 PERRY, TRUSTS (7th ed. 1929) 738.

25. *Cf. In re Flint's Will*, 240 App. Div. 217, 222, 269 N. Y. Supp. 470, 473 (2d Dep't 1934).

26. *Jenkin's Estate*, 260 Mich. 518, 245 N. W. 508 (1932).

27. LEWIN, TRUSTS (13th ed. 1928) 426.

28. In *Hamon's Estate*, 60 Cal. App. 154, 212 Pac. 299 (1923), a trustee who had made no investigation and relied upon appraisals furnished by the owner of the ground was held not to have exercised reasonable care and diligence, and was surcharged for the loss sustained. In *Hart's Estate* (No. 1), 203 Pa. 480, 53 Atl. 364 (1902), a surcharge was sustained against a trustee who had invested in bonds secured by a mortgage on a foundry without first examining the premises and ascertaining the earnings and capitalization of the mortgagor. His defense, that he had relied upon his father's financial adviser, was thrust aside as not being a proper exercise of "his best judgment".

discretion and the care and diligence in the management of the investment that prudent men in general would exercise in the management of their own affairs,²⁹ and even with the somewhat increased measure of responsibility owing to funds belonging to other persons.³⁰ This requirement of vigilance after investment is pertinent to the present inquiry in several respects.

A. *Surrender of Control to the Corporate Mortgage Trustee*

The majority of the bonds issued under mortgages to corporate trustees contain what is known as an irrevocable power of agency, of which the following is typical:

"The holder of this bond shall not have the right to levy upon or cause the mortgaged property to be sold under or by virtue of any judgment that may be obtained by reason of default in the payment of the principal hereof, or of the interest hereon, when and as the same shall become due by lapse of time or in pursuance of any of the provisions of said mortgage; but such proceedings shall be had only by the Trustee under the mortgage as aforesaid on behalf of and for the equal benefit of all holders of said bonds, on its own initiative or upon demand in writing of the holders of not less than twenty-five *per centum* in amount of said bonds then outstanding and unpaid as is provided in said mortgage."³¹

Accordingly, it would seem that upon the purchase of bonds of this type, the fiduciary has surrendered the right of supervision and control over the investment, the exercise of which is necessary for the protection of the corpus.

There has long existed the doctrine that the duties imposed upon a trustee by the bestowal of a testator's confidence or by mandate of court, involve the exercise of a care and discretion which are not delegable.³² While it is true that many of the cases refer to situations where the fiduciary sub-

29. See *In re Stark's Estate*, 15 N. Y. Supp. 729, 731 (Surr. Ct. 1891); *Estate of Allis*, 191 Wis. 23, 30, 209 N. W. 945, 953 (1926); cf. *Halstead's Ex'r v. Ingram*, 175 S. E. 898 (Ga. 1934) (duty of trustee to keep up taxes); *State St. Trust Co. v. Walker*, 259 Mass. 578, 157 N. E. 334 (1927) (failure to examine property and to maintain reasonable watch); *Neely v. People's Bank of Anderson*, 133 S. C. 43, 130 S. E. 550 (1925) (failure to collect note before running of statute of limitations); *Drier's Estate*, 204 Wis. 221, 235 N. W. 439 (1931) (failure to foreclose mortgage at maturity, at which time it could have been accomplished without loss).

30. See *Hart's Estate* (No. 1), 203 Pa. 480, 485, 53 Atl. 364, 366 (1902).

31. This limitation upon individual action is further elaborated upon in the mortgage under the section entitled "Remedies of Trustee and Bondholders" and is sometimes phrased as follows: ". . . no proceedings in law or equity shall be taken by the holder of any bond . . . for the purpose of selling by execution or other process of law the mortgaged premises, except by, through and in the name of the Trustee; it being intended that no one or more holder . . . shall have the right in any manner whatever to affect, disturb or prejudice the lien of this mortgage by his or their action . . . but that all proceedings . . . for its collection shall be instituted, had and maintained only in the name of the Trustee, for the equal benefit of all the holders of said Bonds."

32. *Gaines v. Dahlin*, 228 Ala. 484, 154 So. 101 (1934); *McCollister v. Bishop*, 78 Minn. 228, 80 N. W. 1118 (1899). Otherwise as to purely administrative matters, such as collection of rents and distribution of income: *Beck's Estate*, 12 Phila. 74 (Pa. 1878).

mits to joint or exclusive control of a surety,³³ the rule has been applied to a contract made by a trustee with a trust company for the assumption of her duties.³⁴ The foundation of the doctrine lies in the necessity of exacting the maintenance of a sharp, alert and ever watchful vigil by persons entrusted, by or with the aid of the law, with the care of other people's monies. Should it not follow that the doctrine should comprehend mortgage bond investments? A fiduciary might argue that since the legislation authorizing or permitting investments in bonds secured by mortgages or deeds of trust usually provides that the mortgagee (sometimes corporate) shall hold the property for the benefit of all bondholders equally, a surrender of control by each investor is essential for the proper management of the security. But it may more forcibly be contended that the legislatures never intended that the recognized duties of a fiduciary for the performance of which he was responsible to the court, could be shifted with impunity to a third person (the mortgage trustee), over whom the court could have no jurisdiction to impose its decrees in the event of such negligence in the management of a security as would ordinarily justify a surcharge of a fiduciary primarily responsible to the court.³⁵

B. The Mortgage Provision Requiring Written Request of Holders of Twenty-five Per Cent. in Amount of Bonds to the Trustee for Enforcing the Terms of the Mortgage

Most trust mortgages contain a clause requiring as a condition precedent to the duty of action by the trustee upon default the written request to foreclose by holders of twenty-five *per cent.* in amount of bonds, together with a proffer of such indemnity for costs as the trustee may fix. While it is true that this is generally coupled with an option on the part of the trustee to proceed of its own volition, it has been held that proof of compliance with the former is necessary to sustain an action against the trustee.³⁶ In the event of waste, defaults under the mortgage, or the existence of conditions jeopardizing the security, whether caused or permitted by the corporate trustee, the fiduciary investor, usually holding a small amount of the bonds and not knowing his co-bondholders, would find himself in a position where he could neither take individual action nor, as a practical fact, communicate and arrange with the balance of the required number of holders to procure a request to the trustee to take action. Moreover, even if, by the exertion of a great deal of effort, he could ascertain the identity

33. *Clark v. Clark*, 167 Ga. 1, 144 S. E. 787 (1928).

34. *Meck v. Behrens*, 141 Wash. 676, 252 Pac. 91 (1927).

35. *Cf. Matter of Frazer*, 150 Misc. 43, 50, 268 N. Y. Supp. 478, 485 (Surr. Ct. 1933).

36. *Crosthwaite v. Moline Plow Co.*, 298 Fed. 466 (S. D. N. Y. 1924); *Allan v. Moline Plow Co., Inc.*, 14 F. (2d) 912 (C. C. A. 8th, 1926); *Lidgerwood v. Hale & Kilburn Corp.*, 47 F. (2d) 318 (S. D. N. Y. 1930).

of and assemble twenty-five *per cent.* in amount of the holders,³⁷ action would depend upon their ability and willingness to contribute their share of the indemnity. All this would require the organization of a protective committee and the initial expenditure of considerable sums of money.

The need of such a request to act and of the raising of indemnity is, of course, predicated upon the refusal of the corporate trustee to act of its own volition. It is very possible that a situation might arise where the trustee, because of individual and conflicting interests (such as a close financial connection with the mortgage company issuing the bonds), would set up this clause as a reason for not acting upon its own volition, while in the meantime the mortgaged property might be subject to waste, the equity depreciated in value, or prior charges (such as taxes) permitted to accumulate.

C. *The Exoneration of the Corporate Trustee and Its Immunity from Liability for Failure to Perform Its Duties*

These exemptions are found in the article of the mortgage "Concerning the Trustee", and the following is the usual form of the release:³⁸

" . . . Trustee shall not, nor shall any future trustee . . . incur any liability or responsibility whatever in consequence of permitting the mortgagor, until default and notice, to remain . . . in possession . . . ; nor shall it become liable or responsible for any destruction, loss, injury or damage which may be done or happen to the buildings, machinery, fixtures or estates hereby mortgaged, either by the mortgagor or anyone else, or by or from any accident or any cause whatever; nor shall the Trustee or any future Trustee be in any way responsible for the consequences of any breach of the covenants by the mortgagor, herein contained, nor of any act of him or his agents or servants; nor shall the Trustee . . . be . . . responsible for any exercise of judgment or discretion in any case in which such discretion is allowed or given it, nor for any monies, property or real estate, or personal estate whatsoever except what has actually and in fact come into its hands and possession . . . nor shall the Trustee be liable or responsible for any other cause, matter or thing, except its own wilful and intentional breaches of that trust herein expressed and contained; . . . the said Trustee may resign from the trust by notice in writing to the mortgagor and to all known bondholders, upon fifteen days' notice.

And the Trustee shall not at any time be bound or required to undertake any proceedings at law or in equity or otherwise for the

37. See *Reik's Estate*, 18 D. & C. 252, 257 (Pa. 1933), where the Orphans' Court of Philadelphia County referred to the difficulty bondholders would have in searching for twenty-five *per cent.* in amount of holders, while in the meantime the trustee could have resigned.

38. While investment in securities containing such a release is now forbidden by at least one state, Pennsylvania [PA. STAT. ANN. (Purdon, 1930) tit. 20, § 801], a large amount of the mortgage bonds now in the hands of fiduciaries were purchased before any such prohibition and were secured by mortgages containing such releases from liability. It will, therefore, be discussed here as a problem usually met in the consideration of accounts currently presented for audit.

protection of the Bondholders involving expenditures or any liability for the payment of money, unless, if the Trustee shall see fit to require it, adequate indemnity against such liability or outlay be furnished by the Bondholders asking of it such action or proceeding and the deposit of their Bonds with the Trustee."

This wholesale release is followed by a denial of liability for improper execution and recording, validity of title, and maintenance of insurance. It would seem, therefore, that the trustee is liable only for "wilful and intentional breaches of the trust", proof of which is difficult, requiring evidence of reckless indifference to and disregard of the rights of the beneficiaries.³⁹ There are, however, a number of decisions which seek to qualify the provisions for immunities and to prevent a complete disavowal of responsibility for failure in the discharge of duties. Thus a recent New York Court of Appeals case, *Benton v. Safe Deposit Bank of Pottsville*,⁴⁰ while sustaining the immunities, added the qualification, "in the absence of gross or wilful negligence."

The qualification is hardly substantial, and in the normal case of loss caused either by negligence in the making of the investment⁴¹ or in the management of the mortgaged property by the corporate trustee, the ultimate beneficiaries might find themselves without a remedy. An action against the mortgage trustee would be met, *inter alia*, by a defense based on the exonerations and immunities granted it by the mortgage. To an action for surcharge of the primary fiduciary, the defense of purchase of a "legal investment", as permitted by the various statutes would be set up. Could not the reply be made that the legislature did not intend that the fiduciary should be permitted thus lightly to rid himself of the responsibilities assumed with the acceptance of the trust; that it was not in its contemplation that in the event of a substantial loss the fiduciary could defend on the ground that the negligence was that of a third person (the mortgage guaranty company or corporate trustee) who is not responsible to the court, while he himself is relieved by the statute?⁴²

In recent years, it has frequently happened that during the period of the fiduciaries' inattention to and neglect of the investment and its security,

39. *Harvey v. Guaranty Trust Co.*, 134 Misc. 417, 236 N. Y. Supp. 37 (Sup. Ct. 1929); *cf. Warren v. Pazolt*, 203 Mass. 328, 89 N. E. 381 (1909); *Benton v. Safe Deposit Bank*, 255 N. Y. 260, 174 N. E. 648 (1931); *Bell v. Title Trust & Guarantee Co.*, 292 Pa. 228, 140 Atl. 900 (1928).

40. 255 N. Y. 260, 174 N. E. 648 (1931). See also *Richardson v. Union Mortgage Co.*, 210 Iowa 346, 228 N. W. 103 (1929); *Mullen v. Eastern Trust and Banking Co.*, 108 Me. 498, 502, 81 Atl. 948, 949 (1911); *Conover v. Guaranty Trust Co.*, 88 N. J. Eq. 450, 461, 102 Atl. 844, 848 (Ch. 1917), *aff'd*, 89 N. J. Eq. 584, 585, 106 Atl. 890 (1918); *Rhineland v. Farmers' Loan & Trust Co.*, 172 N. Y. 519, 65 N. E. 499 (1902) (apparently indicating that the trustee cannot be a "mere dummy"); *Doyle v. Chatham & Phenix Nat. Bank*, 253 N. Y. 369, 171 N. E. 574 (1930).

41. See *infra* p. 962, "Investments in Commercial Enterprises".

42. *Cf. Kirkman's Estate*, 143 Misc. 342, 256 N. Y. Supp. 495 (Surr. Ct. 1932).

not only has the property depreciated and the mortgage terminated by repeated breaches of its terms by the mortgagor, but subsequently the mortgage guaranty company has become insolvent and its policy, costing as much as one-half *per cent.* per year (by permission of the legislature in some states), has been rendered worthless. In such cases, if the fiduciary by proper diligence, could have ascertained the default and collected the principal and interest from the guarantor, his failure to do so should subject him to surcharge therefor. Such indifference to a moral as well as legal, responsibility should not be approved when the question of the fiduciary's liability is squarely before the courts. It would seem to the writer that the legislatures never intended that the fiduciary making such investment should be deprived completely of his individual right of action and, perforce, be restrained from keeping a "watchful eye" on the management of the security, or that he should, by making such investment, be relieved completely of all the duties of a fiduciary heretofore recognized as accompanying his appointment. The acts are not meant to excuse indifference to the care and management of trust funds.

III. *Investments in Commercial Enterprises*

The opening of the huge amounts of trust funds to the real estate market occasioned by the authorization of investments in bond issues secured by mortgages, made possible the promotion of many projects of varied nature. It has been an accepted rule that a fiduciary, when making a mortgage investment, should have in mind, first and foremost, the possibility that he might, at some time, have to foreclose and take over the security.⁴³ He would then have to think of the marketability of the foreclosed property. Would it be such as would have a reasonably wide potential market, or would it be such as would, by its very nature, be available for use to only a comparatively few persons. From a rental standpoint, there is ordinarily a relatively large market for the average small dwelling house; from a sale standpoint, the market is large because of the small amount of capital necessary. Its size also makes it possible for the fiduciary to exercise a personal supervision and control.

On the other hand, an investment in a bond secured by a mortgage on a skyscraper, a hotel, or a loft building gives him no individual right of possession in the event of default⁴⁴ and, in the event of a foreclosure, no individual right of supervision and control. These large buildings, financed by mortgages running into the millions of dollars, are primarily the children

43. *In re Jenkins' Estate*, 260 Mich. 518, 245 N. W. 508 (1932); *Durant v. Crowley*, 197 App. Div. 540, 189 N. Y. Supp. 385 (1st Dep't 1921), where it was held that the property securing the mortgage was a special kind of property, which might be difficult to rent if abandoned by the mortgagor.

44. The right of possession on default is a criterion of "real security". *Robinson v. Robinson*, 11 Beav. 371 (Ch. 1848); *Hutton v. Annan*, [1898] A. C. 289.

of periods of inflation. On foreclosure, they truly become orphans. From a viewpoint of liquidity, the possibility of a sale at a figure commensurate with the amount invested is problematical. Usually, no one individual can be found as a purchaser, and the mortgage trustee is faced with the prospect of going into the business of the particular investment, with the attendant necessity of a further delegation of duties to managers and their assistants.

If we consider the modern large hotel, we find that it contains a catering department, ballroom business, restaurants, laundries, lodge and convention rooms, stores, ticket agencies and, in short, many ventures besides the primary purpose of affording lodging. Are these not business ventures and purely commercial projects, dependent upon the fluctuations of general business conditions? Were a trustee to invest in a single one of these enterprises, he would probably find himself surcharged, in the event of a loss. Even though his investment were further secured by a mortgage on the real estate, he might possibly be subject to censure.⁴⁵ In *Palmer v. Emerson*, it was said: "I think the cases which have been cited do come to this, that, if the security is really a business plus the premises upon which it is carried on, trustees are well advised to have nothing to do with it . . ." ⁴⁶ And it was remarked in a New York case: "If the trustee took cash and loaned it upon a summer hotel, he well might be held responsible . . . its substantial value depended upon the continued operation of the hotel . . . As an original loan, it could not well be defended in case of loss . . ." ⁴⁷

On the question of "specialty mortgages" there is little well reasoned precedent, and no general sweeping doctrine can be laid down. Whether the business is incidental to the real estate, or the real estate to the business, and whether the realty might depreciate greatly if the enterprise is not successful, are factors to be taken into consideration, both as to the advisability and as to the amount of the loan.⁴⁸

Despite the seeming legislative and court approval of mortgage bonds and guaranteed certificates, it seems likely that there was no intentment that the old idea of investments in "real security", which enjoy the remedies of possession, foreclosure, and ejectment, with, in short, the personal supervision and *right and ability* to control in the fiduciary, was to be discarded

45. Cf. *Hart's Estate* (No. 1), 203 Pa. 480, 53 Atl. 364 (1902), where a trustee invested in bonds secured by a mortgage upon an iron foundry. In speaking of an investment in a mortgage upon a brickyard, Lord Justice Cotton remarked, in *Whiteley v. Learoyd*, 33 Ch. D. 347, 351 (1886), "It is true it was real security, but the real security depended for its value on the trade of brickmaking to be carried on there, and on the value of the buildings and machinery which could be only used for that particular business and that . . . was one which few people would be willing to bid for and undertake if it was necessary to call in the money. . . . There are many contingencies upon which such a trade depends. . . . It was simply machinery and buildings useful for this purpose."

46. [1911] 1 Ch. 758, 766.

47. *Matter of Sherman*, 180 App. Div. 196, 198, 199, 167 N. Y. Supp. 682, 684, 685 (3d Dep't 1917).

48. See *Hart's Estate* (No. 1), 203 Pa. 480, 53 Atl. 364 (1902), for one of the rare decisions on "specialty" mortgages.

in favor of plunges into hazardous commercial ventures, with no control in the trustee.⁴⁹

IV. *Conflicting and Individual Interests*

While the reports abound with cases establishing the generality that a trustee shall not profit in the making or management of the investment, otherwise than from his legal allowance for commissions,⁵⁰ there is, however, a problem which while falling within the general principle is different in nature from most of the decided situations. In recent years, it has been the practice of certain corporate fiduciaries engaged in making investments of mortgage bonds, to purchase them from particular houses of issue or mortgage guaranty companies. Inquiries have revealed the presence of very close business connections between some of the fiduciaries and various mortgage companies, and, in some instances, the existence of mutual officers, directors and stockholders. While this, of itself, would not create the imputation of fraud in the making of the investment, yet it might logically be argued that the desire to give business to an interlocking or subsidiary company, thereby incidentally enhancing the profits of the common officers and stockholders, would tend to lessen the caution and prevent the exercise of the prudence necessary for the proper consideration of the value and merits of the proposed investment.⁵¹ If the mortgage company were to

49. Curran's Estate, 312 Pa. 416, 167 Atl. 597 (1933), cited note 17 *supra*, was not argued on this theory, but on the ground that the mortgagor was merely a straw man and therefore an agent for a corporation; and consequently, the investment was in the bonds of a private corporation. If it develops that the value of the real estate, as such, is so entirely dependent upon and interwoven with the success of the business, without which the market for the real estate is extremely thin or nonexistent, where then is the distinction between this and the investment in the securities or bonds of a private corporation which is forbidden by the Pennsylvania Constitution [*supra* note 19]? True, the Constitution refers only to corporations, but can it be contended that an investment in what really amounts to a business or commercial enterprise, with real estate added for better security, is better protected by the bonds of an individual (usually a straw man)?

This provision was intended to put an end to the efforts of corporations attempting by special acts of the legislature to have bonds, secured by mortgages on their properties, made legal investments. Between 1870 and 1873, there were four such acts in Pennsylvania, declaring legal investments by fiduciaries in bonds of railroad and canal companies, secured upon their rights of way and buildings, etc. Those, in effect, in the writer's view, were real securities, but so inextricably connected with and dependent upon huge commercial enterprises, as to lose their identities as the "real securities" contemplated by the Legal Investment Act of 1832. Act of 1832, March 29, P. L. 190 (repealed by § 63 of Act of 1917, June 7, P. L. 447). See PA. STAT. ANN. (Purdon, 1930) tit. 20, § 801 (hist. note p. 473).

50. *E. g.*, First Nat. Bank of St. Petersburg v. Solomon, 63 F. (2d) 900 (C. C. A. 5th, 1933); *Quell v. Boyajian*, 90 Pa. Super. 386 (1926), a real estate brokerage case but containing the general principles applicable to this question; *Murphy-Bolanz Land & Loan Co. v. McKibben*, 221 S. W. 650 (Tex. Civ. App. 1920), *aff'd*, 236 S. W. 78 (Tex. Sup. Ct. 1922); *Crummey v. Murray*, 130 Misc. 378, 224 N. Y. Supp. 49 (Sup. Ct. 1927).

51. Note (1931) 44 HARV. L. REV. 1281. In *Jenkins' Estate*, 260 Mich. 518, 245 N. W. 509 (1932), the trustee invested in a mortgage upon property owned by a company of which he was treasurer. The land had previously been purchased from a corporation in which he owned one-third of the stock. It was held *inter alia*: "It was to the interest of the [mortgagor] of which he was treasurer, to secure a loan on its lots on the most favorable terms. He thus placed himself in a position where his self-interest conflicted with his duty as trustee. Under such circumstances the investments made by him will be scanned with closer scrutiny than if made in the usual course of business by a trustee." At 520, 245 N. W. at 509. A surcharge was sustained on appeal.

manage the mortgaged property, its condonation of a breach by the mortgagor, for the purpose of avoiding a claim upon it for its guaranty, might be intentionally overlooked by the interlocking fiduciary, even though it had notice.⁵² A trustee should be ever alert in the interest of its *cestui que trust* and should be unhampered by relations with adverse parties.⁵³ If there were a breach, the fiduciary would be placed in the position of deciding whether to make demand upon the allied mortgage company for payment of the guaranty or of ignoring the breach, with the possibilities that the guaranty company might later become insolvent, or large amounts of prior charges might accumulate, or the mortgaged property might depreciate in value. While the particular facts in each case will govern, yet it seems that if the *cestui que trust* is, because of the interlocking relationship, deprived of his recourse against a surety when solvent, or of a timely foreclosure, he should be permitted to force the fiduciary to make good the loss.

These particular phases of the question of the doctrine of conflicting interests do not seem to have arisen but are undoubtedly latent in many of the accounts now being presented for audit.

V. *The Effect of Subsequent Legislation Prohibiting Investments in Mortgages Containing Exemptions of Corporate Trustees*

The only legislation on this point seems to be the Pennsylvania Act of 1929,⁵⁴ and the discussion under this heading will be as to its effect on investments made before its passage.

If, for argument, it be assumed that bonds issued under mortgages containing the exonerations of the trustee from any liability for negligence are legal investments for trust funds under the Pennsylvania Act of 1923,⁵⁵ one is then confronted by the Act of 1929. This latter Act was an amendment to the legal investment section of the Fiduciaries Act of 1917,⁵⁶ as already amended by the Act of 1923. To the revised legalization of mortgage bonds as investments it added the limitation: "And the trustee [cor-

52. See *In re Rosenfeldt's Will*, 185 Minn. 425, 241 N. W. 573 (1932). Here the fiduciary, a trust company, purchased securities from its subsidiary. Since the two companies had joint officers and management, it was held that the knowledge of the subsidiary's officers as to the fraudulent character of its securities was imputed to them as managers of the fiduciary, which was therefore surcharged for not bringing suit against the subsidiary to recover the fund. In *Strong v. Dutcher*, 186 App. Div. 307, 174 N. Y. Supp. 352 (2d Dep't 1919), a surcharge was imposed because of an investment in a mortgage on property on which a corporation, of which trustee's president was an officer, held a second mortgage. In *First Trust Co. of Lincoln v. Exchange Bank*, 126 Neb. 856, 254 N. W. 569 (1934), the trustee purchased worthless notes from bank of which he was president. Held, that bank's knowledge was imputed to the trustee.

53. Cf. *Michigan Trust Co. v. Luton*, 255 N. W. 351 (Mich. 1934); *In re Culhane's Estate*, 256 N. W. 807 (Mich. 1934); *In re Haines' Estate*, 139 Misc. 593, 249 N. Y. Supp. 750 (Surr. Ct. 1931); *Shanley's Estate v. Fidelity Union Trust Co.*, 157 Atl. 160, 161 (N. J. Ch. 1927); see *Northampton Trust Co. v. Northampton Traction Co.*, 270 Pa. 199, 203, 112 Atl. 871, 872 (1921).

54. PA. STAT. ANN. (Purdon, 1930) tit. 20, § 801.

55. *Ibid.*

56. *Ibid.*

porate mortgage] shall not be exempted, by contract or otherwise from responsibility for performing the ordinary duties of trustees." As this clause was not in the Amendment of 1923, the trust companies and other fiduciaries will maintain that their purchase of bonds issued under mortgages containing the exemptions hereinbefore mentioned, were not illegal investments.

Admittedly, new investments could not be made in such bonds (that is, bonds secured by mortgages containing such exonerations of the trustees) after the passage of the Act, and fiduciaries doing so would be subject to surcharge, in the event of loss. If they now have met disfavor in the eyes of the law and are on the prohibited list for all fiduciaries, why are not those same investments, purchased before the passage of the Act, similarly stricken down? It is the writer's contention that the Act declared illegal their retention for any period longer than that necessary for their disposal without great sacrifice, and that time began to run from April 12, 1929. Inasmuch as the market for real estate bonds was never quite so broad and active as that of securities listed upon an exchange, and sometimes almost entirely dependent upon the house of issue,⁵⁷ it would seem that the fiduciary was entitled to a reasonable time to effect a sale. However, if it can be shown that a market could have been found at a fair price (not necessarily at cost) before the end of 1929, or before the great depreciation in this type of security began, and if this theory should be sustained, the auditing judge should, in the writer's opinion, enter a surcharge for the difference between the value established as existing at a reasonable time after April 26, 1929, and the value at the time of distribution. There is little precedent for this proposition, but it will be interesting to note *Estate of Allis*,⁵⁸ where it was held that "the fact that the trustees continued to hold the stock . . . after the statute permitting the investment of trust funds in such stock had been repealed and until the stock had so greatly depreciated in value, makes a *prima facie* case of failure to exercise reasonable diligence on the part of the trustees which calls for explanation."

If the fiduciary shall point to advice of counsel, as his license to make the investment, he should also be bound to expect the advice of counsel as to the time when the investments cease being legal.

Conclusion

While it is true that criticism in retrospect of the mortgage bond as an investment is to some extent properly qualified by the approval which was accorded it by many careful investors other than fiduciaries, nevertheless, this fact did not detract from the obligation imposed upon fiduciaries personally to administer the trusts accepted by them. The fact that many

57. A condition which of itself should be sufficient to cast doubt upon the investment.

58. 191 Wis. 23, 32, 209 N. W. 945, 948 (1926).

business men of standing invested their surplus funds in such securities did not warrant fiduciaries to delegate the discretionary duties of investment and management to persons who were strangers to both the trust and the court.⁵⁹ In the opinion of the writer, this was one of the important factors contributing to the appalling losses incurred by beneficiaries. Legislative prohibition of investments in bonds secured by mortgages containing exemptions of the corporate trustees is a timely recognition of the abuses which had in many cases crept in. However, the widespread practice of fiduciaries' relying upon mortgage companies for both the investigation of the proposed investment and for its management should be prohibited as a whole.

59. "We do not regard the fact of Mr. Girard's investing a part of his own estate in this same stock as any evidence in favor of the trustees." Black, C. J., in *Hemphill's Appeal*, 18 Pa. 303, 306 (1852). See also *In re Robbins' Will*, 135 Misc. 220, 237 N. Y. Supp. 409 (Surr. Ct. 1929).