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TRUST MORTGAGES - FUNDS DEPOSITED WITH THE TRUSTEE - RIGHT OF RECEIVER TO APPROPRIATE

TRUST MORTGAGES — FUNDS DEPOSITED WITH THE TRUSTEE — RIGHT OF RECEIVER TO APPROPRIATE — There are several important ways in which a receiver of a corporation may clash with the trustee under a trust mortgage as regards the use of funds deposited with the trustee. The receiver, who is acting for the benefit of the general creditors and the estate generally, often seeks to obtain funds in the hands of the trustee who represents the bondholders.[1] Not infrequently the trust deed from which the trustee derives his authority contains provisions for the setting up by the mortgagor of a sinking fund; or for the retention of money obtained through the release of properties from a mortgage lien; or for the holding of funds which are to be disbursed for certain payments as required by the trust deed. The litigation results from a refusal by the trustee either to turn over moneys held or to allow their use by the receiver.

The United States Circuit Court of Appeals, in the recent case of *First Union Trust & Savings Bank, et al. v. Bernardin,*[2] was presented with such problems in regard to a sinking fund and funds which were obtained by the release of properties from the mortgage by the trustee.

The trust deed provided as to these two classes of funds:

1. "The moneys so deposited with the Trustee . . . shall on and after the date so designated stand in lieu of the security of this inden-

[1] 3 THOMPSON, CORPORATIONS, 3d ed., sec. 2399 (1927); 7 FLETCHER, CYCLOPEDIA OF CORPORATIONS, perm. ed., sec. 3178 (1931); Breed v. Baird, 139 Ill. App. 15 (1907); Harvey v. Guaranty Trust Co., 134 Misc. 417, 236 N. Y. S. 37 (1929). For a very valuable article on the duties of the trustee generally see Posner, "Liability of the Trustee Under the Corporate Indenture," 42 HARV. L. REV. 198 (1928).

[2] (C. C. A. 8th, 1932) 60 F. (2d) 419.

ture and shall be held by the said Trustee for and be paid by it to the holders of the said bonds so called for redemption as and when the same, with all unpaid coupons attached thereto, shall be surrendered to the Trustee at any time thereafter. . . ."

2. The mortgagor was vested with the power to select specific bonds for payment out of these funds before the bonds became due and payable.

3. The trustee had the right to declare all the bonds due and payable on default by the mortgagor.

4. The trustee was vested with the power to pay any or all taxes on the properties, but was under no duty to do so.

The facts involved were substantially these: A bill to foreclose was filed by the trustee, thereby declaring all bonds due and payable. The trustee held more than $200,000 which was paid to it for the release of properties, and more than $3,500 in the sinking fund. The cash in the hands of the receiver of the mortgagor, who had theretofore been appointed under a creditor's bill, amounted to more than $90,000 which he alleged was necessary to carry on the business. There were taxes in default upon lands in Louisiana, which lands were included in the trust deed. Upon refusal by the trustee to pay these taxes after the receiver requested it to do so, the latter petitioned the court for an order to compel the trustee to pay the delinquent taxes.

The receiver alleged among other things that the land involved was of much greater value than the taxes then owing, that there was immediate danger of the land being sold by the State for the failure to pay these taxes, and that it was for the benefit of the estate that the tax lien be removed. The receiver further contended that so long as the mortgagor was not in default it could transform the funds into a special trust fund by requiring certain bonds to be paid out of the funds; but that the mortgagor having failed to exercise its right to select bonds for payment prior to default, the funds held by the trustee were but a part of the general security, differing only in kind from machinery, land, and other security held under the trust deed; that since these funds were part of the general security, the receiver was entitled to use any part of them for the purpose of preserving the property. The effect of accepting the receiver's theory, it should be noted, is to extend benefits to parties not included in the trust deed, and to appropriate to the preservation of the receivership estate security which the bondholders sought to retain for themselves.

The receiver prevailed in the trial court and the trustee was ordered to pay the taxes on the ground that it was necessary for the preservation of the receivership estate. However, the appellate court reversed the holding of the lower court on the ground that the order impaired the obligation of the contract. It reasoned that under the trust agreement

the mortgagor stipulated with the bondholders that the funds would only be used for the payment of the bonded indebtedness, and that the power vested in the mortgagor to select specific bonds for payment did not alter the character of the funds so as to authorize a court of equity to compel the use of the funds for any other purpose, such as the payment of taxes.

A trust deed is intended as security for a valid obligation, and equity, looking to substance rather than to form, likens it to a mortgage.[3] The several provisions of the present trust deed were an inducement for making the loan and were therefore a part of the consideration. There can be little or no doubt that the trust deed was a part of the loan contract.[4]

Unless the contrary is indicated, sinking funds ought to be considered cumulative security because they are generally so intended.[5] Here the agreement specifically provided that the sinking fund was for the benefit of the bondholders, and it was to be used only for redeeming bonds. In the face of such explicit language there can be no queston but that the fund was intended to be cumulative security.

It is a matter of elementary law that a mortgagee cannot be compelled to release any part of the property mortgaged until the entire obligation is satisfied,[6] and that he need not release prior to maturity even though the mortgagor tenders full payment and interest to the date of maturity.[7] Specific provisions to the contrary in the instrument are required to achieve a different result. Such provisions delimit the rights of the mortgagor to have the property released. Under the indenture involved in the present case the mortgagor, to obtain a release of its property, was to deposit with the trustee certain moneys to be used for a specified purpose, namely, to redeem bonds which the mortgagor had selected for redemption prior to default. After default the bonds became due and payable, and the release fund was to be disbursed

[3] Schroder v. Berlin Arcade Real Estate Co., 175 Wis. 79, 184 N. W. 542 (1921).

[4] That the trust indenture is a special contract. Posner, "Liability of the Trustee Under the Corporate Indenture," 42 HARV. L. REV. 198 at 204, n. 23 (1928). Authorities holding that the trust indenture is a contract: Wilds v. St. Louis, A. & T. H. R. R., 102 N. Y. 410, 7 N. E. 290 (1886); Truby v. M. & T. Trust Co., 141 Misc. 507, 253 N. Y. S. 108 (1931); Hall v. Nassau Consumers Ice Co., 260 N. Y. 417, 183 N. E. 903 (1933); Brackett v. Middlesex Banking Co., 89 Conn. 645, 95 Atl. 12 (1915); Independent Brewing Co. of Pittsburgh v. Colonial Trust Co., 273 Pa. 12, 116 Atl. 518 (1922).

[5] Generally, sinking funds are intended to be cumulative security for the payment of the debt with which they are connected. Tennessee Bond Cases, 114 U. S. 663 at 698, 5 Sup. Ct. 974 at 992, 29 L. ed. 281 at 293 (1885).

[6] Merritt v. Hosmer, 11 Gray (77 Mass.) 276 (1858); Gibson v. Crehore, 5 Pick. (22 Mass.) 145 (1827).

[7] 3 Tiffany, Real Property, 2d ed., 2588 (1920).

pro rata among the bondholders since none of the bondholders had any priority as to funds held by the trustee.[8] The mortgagor could not direct the trustee to use these moneys in any other manner since he could not have the benefits without the burdens of the agreement.

Did the appointment of a receiver for the properties of the mortgagor alter the rights of the bondholders as regards these funds? [9] The contract provided that the moneys deposited with the trustee were to stand in lieu of the security. The receiver did not question the validity of this agreement; and since the bondholders had a lien against the security they must now have a similar lien against the moneys. It is often said that the receiver has the power to defeat the priorities of the mortgagees when this is necessary to preserve the property. But this statement may be misleading. Thus in the instant case Louisiana lands were in jeopardy, but the funds held by the trustee were not in danger nor in need of preservation. The failure to pay taxes on these lands would in no way endanger the money held by the trustee. Parenthetically, the rule which allows the receiver to issue receiver's certificates having priority over the claims of the mortgagees for purposes of paying delinquent taxes when they are a lien on the land, works no injury upon the mortgagees since it involves a claim that is a preference at all times regardless of who tries to invoke it. It is not, therefore, a variation of the contract rights.[10] But it may be argued that courts of equity have authorized receivers to issue receiver's certificates having priority over the mortgagees where the preservation expense *was* a variation of the contract rights, such as for insurance, watchmen, and repairs.[11] The benefit from such expenditures accrues directly in favor

[8] TRACY, CORPORATE FORECLOSURES, sec. 50 (1929).

[9] It was said, in Brackett v. Middlesex Banking Co., 89 Conn. 645, 95 Atl. 12 (1915): "The receivers, as a general rule, can do what the insolvent company could have done; they take its [the corporation's] assets burdened with all valid liens and equities against it." Authorities to the same effect: CLARK, RECEIVERS, 2d ed., sec. 266 (1929); Wright v. Seaboard Steel & Manganese Corp., (C. C. A. 2d, 1921) 272 Fed. 807; Hanna v. State Trust Co., (C. C. A. 6th, 1895) 70 Fed. 2; Matter of Home Provident Safety Fund Ass'n, 129 N. Y. 288, 29 N. E. 323 (1891); Kennison v. Kanzler, (C. C. A. 6th, 1925); 4 F. (2d) 315; Geddes v. Reeves Coal & Dock Co., (C. C. A. 8th, 1927); 20 F. (2d) 48; Greenebaum v. General Forbes Hotel Co., (D. C. W. D. Pa. 1930) 38 F. (2d) 96; Montgomery Coal Corp. v. Allais, 223 Ky. 107, 3 S. W. (2d) 180 (1928); Lockport Felt Co. v. United Box Board & Paper Co., 74 N. J. Eq. 686, 70 Atl. 980 (1908); Cooke v. Warner, 56 Conn. 234, 14 Atl. 798 (1888); Clifford v. West Hartford Creamery Co., 103 Vt. 229, 153 Atl. 205 (1931); In re J. B. & J. M. Cornell Co., (D. C. S. D. N. Y. 1912) 201 Fed. 381; American Engineering Co. v. Metropolitan By-Products Co., (C. C. A. 2d, 1921) 275 Fed. 34; Raht v. Attrill, 106 N. Y. 423 (1887).

[10] Hanna v. State Trust Co., (C. C. A. 8th, 1895) 70 Fed. 2.

[11] Lockport Felt Co. v. United Box Board & Paper Co., 74 N. J. Eq. 686, 70 Atl. 980 (1908); Turner v. State Wharf & Storage Co., 263 Mass. 92, 160 N. E. 5[illegible] (1928).

of the bondholders, and therefore it is only just and equitable that they should be held subject to such disbursements.[12] But is it just and equitable to take from the bondholders liquid and certain security, and make them in turn seek reimbursement from security which is frozen and speculative? It should be noted that the preservation cases do not sanction the taking of security other than that which is protected.[13] It is generally held that the receiver cannot in the case of a corporation doing a private business appropriate the mortgagee's priority for purposes of continuing the business.[14] It is best for all that contract rights be rigidly construed and protected even though this may result in some injury to the general creditors.[15] All the parties concerned contracted with their eyes open. Why should the law penalize those who had the foresight to provide for themselves in case of future difficulties? If courts of equity should at their discretion change the rights of secured creditors in receivership cases, the security contracted for would be merely illusory.[16] This would handicap business, for in numerous cases necessary loans could not be obtained unless the borrower could give to the lender security, and no one would be able to give security under the rule contended for by the receiver in this case.

The trustee's position may be sustained on the theory that the provisions concerning the funds created an express trust in favor of the bondholders. All the essential elements of an express trust were here present.[17] The agreement provided for the specific subject matter, the trust purpose, the cestuis, and the trustee. The receiver argued that when the power of selection was lost the trust failed. But this proposition does not follow from the expressed terms of the indenture. The receiver's argument amounted to an assertion that the interest of the cestuis must be absolute in order to create an express trust. But that is not true. Revocable trusts are valid and binding as well as irrevocable

[12] Turner v. State Wharf & Storage Co., 263 Mass. 92, 160 N. E. 542 (1928).

[13] Cooke v. Warner, 56 Conn. 234, 14 Atl. 798 (1888): Held, that no part of the security could be used by the receiver to protect other property. In the International Trust Co. v. The United Coal Co., et al., 27 Colo. 246, 60 Pac. 621 (1900), it was held that in order to create a paramount lien on the corpus, the obligation incurred must relate strictly to the preservation of the property.

[14] CLARK, RECEIVERS, 2d ed., sec. 640 (1929); Farmers' Loan & Trust Co. v. Grape Creek Coal Co., (C. C. S. D. Ill. 1892) 50 Fed. 481; In re J. B. & J. M. Cornell Co., (D. C. S. D. N. Y. 1912) 201 Fed. 381; International Trust Co. v. Decker Bros., et al., (C. C. A. 9th, 1907) 152 Fed. 78; In re Regent's Canal Ironworks Co., 3 Ch. Div. 411 (1875); Banco Comercial de Puerto Rico v. District Judge of San Juan, 30 Porto Rico 26 (1921).

[15] Raht v. Attrill, 106 N. Y. 423 (1887).

[16] Banco Comercial de Puerto Rico v. District Judge of San Juan, 30 Porto Rico 26 (1921).

[17] BOGERT, TRUSTS, sec. 19 (1921): No particular form of words is necessary to establish a trust so long as the words used convey an intent to establish a trust.

trusts; they must be revoked in the manner and in accordance with the conditions of revocation.[18] The settlor here reserved a very limited power to change the purpose for which the funds were deposited. The indenture, in effect, provided that the funds should be used for *pro rata* distribution among the bondholders unless the settlor exercised his power of selection prior to default. Since the settlor failed to exercise his power to select specific bonds for payment out of the funds, upon default the trust became absolute by its own terms. Regardless of whether this power of selection was exercised or not, the funds could be used for only one purpose, namely, to redeem outstanding bonds.

The question whether or not the funds are trust funds is always a question of intent.[19] If there is an intention properly indicated that the funds are to be appropriated exclusively for certain purposes and are not to be used for any other purpose, then a trust fund has been created.[20] The trustee cannot be compelled to surrender to the receiver any of the security he holds in trust for the bondholders until the indebtedness for which he holds the property has been paid.[21] The funds must be kept and administered by the trustee in accordance with the instrument under which he performs.[22]

[18] PERRY, TRUSTS, 7th ed., 136 (1929).

[19] Sinclair Cuba Oil Co., S. A. v. Manati Sugar Co., et al., (D. C. S. D. N. Y. 1932) 2 Fed. Supp. 240.

[20] Rogers Locomotive & Machine Works v. Kelley, 88 N. Y. 234 (1882); Grinnell, "Status of Funds Deposited for Payment of Interest on Bonds," 19 ILL. L. REV. 429 (1925); note 22, supra. Authorities holding that sinking funds are trust funds: Struthers Coal & Coke Co. v. Union Trust Co., 227 Pa. 29, 75 Atl. 986 (1910); Independent Brewing Co. of Pittsburgh v. Colonial Trust Co., 273 Pa. 12, 116 Atl. 518 (1922); Equitable Trust Co. v. Green Star S. S. Corp., (D. C. S. D. N. Y. 1922) 291 Fed. 650; Truby v. M. & T. Trust Co., 141 Misc. 507, 253 N. Y. S. 108 (1931); 3 THOMPSON, CORPORATIONS, 3d ed., sec. 2399 (1927).

[21] Cooke v. Warner, 56 Conn. 234, 14 Atl. 798 (1888); Brackett v. Middlesex Banking Co., 89 Conn. 645, 95 Atl. 12 (1915); Greenebaum v. General Forbes Hotel Co., (D. C. W. D. Pa. 1930) 38 F. (2d) 96; Holland Trust Co. v. Sutherland, 177 N. Y. 327, 69 N. E. 647 (1904).

[22] Matter of Home Provident Safety Fund Ass'n, 129 N. Y. 288, 29 N. E. 323 (1891); Greenebaum v. General Forbes Hotel Co., (D. C. W. D. Pa. 1930) 38 F. (2d) 96; Truby v. M. & T. Trust Co., 141 Misc. 507, 253 N. Y. S. 108 (1931); that trust funds cannot be diverted from their specified objects. Fidelity Ins., T. & S. D. Co. v. Shenandoah Val. R. R., 32 W. Va. 244, 9 S .E. 180 (1889); George, Trustee v. Zinn, 57 W. Va. 15, 49 S. E. 904 (1905).

A general provision will be found in certain trust deeds which requires the mortgagor to deposit with the trustee or some other person funds for paying off interest coupons. Such a provision may raise the question whether or not the funds were deposited simply as a matter of convenience so as to create an agency, or whether they were put in the hands of the trustee as a trust fund with the intention that the funds shall not be appropriated for any other purpose than that which is stipulated. As to the former, see Staten Island Cricket & Baseball Club v. Farmers' Loan & Trust Co., 41 App. Div. 321, 58 N. Y. S. 460 (1899); Guidise v. Island Refining Corp., (D. C. S.

What is the effect of these conclusions on the fact that the trustee is to exercise discretion in regard to payments from these trust funds? Thus in the present case it was left to the discretion of the trustee as to whether or not he would pay delinquent taxes. Equity at a very early day assumed control over discretionary powers and compelled the trustee to exercise them in a manner which the court adjudged most beneficial for the cestui; but it is now generally recognized that a court of equity will not control the discretion of the trustee when honestly exercised.[23] The discretion is not an individual or arbitrary discretion. It is a legal discretion,[24] and equity will control the trustee's discretion only when he has fraudulently, arbitrarily, or unreasonably exercised it.[25] The courts have recognized that the fullest possible discretion should be enjoyed by the trustee within the limits of the deed, for to place rigid restriction thereon may destroy the utility of the trust deed as an instrument of finance.[26] Numerous factors must be taken into

D. N. Y. 1923) 291 Fed. 922; Erb v. Banco Di Napoli, 243 N. Y. 45, 152 N. E. 460, 50 A. L. R. 1009 (1926); Grinnell, "Status of Funds Deposited for Payment of Interest on Bonds," 19 ILL. L. REV. 429 (1925). As to the latter, see Rogers Locomotive & Machine Works v. Kelley, 88 N. Y. 234 (1882); Steel Cities Chemical Co. v. Virginia-Carolina Chemical Co., (C. C. A. 2d, 1925) 7 F. (2d) 280; Sinclair Cuba Oil Co., S. A. v. Monati Sugar Co., et al., (D. C. S. D. N. Y. 1932) 2 Fed. Supp. 240. When the parties have created an agency relationship, then the principal may revoke the authority of the agent and require the return of all funds not disbursed. In re Interborough Consol. Corp., (C. C. A. 2d, 1923) 288 Fed. 334, 32 A. L. R. 932 (1924). The question always resolves itself into what the parties intended as deduced from their documentary language and their course of dealing. Sinclair Cuba Oil Co., S. A. v. Monati Sugar Co., et al., (D. C. S. D. N. Y. 1932) 2 Fed. Supp. 240.

[23] PERRY, TRUSTS, 7th ed., sec. 510 (1929); Prendergast v. Prendergast, 3 H. L. Cas. 195, 10 Eng. Repr. 75 (1850); Nichols, Assignee v. Eaton, 91 U. S. 716 at 724, 23 L. ed. 254 at 256 (1875).

[24] Struthers Coal & Coke Co. v. Union Trust Co., 227 Pa. 29, 75 Atl. 986 (1910); Posner, "Liability of the Trustee Under the Corporate Indenture," 42 HARV. L. REV. 198 at 223 (1928).

[25] PERRY, TRUSTS, 7th ed., sec. 510 (1929); Viall v. Rhode Island Hospital Trust Co., 45 R. I. 432, 123 Atl. 570, 32 A. L. R. 437 (1924). In Greenebaum v. General Forbes Hotel Co., (D. C. W. D. Pa. 1930) 38 F. (2d) 96, it was held that the trustee's discretionary power was a valuable right which was not lost by the appointment of a receiver for the debtor.

[26] Posner, "Liability of the Trustee Under the Corporate Indenture," 42 HARV. L. REV. 198 (1928).

The trustee has no power to use the funds for purposes other than those stipulated in the agreement. Matter of Home Provident Safety Fund Ass'n, 129 N. Y. 288, 29 N. E. 323 (1891); Posner, "Liability of the Trustee Under the Corporate Indenture," 42 HARV. L. REV. 198 (1928). His rights, duties, and conduct are controlled by the instrument under which he acts. He cannot alter his duties in regard to the use of funds even though to carry them out literally will result in injury to the majority of the bondholders. Thus in Truby v. M. & T. Trust Co., 141 Misc. 507, 253 N. Y. S. 108 (1931), the indenture provided that the money in the sinking fund should be used for the purpose of redeeming bonds selected by the mortgagor. Shortly after the mortgagor

consideration to determine whether or not taxes should be paid in order to preserve the property. Delinquent taxes should only be paid after a careful investigation to determine that the amount of the taxes does not exceed the value of the property. The trustee should see to it that he is not throwing good money after bad. Present value is undoubtedly a factor to be taken into consideration; but greater attention should be given to prospective value, for it is at some future day that the property will be sold in order to realize on the security.[27] Market value is not a determining factor, for security sales are usually forced sales and it is a matter of common knowledge that very little is realized when property is sold under the hammer. Economic conditions which determine values may vary considerably over a short period of time, as demonstrated by our present era of depression, and therefore it cannot be said in most cases that the refusal to pay delinquent taxes is an unreasonable exercise of discretion. If a majority of the bondholders, but not all of them, requested the trustee to pay the taxes, it is no less a question of discretionary power, for the trustee must act for the benefit of all of the bondholders.[28] His refusal in such an instance would be evidence that the exercise of his discretion was arbitrary and unreasonable, for the trust deed is made for the benefit of the bondholders, and people are not inclined to request something that would be detrimental to their interests. Should all of the bondholders request the trustee to pay the taxes, the trustee would most likely be compelled to pay them out of the funds he holds if, under the terms of the indenture, he could use them for that purpose. His refusal to pay the taxes under such conditions would be substantial evidence of an abuse of his discretionary power. But even then it might not be an abuse of discretion, for it is generally said that the trustee is the agent for both the mortgagor and the bondholders, and he is required to act impartially to protect the interests of both parties.[29]

The trust deed has taken a position of growing importance in our financial system. It has received little attention from the text-writers and has not often appeared in litigation. Courts should be very reluctant to vitiate the common provisions of the trust deed by judicial holdings which will destroy its utility as an instrument of finance.[30]

selected the bonds to be redeemed and before they were redeemed, the mortgagor defaulted. The trustee refused to redeem the selected bonds because all of them could not be paid out of the security. The court held that the selected bonds had to be paid in full out of the fund, for it was a matter of contract, and therefore was not subject to change.

[27] TRACY, CORPORATE FORECLOSURES, sec. 100 (1929).

[28] 7 FLETCHER, CYCLOPEDIA OF CORPORATIONS, perm. ed., sec. 3179 (1931).

[29] 7 FLETCHER, CYCLOPEDIA OF CORPORATIONS, perm. ed., sec. 3178 (1931).

[30] Posner, "Liability of the Trustee Under the Corporate Indenture," 42 HARV. L. REV. 198 (1928).

In this respect the decision of the Court of Appeals in the instant case is to be commended. On the other hand it hardly need be said that draftsmen, in order to prevent litigation and uncertainty, should spell out in detail what should and can be done with all funds held by the trustee.

A. A. V.