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## TRUSTS - FORECLOSURE OF MORTGAGE HELD BY TRUSTEE - DISPOSITION OF PROCEEDS OF SALE

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TRUSTS — FORECLOSURE OF MORTGAGE HELD BY TRUSTEE — DISPOSITION OF PROCEEDS OF SALE — Trustees foreclosed mortgages in which they had invested trust funds and which were in default. Sale of the land brought less than the principal and interest of the mortgages. Beneficiaries of the trust sued for an accounting to determine the respective rights of life tenant and remaindermen to the proceeds of the sale. *Held*, the net proceeds were to be apportioned between life tenant and remaindermen. To be treated as principal was a sum which, if invested at the rate of interest current for trust investments, would have produced during the period from default till final sale an income which with principal sum would equal the net proceeds of the sale.

Regular carrying charges which had been paid out of trust principal were to be repaid in full before apportionment. But the life tenant was to receive interest at the current rate on such advances. *In re Nirdlinger's Estate*, 327 Pa. St. 160, 193 A. 33 (1937).<sup>1</sup>

When a settlor has directed payment of income to a trust beneficiary and the res comprises property which is yielding no substantial return,<sup>2</sup> it is generally the trustee's duty to sell such property and convert it into a normally productive investment.<sup>3</sup> But he may delay selling if that course seems wisest. Then a kind of equitable conversion takes effect as of the date the "duty to sell" arose; and the proceeds of the sale will be apportioned between principal and income accounts.<sup>4</sup> Where the property has been unproductive from the inception of the trust, it has been thought that an equitable conversion had to be justified by an intent of the settlor that the property be disposed of.<sup>5</sup> Since often the settlor neither expresses nor has any clear intent, many cases purporting to be decided on that basis are confusing.<sup>6</sup> There is no excuse for confusion, however, where property becomes unproductive after the establishment of the trust.<sup>7</sup> And the rule of apportionment is well established for cases of foreclosure of defaulted mortgages and sale of the land.<sup>8</sup> Two formulae of apportionment have been stated: one utilizes a ratio;<sup>9</sup> the other is the recapitalization method of the principal case. They are easily demonstrated to be mathematical equivalents.<sup>10</sup> The chief questions at present are three: Shall the

<sup>1</sup> The same case in the Superior Court is noted in 85 UNIV. PA. L. REV. 126 (1936).

<sup>2</sup> 1 TRUSTS RESTATEMENT, § 241 (1935), "substantially less than the current rate . . ."; Uniform Principal and Income Act, § 11 (1): "Where any part of a principal . . . has not produced an average net income of at least one per centum per annum of its fair inventory value or in default thereof its market value at the time the principal was established. . . ." 9 UNIFORM LAWS ANNOTATED, 196 (Supp. 1936). The uniform act has been adopted in North Carolina, Oregon, and Virginia. N. C. Pub. Laws (1937), c. 190, p. 403; Ore. Code Ann. (Supp. 1935), § 63-1201; Va. Acts (1936), c. 432, p. 1024.

<sup>3</sup> 3 BOGERT, TRUSTS AND TRUSTEES, § 611 (1935).

<sup>4</sup> 4 BOGERT, TRUSTS AND TRUSTEES, § 825 (1935).

<sup>5</sup> 4 BOGERT, TRUSTS AND TRUSTEES, § 825 (1935). See 40 YALE L. J. 275 (1930).

<sup>6</sup> See 40 YALE L. J. 275 (1930).

<sup>7</sup> No question of intent is involved. *Matter of Chapal*, 269 N. Y. 464 at 472, 199 N. E. 762 (1936).

<sup>8</sup> 4 BOGERT, TRUSTS AND TRUSTEES, § 820 (1935); 40 YALE L. J. 275 at 279, note 20 (1930). The Uniform Principal and Income Act, § 11, restricts income's portion to no more than the excess of the proceeds over the inventory value. 9 UNIFORM LAWS ANNOTATED 196 (Supp. 1936).

<sup>9</sup> Income, e.g., gets that proportion of the proceeds that the unpaid income bears to the principal invested plus that income. See Bailey and Rice, "Duties of Trustee with Respect to Defaulted Mortgage Investments," 84 UNIV. PA. L. REV. 157 at 173 (1935), 327 (1936). This is the formula stated by all previous cases except *Roosevelt v. Roosevelt*, 5 Redf. 264 (N. Y. Surr. 1881). The recapitalization formula of the principal case is taken from 1 TRUSTS RESTATEMENT, § 241 (1935).

<sup>10</sup> See 49 HARV. L. REV. 805 (1936).

life tenant's income on the hypothetical principal be calculated at the mortgage rate or at the prevailing rate for trust investments? Shall income be calculated only during the existence of the mortgage, i.e., till foreclosure, or till sale of the land? Who shall bear the expenses of foreclosure, sale, and holding of the land? The English rule allows interest at the mortgage rate and only until foreclosure.<sup>11</sup> In this country, however, due at least in part to a misunderstanding of the English precedent,<sup>12</sup> the practice of allowing interest till the date of sale has become well established.<sup>13</sup> The interest rate may be that of the mortgage,<sup>14</sup> or the current rate,<sup>15</sup> or the mortgage rate till foreclosure and the current rate thereafter.<sup>16</sup> Expenses of carrying the property may be charged to income<sup>17</sup> or part allocated to principal.<sup>18</sup> Where the problem of allocation

<sup>11</sup> *In re Moore*, 54 L. J. (N. S.) (Ch.) 432 (1885); *In re Horn's Estate*, [1924] 2 Ch. 222.

<sup>12</sup> *In Hagan v. Platt*, 48 N. J. Eq. 206, 21 A. 860 (1891); followed, *Meldon v. Devlin*, 31 App. Div. 146, 53 N. Y. S. 172 (1898), *affd.* 167 N. Y. 573, 60 N. E. 1116 (1901). But *Roosevelt v. Roosevelt*, 5 Redf. 264 (N. Y. Surr. 1881), had reached a similar result quite independently. Cf. note 16.

<sup>13</sup> *Matter of Chapal*, 269 N. Y. 464, 199 N. E. 762 (1936); *Matter of Pelcyger*, 157 Misc. 913, 285 N. Y. S. 723 (1936). The latter gives very full consideration to the problems involved and follows only under protest the practice of allowing interest after foreclosure. *Trenton Trust & Safe Deposit Co. v. Donnelly*, 65 N. J. Eq. 119, 55 A. 92 (1903); approved, *Equitable Trust Co. v. Swoboda*, 113 N. J. Eq. 399, 167 A. 525 (1933). 1 TRUSTS RESTATEMENT, § 241 (2) (1935).

<sup>14</sup> *In re Horn's Estate*, [1924] 2 Ch. 222; *Hagan v. Platt*, 48 N. J. Eq. 206, 21 A. 860 (1891); *Meldon v. Devlin*, 31 App. Div. 146, 53 N. Y. S. 172 (1898); *Matter of Pelcyger*, 157 Misc. 913, 285 N. Y. S. 723 (1936).

<sup>15</sup> *Roosevelt v. Roosevelt*, 5 Redf. 264 (N. Y. Surr. 1881); *In re Phelps' Estate*, 162 Misc. 703, 295 N. Y. S. 840 (1937). In both cases mortgages were left by the settlor. See note 16.

<sup>16</sup> *Matter of Otis*, 158 Misc. 808, 287 N. Y. S. 758 (1936). This was said to be the rule in New York in *Vaughan*, "Salvage of Mortgages by Trustees," 37 COL. L. REV. 61 (1937).

The Uniform Principal and Income Act, § 11, allows 5 per cent in all cases. 9 UNIFORM LAWS ANNOTATED 196 (Supp. 1936). But a distinction seems to be drawn in that state between cases where the settlor has left the mortgages and those where trustees have invested in them. In the former situation interest is computed at the current rate just as in other cases of equitable conversion of property unproductive at the testator's death. *Roosevelt v. Roosevelt*, 5 Redf. 264 (N. Y. Surr. 1881); *In re Phelps' Estate*, 162 Misc. 703, 295 N. Y. S. 840 (1937). Apparently no distinction is made by the Restatement. Compare illustrations 1 and 4, 1 TRUSTS RESTATEMENT, § 241 (1935).

<sup>17</sup> Where charges have been advanced from principal, they should be repaid before apportionment. *Matter of Chapal*, 269 N. Y. 464, 199 N. E. 762 (1936); see 4 BOGERT, TRUSTS AND TRUSTEES, § 827 (1935); 1 TRUSTS RESTATEMENT, § 241, comment e, illustration 4 (1935).

<sup>18</sup> One method of accomplishing this where principal has advanced the charges is to apportion the whole proceeds without having reimbursed principal. Then life tenant and remainderman pay the expenses in a ratio inverse to that of their respective interests in the proceeds. *Trenton Trust & Safe Deposit Co. v. Donnelly*, 65 N. J. Eq.

of expenses has arisen separately, cases go off in every conceivable direction.<sup>19</sup> Answers to the questions put above will be influenced by the reasons adopted for ordering apportionment. If the reason is that the mortgage is security for both income and principal,<sup>20</sup> interest should be at the mortgage rate and perhaps only during continuance of the mortgage. No clue is given to allocation of expenses. If it is that life tenant and remainderman are engaged in a joint venture to salvage their respective interests, each risking the amount he would have received from the mortgage investment, it seems logical that income should be at the mortgage rate till foreclosure, then at the prevailing rate.<sup>21</sup> It would seem also that expenses of the joint venture should be borne in the ratio of the respective interests. If it is that the settlor's first care was for the support of the life tenant,<sup>22</sup> income should be maintained at any cost to principal. Apparently no such drastic rule has ever been advanced. The rule of the *Trusts Restatement*, here adopted, is based only on general equity and the duty of the trustee to make principal normally productive. In the absence of an expression of the settlor's intent, principal and income should be kept in the normal ratio they would have shown if the trust investments had remained unimpaired. It is submitted, however, that an apportionment of expenses would be more in keeping with this philosophy. In a normal situation the expenses would never have arisen, would not be borne by either beneficiary.

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119, 55 A. 92 (1903); but see *Equitable Trust Co. v. Swoboda*, 113 N. J. Eq. 399, 167 A. 525 (1933).

<sup>19</sup> See *Matter of Pelcyger*, 157 Misc. 913 at 930, 285 N. Y. S. 723 (1936); *Bailey and Rice*, "The Duties of A Trustee with Respect to Defaulted Mortgage Investments," 84 UNIV. PA. L. REV. 157 (1935), 327 at 330 (1936).

<sup>20</sup> *In re Atkinson*, [1904] 2 Ch. 160 at 165.

<sup>21</sup> *Bailey and Rice*, "The Duties of a Trustee with Respect to Defaulted Mortgage Investments," 84 UNIV. PA. L. REV. 157 at 176 (1935), 327 (1936).

<sup>22</sup> *Matter of Marshall*, 43 Misc. 238 at 243, 88 N. Y. S. 550 (1904).