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TRUSTS — MORTGAGE PARTICIPATIONS AS TRUST INVESTMENTS — EFFECT OF INVALIDITY — The Commercial Savings Bank and Trust Company of Toledo, Ohio, in March 1931, executed an instrument called a Declaration of Trust, in which it recited that it had transferred to its trust department certain notes and mortgages for the purpose of issuing certificates of participation therein.[1] The notes alone were physically transferred to the trust department, the mortgages being retained by the real estate loan department of the bank. The real estate loan department also collected the interest and principal on the notes transferred to the trust department. The Declaration of Trust expressly authorized the trust department to make substitutions in the mortgages constituting the trust fund. In August 1931, the bank became insolvent and the Superintendent of Banks took it over for liquidation. Through two actions, one brought by a certificate holder and the other by a general depositor, it was *held*, that the trust is invalid and the certificate holders will be placed in the position of general creditors of the bank. *Ulmer v. Fulton, Superintendent of Banks*, 129 Ohio St. 323, 195 N. E. 557 (1935).

Mortgage participations have come into widespread use in recent years as a form of trust investment,[2] and have received growing statutory approval.[3] Their principal advantage lies in the possibility of combining funds of numerous small trusts into a single amalgamated fund, thus securing more favorable terms than would be possible through separate investment by each. In the larger cities, where mortgages suitable for investment by trustees often run into large figures, this device opens up a desirable field for investment and has the further advantage of providing a market for large-scale borrowers of money. Although the authorities on the validity of this arrangement are not numerous, the New York Court of Appeals has given its approval,[4] and a very recent decision in Minnesota has held the mortgage participation to be a proper form of trust investment.[5] The condemnation of this device by the Ohio court in the principal case proceeds, first, from an exceedingly narrow construction of the state statute defining the powers of trust companies.[6] From an analysis of this statute the court concluded

[1] Two other similar trusts were set up by the same bank, one in 1929 and one in 1930, and the validity of these was also at issue in the principal case. For simplicity in discussion, attention will here be confined to the trust attempted to be set up in 1931.

[2] See MCKINNEY, TRUST INVESTMENTS 24 *et seq.* (1927).

[3] Citations to statutes are collected in 41 YALE L. J. 455 at 460 (1932). And see Case of U. S. Bank and Trust Co., 311 Pa. 320, 166 Atl. 871 (1933).

[4] In re Union Trust Co., 219 N. Y. 514, 114 N. E. 1057 (1916).

[5] Bowden v. Citizens' Loan and Trust Co., (Minn. 1935) 259 N. W. 815. It is interesting to note that this case, decided one month before the principal case, refers to Ohio legislation as authorizing investment by trust companies in mortgage participations. *Ibid.*, 259 N. W. at p. 819.

[6] The court quoted (195 N. E. 557 at 561) the following provisions of the Ohio Code and itself italicized the passages here given in italics:

"Sec. 710-156. A trust company may *receive and hold* moneys, or property

that it was *ultra vires* for a combined bank and trust company to create a trust out of its own assets and to sell participation certificates therein to the public. The language of the court is broad enough to include the assignment of its own assets to express trusts already set up by will or *inter vivos* deed, even where there is no knowledge or consent by the cestui. In support of its general conclusion the court argued that to allow the practice in question would open the door to abuses, for the opportunity would be afforded the bank to place high grade securities in the trust fund and to leave the poorer securities among the general assets of the bank to the prejudice of the depositors. But it would seem that the bank's depositors cannot complain if in exchange for the transferred securities the bank has received cash equivalent in value to such securities. If the power of substitution provided in the particular case opened an avenue to the abuses feared by the court, it would seem that this is in itself no reason for a universal condemnation of the mortgage participation and that the remedy should lie in a surcharging of the trustee for improper conduct rather than in making the holders of participation certificates general creditors of the bank in all cases.[7]

in trust, or on deposit from executors, administrators, assignees, guardians, trustees, corporations or individuals upon such terms and conditions as may be agreed upon between the parties.

"Sec. 710-159. A trust company may act as agent, and *take, accept and execute* any and all trusts, duties and powers in regard to the holding, management and disposition of any property or estate, real or personal, which may be committed or transferred to, or vested in said trust estate. . . .

"Sec. 710-164. In the management of money and property *held* by it as trustee, such trust company may invest such money and property in a general trust fund of the trust company. . . .

"Sec. 710-165. No property or securities *received or held* by any trust company in trust shall be mingled with the investments of the capital stock or other properties belonging to such trust company or be liable for its debts or obligations."

From all these passages together the court draws the inference that the trust company cannot itself set up a mortgage participation plan and that it can merely *accept* trusts created by third parties. But section 710-164 indicates that trust funds can be transferred to a "general trust fund" set up by the trust company, and would seem to indicate that such a general fund can be carved out of assets held by the trust company in essentially the manner proposed under the plan in question. The extremely technical construction adopted in the principal case is further indicated by the obstacle it would raise to the purchase of mortgages or other legal investments for the purpose of *future allocation* to existing trusts. If the securities so purchased were not assigned to specified trusts immediately on acquisition, it would seem that the trust company was attempting to impose a trust on "its own assets" and that its acts would be throughout *ultra vires*. In short, extreme inconvenience must result from a literal construction of the powers of "accepting" and "holding" property transferred to it in trust. Far greater flexibility is required for ordinary administration, both in changing trust investments already made and in purchasing securities for *future allocation* to trusts now existing or to be created in the future.

[7] The principal case involves certificates purchased for investment by persons having full knowledge of all the provisions of the Declaration of Trust. It therefore does not conclude, except by implication, the rights of beneficiaries of express trusts set up by will or *inter vivos* deed, in cases where such beneficiaries had no notice of the terms of the plan and were in no position to object (e.g., as in the case of minors). Clearly

In support of its general conclusion that the issuance of mortgage participation certificates is *ultra vires*, the court further argued that the profit of one per cent interest realized by the trustee rendered the plan invalid. The effect of this argument is considerably diminished by cases allowing a trust company, for very strong reasons of convenience, to deposit trust funds in its own banking department, even though it realizes a profit in so doing.[8] The Supreme Court of Minnesota in its recent decision on the subject held that the trust company's profit of one-half of one per cent did not make the mortgage participation an improper form of trust investment, indicating that this represented merely compensation to the trustee for its service in securing and maintaining the investment.[9] Furthermore, as far as the depositors of the bank are concerned, if any profit resulted from the plan, it enured to their benefit. In any event, it would seem that if the element of trustee's profit made the plan objectionable only the certificate holder should be allowed to complain and at his election to affirm or disaffirm the plan.[10] In the particular case it would be easy to infer consent by the purchasers of participation certificates to the trustee's profit, and familiar principles of trust law permit the cestui, after full disclosure of all the facts, to validate a transaction of this character, assuming that it would otherwise be voidable.[11] The question should be asked in this connection, as in connection with the power of a trust company to assign its own assets to the trust fund, whether the remedy for improper conduct of the trustee should be to make the certificate holder a general creditor in all cases. If it should appear that the securities remaining in the trust fund on the trustee's insolvency exceeded in value the amount that would be realized through an unsecured claim on the bank's general assets, the certificate holder should be given an election between pursuing the assets allocated to the trust and a general claim against the insolvent trustee.

To reinforce its general conclusion that the certificate holder must be a general creditor in all cases, the court argued that on the facts of the particular case no intention was shown to create a trust. The chief difficulty felt by the

such persons should have election between surcharging the trustee and pursuing the assets allocated to the trust fund at the time of insolvency. In the principal case the holder of the participation certificate demanded to be allowed to prove as a general creditor, since in the particular case he would gain more by that means. But the reasoning of the court would force all certificate holders in all cases to assume the rank of general creditors, without regard to the manner in which the certificate was acquired, and without regard to the effect on the holder's claim. Reasoning so broad as this seems unnecessary to the decision and it is to be hoped that the court will later qualify it.

[8] See the cases discussed in 23 COL. L. REV. 465 (1923); 31 MICH. L. REV. 532 (1933); 44 HARV. L. REV. 1281 (1931); and also RESTATEMENT OF THE LAW OF TRUSTS, Tentative Draft No. 2, sec. 165, comment g, p. 136 (1931). The Ohio Code specifically authorizes the deposit of funds awaiting distribution or investment in the banking department of the trust company. Ohio Code, sec. 710-165.

[9] Bowden v. Citizens' Loan and Trust Co., (Minn. 1935) 259 N. W. 815 at 816.

[10] See RESTATEMENT OF THE LAW OF TRUSTS, Tentative Draft No. 2, sec. 165, p. 80 *et seq.* (1931).

[11] See RESTATEMENT OF THE LAW OF TRUSTS, Tentative Draft No. 2, sec. 165, p. 80 *et seq.* (1931).

court was in finding a definite trust res, since the power to withdraw the securities already allocated and substitute others gave too complete a control over the identity of the res to the trustee. The court also pointed to the retention of the mortgages in the real estate loan department of the bank and the collection of interest and principal of the notes by the real estate loan department. But the use of the bank's facilities in collecting and administering the securities allocated to the trust can be justified merely by the convenience of such an arrangement. Since the bank and trust company constituted a single legal entity, economically unified as well, it would seem that the mere allocation of the mortgages in question, without physical transfer, should suffice. As certificates were sold the trust department received mortgages equal in amount to the outstanding certificates, and neither bank examiners nor officers of the institution would have had the slightest difficulty in determining which securities were earmarked for the trust fund. The fact that interests in particular mortgages were never specifically allocated to particular certificate holders would seem to be no objection, since each certificate could be analyzed as a claim on the total undivided fund.[12] The court's condemnation seems to concentrate on the power of substitution possessed by the trustee, a power which does not differ analytically from the power to change trust investments which trustees ordinarily possess by implication and which trust instruments now confer almost as a matter of routine. Admittedly there are dangers in permitting too free a transfer of securities between the trust fund and the general assets of the bank. The temptation to raid the trust fund to support a failing bank or (less probably) to raid the bank's assets to preserve the assets of the trust fund, would expose both depositors and certificate holders to exceptional risks. The court's feeling that the arrangement in question gave exceptional opportunities for wrongdoing to faithless fiduciaries was, from this point of view, entirely justified. If the trustee under such an arrangement is to be given the power to remove particular securities from the fund, it should be for the purpose of sale to third persons and not for transfer to another department of the same institution. But too wide a power in this respect should not have the effect of making the whole arrangement *ultra vires* or of preventing the imposition of a trust on the securities actually found in the fund at the time of the trustee's insolvency.

In the effort to punish officials of trust companies for exposing themselves to temptation, the Ohio Supreme Court has thrown a heavy loss on the purchasers of participation certificates (whose good faith was at no time impugned),[13] has

[12] Sec. 710-164 of the Ohio Code, referred to above, note 6, expressly authorizes the investment of money or property held in trust "in a general trust fund of the trust company."

[13] The injustice of depriving certificate holders of any effective remedy is admitted by the court in the principal case in the following language (129 Ohio St. at p. 342, 195 N. E. 557 at 565):

> "Of course, the holders of the participation certificates are not without relief. Actual knowledge of the invalidity of the 'trusts' is not fairly chargeable to them. To hold under the circumstances that their money is irretrievably gone would be inequitable and unconscionable. If the Commercial Savings Bank & Trust Company were a going, solvent institution, the participation certificate holders would be entitled to demand and receive the full amount paid for their certificates, the

threatened with similar loss the beneficiaries of express trusts (many of whom were in no position to repudiate the trustee's conduct),[14] and has announced rules for trust administration that will probably require legislative intervention.[15] At the same time the court has thrown its weight heavily against the development of the mortgage participation as a normal form of trust investment and has imperiled this device at a time when its legal standing is still insecure.[16]

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bank having been enriched by the receipt of their money; but the bank is insolvent, the purported trusts are invalid; and the rights of other persons are to be considered and protected. We do not see how the certificate holders can be placed in any better position than general creditors of the bank."

[14] As is pointed out above, note 7, the principal case does not involve money already subject to an ordinary testamentary or *inter vivos* trust, which was then invested in participation certificates without the cestui's knowledge or consent. There seems to be no room, under the reasoning of the principal case, for more favorable treatment of such claimants, but it is to be hoped that elementary doctrines of trust law can be applied for their protection, through the imposition of a constructive trust on the traceable proceeds of the trust property.

[15] See above, note 6, for suggestions as to the extreme inconvenience which will probably result from the court's construction of the Ohio legislation on the powers of trust companies.

[16] It seems probable, as a result of the principal case, that the mortgage participation will be held an improper form of trust investment in Ohio, even in its simplest and least obnoxious forms. For example, even if a mortgage were taken by a trust company for the specific purpose of allocation to particular trusts and no power of substitution were reserved, the arrangement would probably fall within the court's condemnation. If this conclusion is correct, a desirable and convenient form of trust investment is foreclosed in Ohio, and the reasoning of the principal case may have an unfortunate effect in other states. For a fuller discussion of the mortgage participation as a form of trust investment see 41 YALE L. J. 455 (1932).