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BANKS AND BANKING -TRUSTS - RIGHT OF BANK TO SELL PARTICIPATING TRUST CERTIFICATES IN SELF-OWNED PROPERTY

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RECENT DECISIONS

BANKS AND BANKING — TRUSTS — RIGHT OF BANK TO SELL PARTICIPATING TRUST CERTIFICATES IN SELF-OWNED PROPERTY — In 1923 the trust company entered into a transaction with the land company by which the land company borrowed $130,000 with which it purchased a city property for slightly less than that amount and gave title to the trust company as security for the loan. Through a series of loans later negotiated the trust company came to have an investment of $150,000 in the property. In 1926 the trust company made an agreement with the land company pursuant to which the trust company declared itself trustee of the property at an appraised value almost fifty per cent above the purchase price, and then sold participating mortgage trust certificates to the general public for the full amount of its loan investment. Plaintiff, one of the purchasers of the certificates, brought a class action against the superintendent of banks after the trust company had been declared insolvent, asking for judgment in the amount of the money paid for the certificates, for a declaration to the effect that the trust was void, and for a judgment setting aside the sale of the property to the trust, and holding the money invested in the property for the benefit of the certificate holders. *Held*, relief granted as prayed. *Haggerty v. Squire*, 137 Ohio St. 207, 28 N. E. (2d) 554 (1940).

This case raises the question whether a trust company can unload one of its bad investments on the general public by declaring itself trustee of the property or mortgage and selling participating trust certificates to investment buyers. It has long been the rule that a trustee cannot sell its own property to the trust account without breaching the duty of loyalty owed to the beneficiaries,[1] and this rule has been held to cover the cases in which the trustee sells participation certificates in its own property to its trust accounts.[2] In the Ohio case of *Ulmer v. Fulton*[3] a banking and trust company had created participating trust certificates in mortgages held by its banking department, and then sold the certificates to the general public. The Ohio Supreme Court held this creation and sale void on the grounds that the statutes allowing the formation of trust companies did not expressly authorize the trust company to do more than accept or receive trust property, and thus the act of the trust company in creating the participating certificates out of its own assets was an ultra vires act. The basis upon which this decision was placed was broad enough to cover both the situation in which the certificates were sold to the accounts already held by the trust company, and that in which the sale of the certificates was to the general public. At the time the decision was handed down in the *Ulmer* case it was widely criticized both as being a narrow construction of the statutes, and as destroying a lucrative

[1] Magruder v. Drury, 235 U. S. 106, 35 S. Ct. 77 (1914); Joliet Trust & Savings Bank v. Ingalls, 276 Ill. App. 445 (1934); In re Riordan's Will, 216 Iowa 1138, 248 N. W. 21 (1933); McAllister v. McAllister, 120 N. J. Eq. 407, 184 A. 723 (1936), affd. 121 N. J. Eq. 264, 190 A. 52 (1937); In re Harbeck's Estate, 142 Misc. 57, 254 N. Y. S. 312 (1931).

[2] 39 MICH. L. REV. 345 (1940).

[3] Ulmer v. Fulton, 129 Ohio St. 323, 195 N. E. 557 (1935).

source of investment for small accounts.[4] Under the facts found in the present case, the decision could have been placed upon the doctrine laid down in the *Ulmer* case.[5] The court chose, however, to look to the element of the breach of duty of loyalty owed by a trustee as being the real grounds for its decision.[6] Thus it seems that the court has changed its approach to this question. In the syllabus [7] the court states that where the trust company participates in the sale of these overvalued certificates "without disclosing to the purchasers of such certificates information within its knowledge affecting the value of such certificates" it is guilty of violating the duty of loyalty which it owes to the beneficiaries. The fault of the trust company then lies in its failure to disclose to the purchasers, but a prohibition of sale upon this basis is not nearly as broad as it was under the former rule denying that the trust company had the power to create the trust, and thus it seems that the Ohio court may have chosen to abandon the rule formerly followed. There are strong policy arguments against allowing trust companies to unload their own bad investments on the general public, but if the court is going to follow the rule of the present case in order to effect this policy, it must recognize the objections raised by the minority justices in their dissenting opinion. The general situation of this case is merely that of an investment firm's issuing and selling securities to the investing public. Yet, because the trust device was employed, the court has seen fit to apply the duties and obligations of trust law thereto, despite the fact that it is difficult to find a breach of duty in the trustee. The duties of the trustee arise from the relationship of trustee and beneficiary, but in the case in which the certificates are sold to the

[4] It was urged by counsel for the trust company that the present case would not come within the rule of the Ulmer case since the property was not that of the trust company but that of the land company, and hence that the trust company had not created the trust out of its own assets. However, the Supreme Court of Ohio was explicit in pointing out that legal title to the property had passed to the trust company as security for the loan; that this was not a mortgage transaction, for to view it as such wouid impute to the trust company a violation of Ohio Gen. Code (Page, 1937), § 710-112, the section limiting the amount to be loaned by banking institutions upon real estate; that any equity which remained to the land company would be only the difference between the amount loaned on the property and any sale price which could be obtained, and inasmuch as the amount of the loan exceeded the purchase price by approximately twenty per cent, this would be small; that in effect, then, the trust company held legal title and most of the equitable title to the asset out of which the trust participations were created.

[5] Noted in 33 MICH. L. REV. 1118 (1935); 36 COL. L. REV. 314 (1936); 9 UNIV. CIN. L. REV. 490 at 492 (1935); 2 OHIO ST. UNIV. L. J. 192 (1936).

[6] There are two reasons for believing that the court in this case rests its decision on the doctrine of the breach of the duty of loyalty rather than the doctrine that the act of the trust company was ultra vires: (1) because the syllabus, which in Ohio is the court's statement of the law, does not contain any reference to the question whether the act of the trust company was authorized; and (2) because the sole point of difference between the majority and dissenting opinions is that there was no breach of duty of trusteeship existent at the time of breach. Certainly the question whether the act was authorized by the statutes would have to be considered before there could be any decision whether the act as done was legal or illegal.

[7] In Ohio the syllabus by the court is the statement of the law of the case.

general public, that relationship does not arise until after the sale is made. Thus it does not seem that the trust company owed any duty to the cestuis at the time it declared itself trustee of the overvalued certificates, for they were not in any relationship with the trust company then. At the time of the sale of the certificates it would seem that the principles of vendor and vendee would apply rather than those of trustee and beneficiary, and in the absence of actual fraud it would be impossible to hold the trust company liable. The most satisfactory approach to this problem seems to be that used in recent legislation [8] which allows trust companies to issue participation interests in security pools, but prohibits the sale of these participations to any but trust accounts. Thus the dangers arising from sale to the general public are avoided by absolute prohibition, while at the same time the advantages of the participating trusts can be made available to trust accounts. If any attempt should be made by the trust company to unload its bad investments to its trust accounts under such a statute, a remedy could be afforded by surcharging the account of the trustee.[9]

[8] Pa. Ann. Stat. (Purdon, 1939), tit. 7, § 819-1109, and amendment of June, 1939 (P. L. 1939, p. 726).

[9] 2 SCOTT, TRUSTS, § 170.14 (1939).