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

PARKER BAILEY† AND CHARLES KEATING RICE‡

Since the two installments of this article appeared in this REVIEW, the New York Court of Appeals has rendered a decision in *Matter of Chapal* [1] which removes much of the previous uncertainty in the New York law concerning foreclosure of trust mortgages. In this case it will be recalled [2] that the Appellate Division, in modifying the decree of the surrogate, had held that the entire proceeds of sale of the foreclosed real estate should be allocated to principal. It added, by way of *dictum,* that the income account should bear carrying charges which accrued during the carrying period. Dissatisfaction with the results of this decision was expressed by the present authors in the previous discussion of these problems.[3]

Upon appeal from the decision of the Appellate Division, the Court of Appeals unanimously reversed the order and reinstated the decree of the surrogate in so far as it directed an apportionment of the proceeds of the final sale between the respective accounts. The remarks of the Appellate Division regarding carrying charges were treated as *dicta,* not to be followed in the final accountings in the distribution of the estate. The Court of Appeals stated that carrying charges should initially be paid out of principal, and thereafter deducted from the proceeds of sale and returned to principal before apportionment of the residue.

There are several significant points to be noted in this case. In the first place the court appears not to have regarded equitable conversion as a controlling factor, and it expressly repudiated the analogy of the cases in the field of trusts of unproductive real estate with an imperative power of sale in the trustee. The court seems to have looked upon the trust mortgage cases as *sui generis,* not to be governed by analogous precedents. As far as apportionment of the proceeds of ultimate sale is concerned, it is of little practical importance whether the apportionment is said to be brought about by equitable conversion, the investment theory, or some other equitable

* The first installment of this article, containing footnotes 1-71, appeared in the December issue of the REVIEW (1935) 84 U. OF PA. L. REV. 178. The second installment, containing footnotes 72-129, appeared in the January issue (1936) 84 U. OF PA. L. REV. 327. References thereto will be without title.

ERRATA: In 84 U. OF PA. L. REV. 157, 161, line 29 should read: "The remainderman was given that sum. . . ." In 84 U. OF PA. L. REV. 327, line 10, should read: "closure. This question involves a problem which transcends that of liquida-"

† A. B., 1923, Yale University; LL. B., 1934, Cornell University; member of the New York Bar.

‡ A. B., 1932, LL. B., 1934, Cornell University; member of the New York Bar.

1. 269 N. Y. 464 (1936).
2. See 84 U. OF PA. L. REV. at 166.
3. *Id.* at 166, 167, 339.

rationalization, as long as the same formula for apportionment is employed: namely, the ratio of the unpaid interest to the principal involved.

In the determination, however, of questions such as the rate of interest to be allowed, and the disposition of a profit realized on the sale of foreclosed real estate, the theory on which an apportionment is made is important. In the earlier cases [4] in which the life tenant was awarded "equitable income", such award was made not on any theory of equitable conversion, nor upon any theory of "salvage" or investment, but purely upon equitable considerations. In subsequent cases it was said that the real estate acquired by the trustee upon foreclosure was to be regarded as personalty, and this upon the principle of equitable conversion.[5] It is difficult to determine from these cases what circumstances operated to effect such a conversion. Presumably it was the fact that normally a trustee has no right to hold real estate as a trust investment, and is under a duty to dispose of such property as soon as possible. The introduction of the conversion theory into the cases immediately suggested to practitioners in this field the related cases in which a trustee held unproductive real estate under an imperative power of sale. In these cases, too, the trustee's duty to convert as soon as practicable is held to effect an equitable conversion, with the result that the life tenant is permitted to share in the proceeds of sale. The analogy was strong and furnished an additional ground for the apportionment of such proceeds. A further argument for apportionment was developed in the so-called "investment" theory, under which it is said that the bid of the trustee at the foreclosure sale represents both principal and unpaid interest and that the respective parties have an investment in the realty such that each should share in the proceeds of ultimate sale.[6]

The Court of Appeals in the *Chapal* case allows an apportionment of the proceeds, but apparently does not adopt any of the existing theories. It summarily dismisses the close analogy of cases in the field of trusts of unproductive real estate. The theory of the court is expressed in the following language of Judge Loughran:

> "In such an investment situation what is involved is the salvage of a security. The security, it is to be remembered, is a security, not for principal alone, but for income as well. . . ." [7]

4. Roosevelt v. Roosevelt, 5 Redf. Surr. 264 (N. Y. Surr. Ct. 1881); *In re* Moore, 54 L. J. Ch. (N. S.) 432 (1885); Meldon v. Devlin, 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); Hagan v. Platt, 48 N. J. Eq. 206, 21 Atl. 860 (Ch. 1891).

5. See Matter of Marshall, 43 Misc. 238, 88 N. Y. Supp. 550 (Surr. Ct. 1904); 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); *In re* Park's Estate, 173 Pa. 190, 33 Atl. 884 (1896).

6. See Parker v. Seeley, 56 N. J. Eq. 110, 38 Atl. 280 (Ch. 1897).

7. 269 N. Y. 464, 472 (1936). Judge Loughran's language is here suggestive of the jargon employed in Matter of Marshall. The distinction between the so-called "salvage" and "investment" theories is not sharply defined. In a profit case, however, it might be supposed

This is not quite the same as the investment theory, since Judge Loughran's argument apparently is that the real estate represented security for both principal and interest from the very outset, rather than an investment of principal and unpaid interest after default and foreclosure.

The Court of Appeals declined to decide the question of the rate of interest to be allowed for the period of default. Under the theory of apportionment adopted, however, it seems probable that the court will allow a uniform rate for the entire period of default, rather than allow the mortgage rate for the period up to foreclosure and the prevailing rate thereafter, as in *Matter of Marshall.* The practice of allowing the prevailing rate of interest for the period following foreclosure was largely due to the influence of the equitable conversion theory. This theory gives the life tenant the prevailing rate of interest for trust investments generally from the moment the conversion takes place, and the real estate is thereafter regarded as metamorphosed into a productive investment. Since the conversion theory has been rejected by the Court of Appeals as a basis for apportionment, it seems inevitable that the court will allow a uniform rate of interest for the entire period of default. Probably this will be the mortgage rate,[8] although conceivably the court might allow the prevailing rate throughout, as has been done in related cases.[9]

The theory on which apportionment is based is also of importance in the disposition of a profit resulting from the ultimate sale. Normally any profit so resulting belongs to *corpus,* and it is only through some theory such as that of the dual investment of funds of life tenant and remainderman that the life tenant is permitted to share in the surplus over the principal invested plus the amount of interest which he would have received had the investment proved successful. Since the Court of Appeals simply regards the real estate as security for the amount of interest due under the mortgage, it is unlikely that it would permit the life tenant to share in such a surplus.[10] It would seem, however, that the acquisition of the real estate is literally a "joint venture", and that the life tenant should share proportionately in the success of the venture.[11]

With regard to carrying charges, the Court of Appeals repudiated the rule laid down in *Matter of Marshall,* and adopted the view taken by the New

that under the "salvage" theory the life tenant would be satisfied to recover the amount of interest due under the mortgage, while under the "investment" theory he might expect to share in any surplus realized on the ultimate sale.

8. In Matter of Hutter, N. Y. L. J., Jan. 23, 1936, at 416 (N. Y. Surr. Ct. 1936; decided *after* Matter of Chapal), the mortgage rate was allowed for the entire period of default. Surrogate Wingate said: "The whole theory of the allowance of interest, as such, at all, is that the vanished obligation of the bond still continues in existence until the date of the final liquidation. If this theory is to be considered valid in any connection it should apply throughout, and the rate reserved therein should govern."

9. *Cf.* Roosevelt v. Roosevelt, 5 Redf. Surr. 264 (N. Y. Surr. Ct. 1881); Cox v. Cox, L. R. 8 Eq. 343 (1869).

10. Such a result would be in accord with the only New York case on the point. See Schoonmaker v. Van Wyck, 31 Barb. 457 (N. Y. Sup. Ct. 1860).

11. See RESTATEMENT, TRUSTS (1935) § 241, comment *c.*

Jersey courts and the Restatement of Trusts, namely, that such charges should be initially allocated to principal and thereafter deducted from the gross proceeds of sale and returned to principal. As was pointed out in a previous installment,[12] the rule adopted leads to a somewhat fairer result, particularly when the carrying period is protracted.

The Court of Appeals was not confronted with the difficult questions of the disposition of surplus rents over carrying charges, liquidation by means of Home Owners' Loan Bonds, and apportionment where a purchase money mortgage represents a part of the sale price.[13]

12. See 84 U. OF PA. L. REV. at 342.

13. In Matter of Hutter, N. Y. L. J., Jan. 23, 1936, at 416 (N. Y. Surr. Ct. 1936), cited note 8, *supra*, the principle of apportionment was applied to a liquidation by means of H. O. L. C. bonds. Surplus rents existing after carrying charges were paid were used to pay the expenses incurred in acquiring the property.