THE DUTIES OF A TRUSTEE WITH RESPECT TO DEFAULTED MORTGAGE INVESTMENTS *

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D. Liquidation by Means of Conversion into Home Owners’ Loan Bonds

The conversion of a defaulted mortgage investment into cash or its equivalent generally comes about in one of two ways: (1) foreclosure by action in equity, or (2) the acceptance of a deed to the mortgaged premises, in lieu of foreclosure. Still a third possibility is the exchange of the mortgaged security for bonds of the Home Owners’ Loan Corporation. Since these bonds are accepted by the trustee, in the great majority of cases, with the intent of immediately disposing of them at the current market price, a question arises whether the proceeds resulting from such sale should be apportioned in the same manner as when the conversion is effected by foreclosure because it is said that this is the amount which he “invests” in the transaction by this particular means, and brings into sharp contrast the seeming inconsistencies between the conversion theory and the investment theory.

Under the investment theory the life tenant generally receives the mortgage rate of interest for the period of default until the time of foreclosure, and the prevailing rate for trust investments during the period until the final sale. He receives the mortgage rate for the period before foreclosure because it is said that this is the amount which he “invests” in the foreclosed real estate. He receives the prevailing rate thereafter because it is also said that the acquisition of title by the trustee brings about an equitable conversion of the original investment into a supposedly productive security, on which the prevailing rate of interest for trust investments is allowed. But if upon foreclosure of the defaulted mortgage the property is sold to someone other than the trustee, there is, obviously, nothing in which the life tenant can be said to have risked an investment. Likewise, if it be the acquisition of title by the trustee which effects the equitable conversion, the life tenant cannot be granted equitable income on this basis, since the property is sold to a third person. Yet it seems to have been held that under these circumstances the life tenant should share in the proceeds of sale.72 If it were the theory of such cases that the default on the mortgage somehow brings about the conversion, then it would seem that in the cases in which

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the trustee acquires the title, the prevailing rate of interest should be allowed from the time of the first default instead of from the time of foreclosure. This theory would also involve the anomaly of a conversion in a case in which the property was originally productive, and as to which the testator could hardly be supposed to have had a conversional intent.\textsuperscript{73} The truth of the matter is that in the cases in which the investment theory cannot be applied, \textit{i.e.}, those in which there is no carrying period, the courts have merely applied an equitable method of relieving the life tenant from the entire burden of loss. To place this result on the basis of an equitable conversion as of the time of the first default is not only inconsistent with the requirement of a conversional intent in such cases, but makes illogical the cases in which the investment theory has been applied.

It may be doubted, however, whether strict logic is either desirable or necessary in this field, and probably all would agree that some form of apportionment should be employed in both situations. Although previously in this discussion approval has been indicated of a construction placing the date of conversion as of the time of foreclosure, with the further implication that a carrying period would ensue, it is not felt that this should preclude apportionment when there is no carrying period. Perhaps the courts may ultimately resolve the seeming inconsistencies in this field by holding that the case of a foreclosed trust mortgage is an exception to the general rule requiring a conversional intent, and that a conversion is effected as of the date of the first default. The investment theory may then be reconciled with this result, in those cases in which a carrying period is involved, by holding that the life tenant has an investment of income, calculated not at the mortgage rate of interest, but at the prevailing rate, for the period until foreclosure.\textsuperscript{73a} Until the courts are willing to take this view, it is believed that

\textsuperscript{73}. As indicated previously (84 U. of PA. L. Rev. at 177, n. 71), it is generally held, in the field of trusts of unproductive realty, that the testator must have the intent to effect the conversion. In the case of a foreclosed trust mortgage, since the trustee has a duty to dispose of the real estate which he has acquired as soon as possible, it may be said that there is a conversion irrespective of the settlor's intent, based on the delay where there exists a duty to sell.

\textsuperscript{73a}. It will perhaps not always be possible to reconcile the two theories. Suppose, for example, that a testator leaves real estate in trust, with a \textit{discretionary} power of sale in his trustee; that the trustee, pursuant to this authority, sells the property, taking a purchase money mortgage in part payment; that it becomes necessary for him to foreclose this mortgage and reacquire the property at the foreclosure sale; and that finally he disposes of the property for cash. Since the power of sale was a discretionary one, there was probably no equitable conversion such that the life tenant would have been entitled to share in the proceeds on the first sale of the property. Likewise, there was probably no equitable conversion when the trustee reacquired the property at the foreclosure sale, since the trustee had a right under the will to hold real property. Therefore, if the conversion theory were solely relied upon by the life tenant, he would probably not share in the cash received on either sale, unless a court were willing to hold that the default on the purchase money mortgage created a delay sufficient to effect a conversion. If the investment theory were invoked, however, it might be said that the unpaid interest due on the purchase money mortgage represented a sum which the life tenant invested in the foreclosed property, and that as a consequence he should share in the proceeds from the second sale. \textit{Cf.} 84 U. of PA. L. Rev. at 170, n. 46.
the investment theory, as it is now stated, represents a fair basis for apportionment, leaving the cases in which no carrying period is involved to be decided on some equitable basis, unassociated with any concept of conversion.

While it might be said that there is an investment both of principal and of income in the Home Owners' Loan Bonds, usually the acquisition of these bonds is but one step in the liquidation of the mortgage into cash. It would seem, therefore, that there should be an apportionment of the proceeds, much as if the mortgage had been foreclosed and the property sold to a third party. In the case of the Home Owners' Loan Bonds there is the additional complication that such bonds have frequently been made legal investments for trustees, whereas if a trustee bid in the property or accepted a deed in lieu of foreclosure, he would be under a duty to dispose of it as soon as possible. There would thus be no equitable conversion at the time of exchange of the property for the bonds, but in those cases in which the trustee treats the exchange as a salvaging process and immediately sells the bonds for cash, the life tenant should be entitled to share in the proceeds.

E. Disposition of Final Proceeds of Sale Where a Purchase Money Mortgage Represents a Part Thereof

It frequently happens that when a trustee sells the real estate which he has acquired through foreclosure of a trust mortgage, he is compelled to take back as part payment a purchase money mortgage on the property sold. The question then is whether the life tenant should receive his portion of the proceeds entirely in cash, or whether he should share partly by way of cash and partly by way of participation in the purchase money mortgage. It would seem that when possible the life tenant should receive his share entirely in cash. Normally a life tenant is entitled to be paid in money rather than by some other medium of payment. The remainderman, on the other hand, whatever may be allocated to his account, is not entitled to receive it outright. His share will, in any event, be reinvested by the trustee. The purchase money mortgage might be regarded, as to him, as such a reinvestment. The necessity of participating such a mortgage between the respective accounts would only result in further complicating the trust administration, without a corresponding benefit to the parties.

76. 4 BOGERT, TRUSTS AND TRUSTEES (1935) § 814.
77. There is little or no authority on this point in the cases. In Meldon v. Devlin, 31 App. Div. 146, 53 N. Y. Supp. 172 (1st Dep't 1898), aff'd on opinion below, 107 N. Y. 573.
II

Allocation of Charges Incurred as a Result of Acquisition of Title by a Trustee

The management of real property, even of that which is unproductive, entails certain necessary expenditures, commonly known as "carrying charges." These include annual taxes, repairs, water rent, and other expenses of maintenance. To these are added, in the case of foreclosed trust properties, the expenses which, strictly speaking, precede and follow the "carrying" period; namely, the foreclosure expenses on the one hand and the expenses of ultimate sale on the other. These are expenditures scarcely contemplated by the testator or settlor in the case of foreclosed real estate, and their disposition has been a constant source of dispute between life tenant and remainderman, especially when such real estate is unproductive.

The rules with respect to the allocation of carrying charges arising out of the administration of real estate acquired by a trustee by other means than foreclosure are well established. It is the general rule that carrying charges on real estate held by a trustee for a life beneficiary are to be paid out of the income of the trust estate, and are not properly chargeable to the capital account unless the trust instrument contains unmistakable directions to that effect.

But it has also been held that this rule of construction must yield to the plain intent of a testator or settlor, and just as courts, in the disposition of proceeds from the ultimate sale of unproductive realty, have often awarded the life tenant equitable income on the basis of the testator's intent to effect an immediate conversion of the property, in like manner they have sometimes allocated the carrying charges of such realty to principal.

60 N. E. 1116 (1901), the trustees received the so-called O'Connor mortgages in payment for part of the foreclosed real estate sold by them. These mortgages were ordered to be delivered to a receiver who was to collect the proceeds thereof and pay the interest out of the sum collected. Of the proceeds of this sale Judge Barrett said: "There should have been an apportionment between principal and interest, as in the case of the water lots. And it was the whole purchase price received by Mrs. Devlin, and not merely the mortgages, which thus stood for principal and interest. The amount thus received should be ratably apportioned between the principal and unpaid interest of the old mortgages. The amount due to interest should be thus determined and deducted out of the proceeds of the purchase-money mortgages." At 162, 53 N. Y. Supp. at 183. The record on appeal does not clearly show how much, if any, money was received in addition to the purchase money mortgages. It might be inferred from this opinion that the amount to be allocated to interest was to be deducted from the proceeds of the purchase money mortgages, but this may have been due to the fact that insufficient cash to pay off the life tenant was realized. The record on appeal is not sufficient to warrant any generalization other than that the purchase money mortgages were ordered to be delivered to a receiver for collection.

78. Bridge v. Bridge, 146 Mass. 373, 15 N. E. 899 (1888); Mulford v. Mulford, 42 N. J. Eq. 68, 6 Atl. 609 (Ch. 1886); Matter of Albertson, 113 N. Y. 434, 21 N. E. 117 (1889); Matter of Estate of Ardrey, 232 N. Y. 109, 133 N. E. 369 (1921).

This, too, is done on the supposition that the testator would not have intended to burden the life tenant, usually the primary object of his bounty, with the carrying charges of property which yielded him no income. The reason for this exception to the general rule is clearly stated in a New York case:

"It must be borne in mind that the intention of the testator in such a case as this is to benefit his children, the life tenants, who are his first consideration, and the fact that he leaves the estate in trust, and gives to his children only the income, is not so much because he desires their issue, in whom he may have no particular interest, to be benefited, but that his children shall always have support and maintenance and something to constantly remind them of a provident parent. It never could be that a father should intend that his children should live in discomfort and distress in order that unproductive and speculative real estate may be held to appreciate for the benefit of a third or fourth generation, and yet such might well happen if the general rule stated above is without exception." 80

Even where the carrying charges are allocated to principal, it is not wholly settled whether the allocation is a permanent one or whether it is subject to revision after the unproductive property has been sold. It has been held that the life tenant should have the benefit not only of an apportionment of the final proceeds of sale, but also of a permanent allocation of carrying charges to principal.81 Frequently the cases allocating such charges temporarily to principal have arisen on intermediate accountings, and it is difficult to determine what disposition would have been made of these expenses if the cases had arisen after final sale.82 In other cases such charges have been deducted from the gross proceeds of sale before appor-

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81. Furniss v. Cruikshank, 230 N. Y. 495, 130 N. E. 625 (1921); Note (1930) 40 Yale L. J. 275. See the following language of Pound, C. J., in Matter of Satterwhite, 262 N. Y. 339, 342-343, 186 N. E. 857 (1933) : "... if the language of the will indicates an intention of the testator to constitute an imperative power of sale and an equitable conversion of the real estate into personalty at the time of the testator’s death, it must be presumed that while the trustees were converting the real estate into personalty the right of the life tenant to income was the same as if the fund had come into existence immediately after testator’s death and that an exception to the general rule of loading on the life tenant charges of carrying unproductive real property pending a sale thus came into existence.” Italics added.
82. It is to be noted that the Restatement of Trusts, although it provides that these charges be initially allocated to principal (supra note 79), also provides that the net proceeds to be apportioned after final sale shall be determined by deducting from the net sale price the net loss incurred in carrying the property. See Restatement Trusts (1935) § 241. Accord: Uniform Principal and Income Act [see 9 U. L. A. (Supp. 1934) 114; Ore. Laws 1931, c. 371] § 11 (2).
A well-known authority on the law of trusts has recently discussed the question as follows:

"Pending the conversion of the unproductive property, carrying charges on it will have accrued and been met from trust income or capital, or allowed to remain unpaid. There is presented the problem as to what the trustee should do by way of paying such charges, or reimbursing capital or income for having paid them, or making other bookkeeping entries, after he has sold the unproductive property. Such charges include commonly taxes and mortgage interest. The trustee conceivably might (1) deduct such carrying charges from the gross proceeds of the sale before making his apportionment computation; (2) deduct them from either the principal or interest portion of the proceeds apportioned after the apportionment computation. It would seem that they should be subtracted from the gross proceeds of the sale before any apportionment computation is made.

"The object of the apportionment is to give the life beneficiary the usual net income on trust investments. If the carrying charges were taken out of his share after apportionment, he would get much less than such net return. He would in effect have to pay carrying charges twice. Deduction of the carrying charges from the gross proceeds enables the trustee to pay from such sum carrying charges not yet paid, and to repay the income or capital account of the trust if carrying charges have in the past been paid out of trust income or capital." 84

In the situation presented where the trustee has acquired real estate through foreclosure of a trust mortgage, some courts and writers have felt that the allocation of carrying charges should be governed by analogy to the rules discussed above. Others have taken the position that the allocation of such charges in a given case would not depend upon whether the property were productive or unproductive, nor upon the testator's supposed intent. They emphasize the fact that these are not operating expenses in the usual sense, but are charges upon a particular piece of salvage, such that the burden of them should in some manner be equitably distributed between life tenant and remainderman. The precise question in a mortgage case appears to have arisen for the first time in a Massachusetts decision, Stone v. Littlefield. 85 In this case the trustee foreclosed a mortgage for default in interest, taxes, and principal, and afterwards sold the property, which was unproductive. Before selling, he was compelled to pay taxes for

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84. Bogert, loc. cit. supra note 83. Brandis, Trust Administration: Apportionment of Proceeds of Sale of Unproductive Land and of Expenses (1931) 9 N. C. L. Rev. 127, 136, takes the contrary view. The present authors are substantially, though not wholly, in accord with the view of Professor Bogert, but since this portion of the discussion is given principally by way of background, it is not deemed advisable to prolong the analysis at this point. It should be noted that the cases reveal a third method of disposing of these charges, namely, permanent allocation of them to principal. See supra note 81.
85. 151 Mass. 485, 24 N. E. 592 (1890).
two years, which the mortgagor ought to have paid. The question arose whether this charge should be deducted from principal or should be taken from other and productive investments of the same trust estate. The court held that these expenses should be deducted from principal, since otherwise a loss upon some one investment might absorb the life tenant's whole income for the year.

The question next came up in a New Jersey case, In re Tuttle. Here the trustee bid in the property involved at the foreclosure sale and carried it for some time. He paid out $573 in taxes while he held the property. The court held that this amount should be deducted from the income allotted to the life tenant after the apportionment of the proceeds of sale, rather than from the proceeds prior to apportionment. The opinion states, in substance, that in following the apportionment rule laid down in Hagan v. Platt, the life tenant is allotted a portion of the proceeds as income, and is treated as though he had been at all times in enjoyment of the fund. It also states that since the general rule is that in a trust of productive property the life tenant must pay all carrying charges and expenses of maintenance, and since by equitable conversion the life tenant is treated as though he had been the life tenant of productive property, he should pay the necessary carrying charges. This decision is an unusual one, though not wholly illogical. The principal criticism of the case is that it puts a heavier burden on the life tenant than is warranted by the investment theory, under which the life tenant and remainderman are regarded as participants in a joint venture. There appears to be no decision similar to this, either in New Jersey or elsewhere.

In a subsequent New Jersey case, Trenton Trust & Safe Deposit Co. v. Donnelly, the trustee acquired title on foreclosure and held the property for only fifteen days, selling it for a price considerably less than the original investment. Taxes and commissions were deducted from the ultimate proceeds of sale, which were then apportioned between life tenant and remainderman. The remainderman took the position that the taxes paid by the trustee should have been deducted from the life tenant's share after it had been ascertained. The court held, however, that since the taxes paid were not taxes assessed upon the property during the time while it was held by the trustee, they constituted a part of the expense necessary for the final sale of the property, and were therefore deductible from the gross proceeds of sale. It will be recalled that in Stone v. Littlefield, taxes in arrears at the time when the trustee acquired the real estate were held chargeable to principal. As to this type of taxes, therefore, there seems to be a lack of harmony between the Massachusetts and New Jersey decisions.

86. 49 N. J. Eq. 259, 24 Atl. 1 (Prerog. 1892).
87. 48 N. J. Eq. 206, 21 Atl. 860 (Ch. 1891).
88. 65 N. J. Eq. 119, 55 Atl. 92 (Ch. 1903).
89. 151 Mass. 485, 24 N. E. 592 (1890).
In a recent New Jersey case the court ignored the rule set forth in the Tuttle case, and stated that if the property acquired by the trustee after foreclosure were unproductive, carrying charges should be paid out of principal in the first instance, and later deducted from the gross proceeds realized upon the ultimate sale. The court relied upon Trenton Trust & Safe Deposit Co. v. Donnelly as its authority. Thus it may be seen that the New Jersey decisions are in conflict on the allocation of operating expenses, since the Tuttle decision had ordered the deduction of such charges from the life tenant's share after apportionment.

In the earlier cases in New York the question of carrying charges on foreclosed real estate was treated pragmatically, the court approving whatever seemed fair in each particular case. Thus, in Meldon v. Devlin, the record on appeal discloses that the carrying charges were paid out of the income received by the trustee from other parts of the estate. No question was raised on either appeal as to the propriety of this method. Similarly, in Matter of Olmstead, the trustee charged against the estate all the taxes and assessments upon the foreclosed property. The re-

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90. Equitable Trust Co. v. Swoboda, 113 N. J. Eq. 399, 167 Atl. 525 (Ch. 1933).
91. In First National Bank of Hoboken v. Steneck Title & Mortgage Guaranty Co., 13 N. J. Misc. 4, 170 Atl. 93 (Ch. 1934), certain bonds and mortgages were deposited with the Steneck Trust Co. as trustee by the Steneck Title & Mortgage Guaranty Co., which issued participation certificates against the mortgages so deposited. Subsequently the First National Bank of Hoboken was appointed a trustee to succeed the Steneck Trust Co. The new trustee applied to the court for instructions as to the problems confronting it in the administration of the trust. Many of the mortgages had been foreclosed by the trustee, and the property bid in by it. The trustee had thus come into possession of real estate from which rent was derived. The trustee was also receiving interest from other mortgages in the trust. Specific instructions were sought as to how the foreclosure expenses, taxes in arrears and to accrue, water rent, expenses of insurance, repairs, etc., were to be met and allocated. The court held that the trustee should pool all the income receipts, including income from rents and interest on mortgages, and pay these expenses out of this fund. The certificate holders had an interest in all of the mortgages deposited, however, so that there could be no complaint against the use of interest from other mortgages to meet these charges. Furthermore, there was no issue between a life tenant and remainderman in this case.

The exact nature of the interest of a mortgage participation certificate holder in the mortgage or mortgages participated in or in real property acquired by the issuing corporation or trustee upon the foreclosure of a participated mortgage has not been made clear by the cases. Mortgages may be participated in two ways: either directly by the owner of the mortgage, who retains its custody, or indirectly through deposit with a trustee of a mortgage or mortgages against which certificates are issued by the depositor. See 3 Bozett, TRUSTS AND TRUSTEES (1935) § 676. The relation between the certificate holders and the custodian or depositary of the mortgages has been variously described as one of trust or agency, or as a debtor-creditor relationship. See Prudential Insurance Co. v. Lieberdar Holding Corp., N. Y. L. J., March 21, 1934, at 1349 (S. D. N. Y.), rev'd, 72 F. (2d) 395 (C. C. A. 2d, 1934); In re Lehrenkrauss, 6 F. Supp. 687 (E. D. N. Y. 1934); Kline v. 275 Madison Ave. Corp., 149 Misc. 747, 268 N. Y. Supp. 582 (Sup. Ct. 1933); Board of County Commissioners of Shawnee County v. Cook, 141 Kan. 677, 42 P. (2d) 568 (1935); Bankers Trust Company of Detroit v. Russell, 263 Mich. 677, 249 N. W. 27 (1933). The problem becomes acute in New York in the determination of questions such as whether the consent of certificate holders is necessary to the sale of foreclosed real estate where the certificates were issued prior to the recent amendment to Section 168 (7) of the Banking Law. See 84 U. of PA. L. Rev. at 157, n. 4.

92. 31 App. Div. 146, 53 N. Y. Supp. 172 (1st Dep't 1898), aff'd on opinion below, 167 N. Y. 573, 60 N. E. 1116 (1901).
93. 52 App. Div. 515, 66 N. Y. Supp. 212 (1st Dep't 1900), aff'd without opinion, 164 N. Y. 571, 58 N. E. 1090 (1900).
remainderman objected to this disposition of the charges, but the surrogate allowed the trustee's accounts. In the Appellate Division opinion the problem of carrying charges is not discussed, but the decree of the surrogate was affirmed on all points.

Not until the decision of Surrogate Silkman in *Matter of Marshall* 94 did the question of carrying charges receive specific consideration in the opinion of a New York court. The surrogate held that charges of this nature were not to be treated as ordinary carrying charges, but as an expense in the operation of the joint venture by life tenant and remainderman. His comment follows:

"The purchase of the property was in effect an act intended only as temporary, in order to prevent immediate loss to the estate. The form of the security, although physically realty, was still to be regarded as personal property, and would eventually have to be distributed as such. "The taxes thereon, in a sense, were not annual taxes imposed against the trust estate, but a charge against this particular piece of salvage, which the executors had taken temporarily in the exercise of their prudent judgment. The taxes were part of the general expenses to which the estate was put in an effort to prevent loss." 95

It was necessary in this case to pay the cost of carrying the properties out of principal. Under the court's theory that these were but the expenses of a salvaging operation, it is apparent that they could not remain as a permanent charge against principal. Accordingly the court declared that the principal locked up in the investment included the various operating expenses in addition to the amount of the original investment in the mortgages. In this manner the remaindermen, although not compensated in full for the amounts paid out of principal, were not subjected to the entire burden of carrying the property pending its final sale. The result was a distribution of the cost of salvaging the investment between the life tenants and the remaindermen.

Two cases which arose shortly after the *Marshall* decision have been the subject of considerable speculation and have been cited for various propositions by contending counsel. In *Matter of Pitney* 96 the trustees invested $20,000 in a mortgage, which they subsequently foreclosed. They bid in the property at the foreclosure sale, and at the time when the case was decided they still held the property, being unable to find a purchaser. No income was received from the property, and the carrying charges on it amounted to about $570 a year. The trustees, with the approval of the lower court, deducted the $570 from the income realized from the balance of the trust

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95. Id. at 243, 88 N. Y. Supp. at 553.
96. 113 App. Div. 845, 99 N. Y. Supp. 588 (1st Dep't 1906), modified on other grounds, 186 N. Y. 540, 78 N. E. 1110 (1906).
The Appellate Division reversed this decision on the ground that the carrying charges were paid in order to protect principal, and not in any way to benefit the life tenant. It therefore ordered that these charges be allocated to principal. This case involved only an intermediate accounting, and it is impossible to tell whether the court would ultimately have apportioned the proceeds of sale of the property and the expenses of operation in the manner employed in Matter of Marshall. The court did not seem to have in mind the "salvage" theory enunciated in the Marshall case, and one receives the impression that the court intended to charge principal permanently with these expenses. Insofar as it allocates carrying charges to principal before the ultimate sale, the case is in accord with Matter of Marshall; what the court would have held regarding these expenses after the sale is a matter for conjecture.

In Matter of Menzie a mortgage was foreclosed by the trustee in 1891, and the property was bid in by him. The property, which was farm land, was rented by the trustee from 1891 until 1897, when it was sold. From 1889 until 1897 the property yielded practically no revenue "above an amount sufficient to preserve the fund for the remainderman." The question of how the expenses and disbursements in connection with the administration of the property were to be charged came up upon a proceeding on the accounting of the trustee. The court held that these items were to be charged against the corpus of the estate, on the ground that they were expenses necessary to preserve the property for the benefit of the remainderman. The court relied upon Matter of Pitney as its authority. The Pitney and Menzie cases are similar in that both allocated carrying charges to principal on intermediate accountings; they differ in that in the Menzie case the property had been disposed of by the trustee at the time when the decision was rendered. It is to be noted, too, that in the Menzie case the property was not wholly unproductive. It does not seem that the court contemplated any ultimate apportionment either of expenses or proceeds of sale, in either case.

Whether or not Matter of Brooklyn Trust Co. (Weaver Estate) may be cited as authority, by implication, against apportionment of the proceeds of sale of foreclosed real estate, there is no doubt that it is direct authority for the proposition that the carrying charges during the period of ownership by the trustee should be charged against income, even if they have to be paid out of income from other assets in the trust estate. The trust in this case provided that the "net income" from the testatrix's residuary estate, which included the mortgage in question, should be paid to the life tenant.

97. 54 Misc. 188, 105 N. Y. Supp. 925 (Surr. Ct. 1907).
Thereafter the trustees took the mortgaged premises in merger of the mortgage, and paid out the expenses of maintenance which became the subject of dispute. Surrogate Ketcham held that the question was governed by the usual rule that the expenses of carrying the assets of a trust must be borne by the life tenant. The surrogate stated that the question was controlled by the opinion of the Appellate Division in *Spencer v. Spencer*, wherein it was held that carrying charges must be borne by the person having the life interest in the trust property, unless the will evidences an intent on the part of the testator that these charges be paid out of principal. The emphasis placed by the court upon the testator's intent is the unfortunate feature of the case. As has been previously pointed out in this discussion, the acquisition of title by the trustee is an occurrence probably not contemplated by the settlor or testator. His putative intent, therefore, should not be the controlling factor. The affirmance of this case, even though without opinion, by the Court of Appeals, gives it an authority which it could not compel by virtue of its reasoning. As has been shown, however, the briefs filed did not contain adequate citation of authorities, and the case is not favorably commented on by students in this field.

New York courts which have passed upon the question of allocation of carrying charges since the *Brooklyn Trust Co.* case was decided have not felt constrained to follow that decision, but the majority of them have preferred to allocate these charges to principal, either permanently or temporarily. This approximate uniformity in result, however, has not been accompanied by similar uniformity in reasoning. In the recent case of *Matter of Wardman*, for example, Surrogate Slater found several grounds upon which he might base a decision allocating these charges to principal.

99. 169 App. Div. 54, 154 N. Y. Supp. 527 (1st Dep't 1915). This case was subsequently reversed on the ground that the facts did indicate an intent on the part of the testator that the charges in question be allocated to principal. 219 N. Y. 459, 114 N. E. 849 (1916). The rule as the Appellate Division stated it was not questioned by the Court of Appeals.

100. 84 U. of Pa. L. Rev. at 177, n. 71. See also 4 Bogert, *Trusts and Trustees* (1935) § 820.

101. Surrogate Ketcham relied largely upon cases in the field of trusts of unproductive reality. In these cases intent is, and under the decisions must be, an important factor, because it is the settlor's intent to effect an equitable conversion which changes the distribution of these charges. In the case of foreclosed real estate, however, the equitable conversion is brought about by other circumstances, unconnected with the settlor's intent. To this extent the cases on unproductive reality are not relevant to the issue at hand.

102. See 84 U. of Pa. L. Rev. at 165, n. 28.

103. See Farb, *Distribution of Proceeds on Sale of Properties under Foreclosed Mortgages* (1933) 58 Trust Companies 245, 249.

104. In *Furniss v. Cruikshank*, 191 App. Div. 450, 181 N. Y. Supp. 522 (1st Dep't 1920), modified on other grounds, 230 N. Y. 495, 130 N. E. 625 (1921), 231 N. Y. 550, 132 N. E. 884 (1921), the trustee made a loan of about $19,000, secured by a mortgage on real estate. Upon foreclosure the title was acquired by the trustee, who subsequently sold the property for $17,000. The expenses, including arrears of taxes, amounted to over $4,000, leaving a loss of about $6,000 on the investment. This loss was charged to capital. No apportionment of the proceeds of sale was requested by the life tenant (see 84 U. of Pa. L. Rev. at 166, n. 30), and the question as to the proper allocation of these charges was not raised on any of the appeals.


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102. See 84 U. of Pa. L. Rev. at 165, n. 28.

103. See Farb, *Distribution of Proceeds on Sale of Properties under Foreclosed Mortgages* (1933) 58 Trust Companies 245, 249.

104. In *Furniss v. Cruikshank*, 191 App. Div. 450, 181 N. Y. Supp. 522 (1st Dep't 1920), modified on other grounds, 230 N. Y. 495, 130 N. E. 625 (1921), 231 N. Y. 550, 132 N. E. 884 (1921), the trustee made a loan of about $19,000, secured by a mortgage on real estate. Upon foreclosure the title was acquired by the trustee, who subsequently sold the property for $17,000. The expenses, including arrears of taxes, amounted to over $4,000, leaving a loss of about $6,000 on the investment. This loss was charged to capital. No apportionment of the proceeds of sale was requested by the life tenant (see 84 U. of Pa. L. Rev. at 166, n. 30), and the question as to the proper allocation of these charges was not raised on any of the appeals.

They were substantially: (1) an equitable conversion was effected by the testator’s will, since it could not be supposed that he intended the life tenant to be burdened with carrying charges for the benefit of the residuary estate; 106 (2) the testator’s implied intention must have been to relieve the life tenant of these charges, since the income, not the net income, of the trust was given to the life tenant; 107 (3) the decision in Matter of Pitney 108 is controlling, since the object of the charges is the preservation of the property for the benefit of principal. At the time of this decision the trustee still held the property pending a final sale, and it does not appear whether the allocation of carrying charges to principal was intended to be permanent.

Several other recent New York cases have allocated these charges to principal on intermediate accounting, with the express statement that the allocation is a temporary one. 109 The inference from these cases is that upon a final sale of the properties the carrying charges will be apportioned between principal and income, probably in the manner set forth in Matter of Marshall.

Only one New York decision has been found which is in accord with that in Matter of Brooklyn Trust Co. to the effect that carrying charges should be debited on the income account. This is the recent opinion of the Appellate Division in the Second Judicial Department in Matter of Chapal. 110

106. The Surrogate here cited as authorities for this proposition the cases of Lawrence v. Littlefield, 215 N. Y. 561, 199 N. E. 611 (1915); Spencer v. Spencer, 219 N. Y. 459, 114 N. E. 849 (1916); Matter of Jackson, 258 N. Y. 281, 179 N. E. 496 (1932); Matter of Satterwhite, 262 N. Y. 339, 186 N. E. 857 (1933); Matter of Schuster, 150 Misc. 444, 269 N. Y. Supp. 546 (Surr. Ct. 1934). In the instant case the mortgage in question was a purchase money mortgage, and the foreclosed real estate was an original part of the corpus of the trust. Under these circumstances an equitable conversion by the will of the testator is a possible result, but in the normal case of foreclosed real estate the equitable conversion is based on circumstances other than the intent of the settlor or testator. See supra note 101.

107. In this connection the Surrogate added that this was a trust fund consisting entirely of personal property (apparently by equitable conversion) and that trusts of personal property should not ordinarily be burdened with such charges.


In Bankers Trust Co. v. Willis, N. Y. L. J., June 6, 1935, at 2927 (N. Y. Sup. Ct 1935), Bankers Trust Co. was trustee under a separation agreement. Part of the corpus of the trust consisted of a second mortgage of $30,000, reduced to $27,000, on certain vacant premises. This mortgage was subject to a first mortgage of $22,000. After default, the second mortgage was foreclosed and title to the premises was taken by the trustee. Another asset of the trust fund was the entire stock of a certain corporation. The corporation owned real property, which it sold subject to an existing mortgage, and took back a second purchase money mortgage. This second mortgage also became in default; it was foreclosed, and title to the premises was taken by the trustee. The question was whether mortgage interest, taxes, foreclosure costs, and other carrying charges of these two parcels should be chargeable to principal or to income. Referee Morschauser held that although under the general rule carrying charges are to be paid out of income, the facts in this case brought it within the rule enunciated in the Pitney, Furniss, and Wardman cases. A further circumstance which the referee said compelled this result was that the separation agreement provided that the wife, in consideration of the relinquishment of certain marital rights, should have $3000 a year from the net income of the trust fund. In view of this fact, the referee thought it only equitable to charge principal with these expenses.

The surrogate of Nassau County had held that if the income of a particular parcel was insufficient to pay carrying charges, the trustee should pay the deficiency from the principal of the trust, and not from income. The Appellate Division stated (apparently by way of dictum) that the carrying charges should be allocated to income in the absence of an intent on the part of the testator to burden principal with these expenses. The court stressed the fact that these properties represented only a minor part of his estate, and added that if the testator had intended to relieve the life tenant of these charges, he would have so provided in his will. The fallacy of making the settlor's intent the controlling feature as to an event which he probably never envisaged has been pointed out in the discussion of the Brooklyn Trust Co. case. Suffice it to say that these two decisions have no other support in the case law of New York or any other jurisdiction, as to the disposition of carrying charges.111

The allocation of foreclosure expenses must necessarily be treated as a problem peculiar to the trust mortgage cases. There are, of course, no analogies to be drawn from the field of trusts of unproductive real estate. Comparatively few of the cases in the field of trust mortgages have mentioned foreclosure expenses specifically. In Meldon v. Devlin112 the record on appeal reveals that these expenses were paid out of income from other parts of the trust estate. In Matter of Olmstead113 the trustee charged against the estate all expenses of the foreclosure. The trustee's accounts were allowed by the surrogate. In the Appellate Division the principal question turned on another phase of the situation, but the court stated that it agreed with the surrogate in his disposition of the other questions presented. In Matter of Marshall114 foreclosure expenses were treated as one of the items constituting the aggregate principal locked up in the investment and subsequently apportioned between principal and income. In Matter of Ely115 these expenses were temporarily charged to principal pending an apportionment of the proceeds of the final sale.

These cases appear to be the only ones in New York in which it can be ascertained how the foreclosure expenses were treated. The method employed in Meldon v. Devlin is of doubtful validity. While the Olmstead case probably may be cited as favoring the permanent allocation of these

111. Only one other jurisdiction appears to have passed upon this question. In the case of Keen's Estate, 306 Pa. 303, 159 Atl. 713 (1932), a trustee accepted title to mortgaged property in his own name to avoid the expense of foreclosure. He collected the rents, credited the estate with the amount received, and charged it with the taxes and costs of repairs. He later sold the property and credited the estate with the purchase price. No question was raised on the appeal as to the propriety of this disposition of these items.
113. 52 App. Div. 515, 66 N. Y. Supp. 212 (1st Dep't 1900), aff'd without opinion, 164 N. Y. 571, 58 N. E. 1090 (1900).
114. 43 Misc. 238, 88 N. Y. Supp. 559 (Surr. Ct. 1904).
charges to principal, the more recent Marshall and Ely cases indicate that they are to be ultimately apportioned between life tenant and remainderman.

There exists a similar lack of harmony as between other jurisdictions. In one New Jersey case\(^\text{116}\) the costs of foreclosure were deducted from the ultimate proceeds of sale prior to the apportionment of these proceeds. More recently it was said, in a case in which the foreclosure sale had not as yet occurred, that the costs of foreclosure should be borne by principal, and that a final adjustment of these costs must abide the events following the sale.\(^\text{117}\) The court indicated, however, that it would follow the rule laid down in the earlier case. In Delaware, on the other hand, it is said that the expenses of foreclosure are to be paid out of the trust fund.\(^\text{118}\)

As to the expenses of the final sale of the foreclosed property, one may revert to the analogous cases on the sale of real estate held in trust. These expenses include brokers' commissions, costs of survey, mortgage taxes, and recording fees. While there is but little authority on the subject, the cases favor the allocation of these charges to principal, when real estate acquired by a trustee by other means than foreclosure is sold.\(^\text{119}\) But it has been argued that since these expenditures are calculated to benefit both principal and income, they should be apportioned between the two accounts.\(^\text{120}\) Some real estate lawyers have been accustomed to deduct these expenses from the ultimate proceeds of sale. This has been true even in New York, in the absence of authority in appellate courts.

On this point there is but one case in which the trustee was selling foreclosed real estate. In this case\(^\text{121}\) the New Jersey court held that the expenses of sale should be deducted from the final proceeds realized, prior to an apportionment of such proceeds. This has frequently been the practice in many states where a trust mortgage has been foreclosed, and the property sold to a person other than the trustee.\(^\text{122}\)

\(^{116}\) In re Tuttle, 49 N. J. Eq. 249, 24 Atl. 1 (Prerog. 1892).

\(^{117}\) Equitable Trust Co. v. Swoboda, 113 N. J. Eq. 399, 167 Atl. 525 (Ch. 1933).

\(^{118}\) In re Bellah, 8 Del. Ch. 59, 67 Atl. 973 (Ch. 1896). See also In re Baker, 8 Del. Ch. 355, 68 Atl. 449 (Ch. 1899).

In Appeal of Wordin, 71 Conn. 531, 42 Atl. 659 (1899), the trustee foreclosed a trust mortgage and obtained a decree of foreclosure. Subsequently, however, the decree was set aside. It was urged that the costs of foreclosure should be charged against the corpus of the estate. The court held, however, that these expenses must be borne by the life tenant, since no conversion of the security had actually taken place. It added that if another decree of foreclosure were subsequently obtained, it would determine, in view of all of the attending circumstances, in what manner these costs might be equitably allocated. At this point the court cited as its authorities In re Tuttle, 49 N. J. Eq. 249, 24 Atl. 1 (Prerog. 1892), and In re Park's Estate, 173 Pa. 190, 33 Atl. 884 (1896). Meanwhile the court felt that since the foreclosure may have been brought simply as the best means of exacting payment of the interest in arrears, this was a carrying charge which should be debited on the income account.

\(^{119}\) In re Fargo's Estate, 68 Misc. 273, 125 N. Y. Supp. 156 (Surr. Ct. 1910), 72 Misc. 305 (Surr. Ct. 1911); Gould v. Gould, 126 Misc. 54, 213 N. Y. Supp. 286 (Sup. Ct. 1925); Brandis, supra note 84, at 149.

\(^{120}\) 4 BOGERT, TRUSTS AND TRUSTEES (1935) § 805.

\(^{121}\) In re Tuttle, 49 N. J. Eq. 249, 24 Atl. 1 (Prerog. 1892).

\(^{122}\) No cases have been found in regard to the allocation of the trustee's commissions in the management of foreclosed real estate. In New York, under Section 285 of the Surrogate's Court Act, it has been recognized that the trustee is entitled to commissions on moneys
The Restatement of Trusts provides that expenses of foreclosure should be paid out of principal, and that if the trustee purchases the property for the trust on the foreclosure sale, and it produces no income, the carrying charges should be paid out of principal until it is sold or becomes productive.\textsuperscript{123} It is further provided, however, that from the net proceeds of sale to be apportioned, there should be deducted the net loss incurred in carrying the property prior to the sale.\textsuperscript{124} This is substantially in accord with those cases which have temporarily allocated carrying charges to principal pending a final sale, and thereafter authorized their deduction from the ultimate proceeds. It will be noted that these rules are limited in their application to foreclosed real estate which is unproductive, the inference being that as to productive property such charges are to be paid out of income as they accrue.

It would seem, then, that there are four possible ways in which carrying charges, expenses of foreclosure, and costs of ultimate sale may be disposed of: (1) permanent allocation to principal; (2) temporary allocation to principal pending final sale and addition of these items to the amount constituting the aggregate principal when apportionment is made of the proceeds of sale; (3) deduction of these expenses from the proceeds of sale before apportionment of the proceeds; and (4) deduction from the share allocated to the life tenant after apportionment of the proceeds of sale. Each of these methods has some support in the cases existing in the various jurisdictions.

Of these alternatives, the first places an undue burden on the remainderman. If the acquisition of title by the trustee be regarded as an investment of both principal and income, it is unfair that the principal account should bear the entire brunt of carrying the property pending its conversion into distributable proceeds. While it is true that there is also some authority for such a procedure in the field of trusts of unproductive realty, the better view is that such expenses in both fields should in some manner be apportioned between the respective accounts.

received as rentals, and on expenditures for taxes and upkeep of the real estate. Matter of Lathers, 122 Misc. 543, 203 N. Y. Supp. 191 (Surr. Ct. 1924). This was a case in which the trustees had foreclosed a trust mortgage and bid in the property. The surrogate overruled a contention that the trustees were entitled to commissions only upon the net income of the real estate.

Taxes, other than annual levies, such as an income tax on the sale of the real estate at a profit, have apparently not been the subject of much litigation in this field. It has been held that income taxes paid on the income of an estate are properly chargeable against principal sofar as they are imposed upon profits made by the estate, not distributed or distributable to the life tenant as income. Matter of King, 130 Misc. 296, 224 N. Y. Supp. 283 (Surr. Ct. 1927). A clear direction by the testator that such taxes be charged to income will be respected by the courts. Matter of Keim, N. Y. L. J., Feb. 3, 1931 (N. Y. Surr. Ct. 1931). In the present situation these views would doubtless be acceptable to courts which, when the final sale results in a profit, give the life tenant merely the amount he would have realized if the investment had not become unproductive. On the other hand, those courts which favor apportionment of such a profit would probably favor an apportionment of the tax as well.

\textsuperscript{123} See \textit{Restatement, Trusts} (1935) \textsection 233, comment \textit{m}.

\textsuperscript{124} Id. \textsection 241 (3). \textit{Cf. 4 Bogert, Trusts and Trustees} (1935) \textsection 820: "Carrying charges on \textit{unproductive} realty taken on foreclosure by a trustee should be borne by trust capital when the retention of the property is solely for the benefit of trust capital, and should not be paid out of the income of other property." Italics added.
As between the second and the third alternatives outlined above, it is 
more difficult to choose. Each obviously has many elements of fairness 
to commend it. Under the second method the principal account is initially 
charged with these expenditures, and is not recompensed therefor to the 
full amount advanced, since by the addition of these charges to the sum 
calculated as aggregate principal, the remainderman merely gets a larger 
proportion of the proceeds of the final sale; not enough, however, in the 
usual case, to constitute a full repayment of the sums advanced. Under 
the third method the remainderman receives payment in full for all sums 
advanced by him to meet carrying charges pending the final sale. This is 
accomplished by the deduction of this amount from the final proceeds of sale. 
The residue to be divided between the two accounts is accordingly smaller 
than under method (2). Where the final sale is had within a relatively 
short time after the trustee acquires title, it would not matter greatly 
whether method (2) or (3) were used, since either would yield a substan-
tially equitable result. Where the carrying period is protracted, and interest 
and carrying charges represent increasingly larger factors in the final com-
putation, method (3) would seem to reach a somewhat fairer result. Other-
wise, under the "Marshall" rule, method (2); the principal account might 
receive but little more than the amounts actually furnished by it to meet 
current expenses. Under either method the life tenant should receive inter-
est upon the amounts of principal expended to meet operating charges.

The fourth method is logical in some respects, but it places a heavier 
burden on the life tenant than is justified by the "joint venture" theory. The 
income which the life tenant receives will usually be somewhat less than 
the settlor contemplated, and to deduct from this amount the entire burden of 
carrying charges might in some cases deprive the life tenant of the very 
benefit which the conversion theory was intended to bring to him. 125

III

Disposition of Rents Received by the Trustee During the 
Carrying Period

The disposition of rents received during the carrying period is not the 
least of the problems facing a trustee who has foreclosed a trust mortgage 
and bid in the property. While frequently the foreclosed property is unpro-
ductive, there is often some income in the form of rents, and occasionally 
an excess of income over carrying charges. Where the carrying charges 
are greater than the rents received from the property, the trustee might use

125. Certain charges in the management of trust realty are allocated permanently to 
principal such as those for permanent improvements. When the trustee is holding foreclosed 
realty, however, it seems that even such charges should be apportioned in some manner, since 
the trustee must dispose of the property as soon as possible. Cf. Matter of Suydam, 138 
the income to pay the charges as they accrue, or he might pay them out of principal and add the rents to the proceeds of the final sale, treating them not as income in any ordinary sense, but as salvage. If the method of charging these expenses initially to principal and thereafter deducting them from the final proceeds of sale were employed as to the allocation of carrying charges, the result would be the same whatever was done with the rents. Under the Marshall method of allocation, however, the life tenant would probably receive a slightly higher share if the rents were added in full to the final proceeds of sale rather than used to pay carrying charges as they accrued.

It would seem preferable to treat these rents just as if an ordinary trust of productive realty were involved. In such a case income would be used to pay current expenses. This rule would lead to a simpler method of trust administration and would avoid the necessity of keeping dual accounts. Although the cases have not squarely passed on the point, this seems to have been the method generally followed.126

Where the rents exceed the carrying charges, the trustee must in some manner dispose of the surplus. He might immediately distribute the excess rents to the life tenant, he might immediately apportion them, or he might add them to the final proceeds of sale for apportionment at the time of sale. The trustee is often reluctant to make an allowance to the life tenant out of the surplus prior to the final sale, because of the danger of paying the life tenant more than he may be ultimately held entitled to on the final apportionment. This view has been expressed as follows:

"If income is collected on the property during the time it is held, exceeding the ordinary carrying charges, so that at the end of an operating period there is a net income, the question arises as to whether the life tenant is entitled to the full amount of the net income or whether it should be allocated to principal. Where foreclosed property is held, the fiduciary usually sets forth the carrying charges and the income in a special account. Payment to the life tenant should be deferred until the ultimate disposition of the property, when an adjustment of the proceeds is made as above stated, since the income on the venture is not definitely known till then. Where the property is managed over a period of years by the fiduciary and the operating income far exceeds the operating expenses so that a surplus arises, a portion thereof may be paid to the life tenant. Payments to the life tenant should not exceed that which shall be ultimately apportioned to the income account, since they are simply payments on account. Rent collected is not ordinary income in that the original property held was not real property." 127

127. Dodge, ESTATE ADMINISTRATION AND ACCOUNTING (1932), Supp. No. 1 (1933) 293.
The inequitable results which these rules might often necessitate are apparent. The life tenant is usually the chief object of the settlor's solicitude, yet under the rules stated above he may be deprived of any income whatever for a long period of time.\(^2\) The hardship to a life tenant dependent upon the income from such a trust investment suggests the adoption of some rule more consonant with justice and the equities of the situation. The whole basis of the rule of apportionment in the case of trusts of unproductive realty is the furtherance of the expressed or inferred intent of the testator to benefit the life tenant. By parity of reasoning, a rule protecting trustees in making payments of excess income should be established.

Trustees now fear that any payment to the life tenant during the carrying period may be more than he will be ultimately entitled to on the final apportionment. It would seem that there might be implied an intent on the part of the settlor that the trustee should invade principal if it becomes necessary to protect the life tenant. The life tenant should receive at least the prevailing rate of interest on the inventory value of the property if surplus rents exist after carrying charges have been paid and a sum has been reserved for future contingencies. If, due to a declining real estate market, it is found upon final sale that the life tenant has already received somewhat more than his share, it should be deemed that the settlor would have approved this result rather than the life tenant's complete or substantial deprivation of income.\(^2\) Such a theory is based on the same equities which originally gave rise to the doctrine of apportionment.

\(^{28}\). In the Myers and the Marshall cases the carrying periods were for twenty years or more.

Fiduciaries are sometimes apprehensive that in withholding any income from the life tenant during this period, they may be technically violating a rule against accumulations, in that some portion of the surplus rents so withheld admittedly constitutes income. It is not believed that such conduct amounts to a violation of the rule. It is well established that a liberal discretion is allowed trustees to withhold income temporarily in order to meet future contingencies, such as a sinking fund for the depreciation of real property. Matter of Parr, 45 Misc. 564, 92 N. Y. Supp. 990 (Sur. Ct. 1904), aff'd without opinion, 113 App. Div. 921, 100 N. Y. Supp. 1133 (2d Dep't 1906); 3 Bogert, TRUSTS AND TRUSTEES (1935) § 600. Furthermore, there is, in the typical case involved in this discussion, no direction that the trustee accumulate, and there is nothing to prevent him from paying over income to the life tenant if he wishes to risk an overpayment. It has been held that where a trustee has discretion to pay or withhold income, without there being an express direction for accumulation, there is no violation of the rule. Hill v. Guaranty Trust Co., 163 App. Div. 374, 148 N. Y. Supp. 697 (1st Dep't 1914); Matter of Bavier, No. 1, 164 App. Div. 358, 149 N. Y. Supp. 728 (1st Dep't 1914). And see In re Spring's Estate, 216 Pa. 529, 534, 66 Atl. 110, 112 (1907).

\(^2^9\). There seem to be no cases dealing with this precise question. Cf. Willis v. Holcomb, 83 Ohio St. 254, 94 N. E. 486 (1911); Van Vleck v. Lounsbery, 34 Hun 569 (N. Y. 1885); In re Bellah, 8 Del. Ch. 59, 67 Atl. 973 (Ch. 1896). When the case of Matter of Chapal, 245 App. Div. 818, 280 N. Y. Supp. 811 (2d Dep't 1935) was before the Surrogate of Nassau County, he had held, inter alia: "2. If the income of a particular parcel is more than sufficient to pay carrying charges, trustees will be bound to exercise their own discretion and judgment upon the question of distributing such surplus income entirely, or retaining the same or some part thereof to meet possible subsequent deficiencies."

"3. If such surplus exists in the case of a particular parcel as to which the trustees have already taken funds from the principal of the trust to pay deficiencies, the trustees should reimburse the principal from such surplus income."