

THE LEGALITY OF PARTICIPATING MORT- GAGE CERTIFICATES AS INVESTMENTS FOR TRUSTEES

The tendency of the law to bring up the rear in the march of progress is a commonplace observation. Its truth is perhaps nowhere more strikingly shown than in the varying rules which have been adopted by different states governing investments by trustees. The courts and legislatures have failed to recognize the changed conditions which now exist in the investment world, and they have rendered decisions and passed laws which, for lack of uniformity, can scarcely be paralleled. It would be of interest to point out some of these inconsistencies, to discuss the effect of the English Trust Investment Act of 1889, and to indicate the benefits which would be derived from a uniform law on this subject in the United States, but the present discussion is limited to a comparatively new form of investment.

A participating mortgage, as the term is understood by the leading trust companies, is a mortgage in which several trust estates share, the interest of each being evidenced by a participating certificate. Usually a portion of the mortgage, and sometimes all of it, is held by the trust company as an investment for its own funds pending a transfer to a trust estate. For the purpose of keeping the transactions of the various trust estates separate from the ordinary business of the company, books of account are kept for such mortgages and they are usually designated as reserved for the investment of trust funds, the funds of the company being used only when necessary to retain the security.

The advantage of this form of investment, especially to the small estate, is obvious. In large cities where it is almost impossible to obtain a first mortgage on desirable realty for the investment of a small fund, the beneficiary in a small estate, who can ill afford to have his money remain idle, obtains the advantage of immediate investment. This point was emphasized in the unreported case of *Real Estate Trust Company v. White*,¹ where Mr. Justice Sweezy said:

“In these days it has become extremely difficult for trustees to perform the duty which the law imposes upon

¹ N. Y. L. J., Oct. 23, 1901.

them of securing proper investments for trust funds, and this is particularly so in New York City with respect to investments for small amounts for which, owing to the great value of property in such city, it is almost impossible to obtain separate bond and mortgage investments. By combining funds of several trusts in one mortgage, it is often possible to get good investments for trust moneys that might otherwise be very difficult of investment."

The Court therefore sustained the investment upon the ground of expediency. But in a recent decision by Surrogate Ketcham of New York,² the learned Surrogate, although constrained to approve the investment because of the apparent weight of authority, expressed his personal disapproval and pointed out some of the objections to the investment of trust funds in this manner. He said that the bond and mortgage were taken in the name of the Union Trust Company; that neither instrument contained a word to qualify its affirmation that both were held by the company in its individual name and solely as its own, and that although the mortgage was recorded, there was nothing of record to show any declaration of trust in the transaction.

The trust company argued that the investment was advantageous to all who were interested in the estate; that the practice had grown up as a matter of necessity; that the company did not mingle trust funds with its own, or with the funds of others, or use such funds in its own business, and that this method of investment was common among trust companies. If it is not sanctioned by the courts, contended the company, many existing transactions involving large sums of money and affecting many estates will be disturbed. To this the Surrogate answered that there could be no reason in approving a wrong simply because it had been indulged in for a long period of time. To the Surrogate's contention that, in case of necessity, it might be difficult to liquidate one of the trusts, the company replied that it was always easy to transfer portions of the fund from one mortgage to another, and that the companies were always ready to convert participating certificates into cash. But the Court reasoned that any investment of trust funds which depends upon the financial responsibility of the trustee for its convertibility is not safe. And finally, the learned Surrogate found one feature of the plan which of itself was sufficient to warrant condemnation. "Under the accountant's proposition," he said, "unless that which is

² *Matter of Union Trust Company*, 86 Misc. (N. Y.) 392.

wrong for one may be right for another, trustees of all sorts and conditions may, in manner like unto that adopted by this accountant, invest moneys of a trust in the individual name of the trustee, a heresy frightful in its conception and effects. Whether the trustee were individual or corporate, can the mind exclude the peril which, in the hour of temptation, would be imposed by the license thus offered?" His personal opinion was, therefore, that he should disapprove the investment, but after citing numerous authorities, which he interpreted as being against his personal views, he yielded his individual judgment and approved the account of the trustees.

Although we appreciate the cogency and clearness of the reasoning of the Surrogate, we are compelled to disagree with him both as to the dangers which may follow in permitting this method of investment of trust funds and also as to the effect of the decisions.

It is unnecessary to cite authorities in support of the general rule that trustees may not invest trust funds in their own names, or mingle such funds with their own or with the funds of other trusts. But the exceptions to this rule have an important bearing on the question under discussion. And in the study of the cases which relate to this form of investment, we should not lose sight of the fact that the courts, even when they have followed the strict rules governing investments by trustees, have also been lenient, if a trustee has exercised the care and prudence of an average man in his own like affairs. They have adopted the attitude of the Master of Rolls in an early English case, who said that no man who ever sat in his court had been more adverse than he to charge executors who intended fairly to discharge their duty, and more cautious not to hold them liable on slight grounds, thereby deterring others from taking on the burdens of such an office. In this day of corporate trusteeships, perhaps the rule of leniency is no longer a necessity, but we can see no great danger in its observance.

Following the rule of leniency, the Supreme Court of Minnesota has said that "A trustee is not to pay interest solely because he has deposited trust funds with his own, or even because he makes use of them in his business, unless there be superadded some breach of trust."³

³*In re Shotwell*, 49 Minn. 170.

And the Supreme Court of California has decided that the mere fact that a trustee has mingled the proceeds of a sale of a trust estate with his own money would not, of itself, justify charging him with interest, and that a trustee is chargeable with neglect only when the mingling of funds is for use in his own business or where he is guilty of wilful neglect or misfeasance.⁴

The same exception in favor of a faithful trustee has been made in other jurisdictions,⁵ and in at least three cases,⁶ the court has approved the accounts of a trustee who mingled funds belonging to small estates with his own or with the funds of others in order to obtain good mortgages. On the other hand, the Supreme Court of Vermont, a State which is most liberal in its treatment of investments by trustees, has taken a contrary view in a similar case and has disapproved an investment where funds were mingled to obtain good security.⁷

Two cases have sometimes been cited as applicable to the question of investments by trustees in participating mortgages, but an analysis of these cases shows that while they may be in point, they are not decisive of the question under discussion. *In Matter of Menzie*,⁸ a trustee had allowed trust funds, which he received from an estate, to remain invested in a mortgage in which he also had an interest, and the court did not approve of the investment. But it placed its decision upon the impropriety of continuing an investment made by the testator, rather than upon the question of mingling funds. *In Matter of Long Island Loan & Trust Company*,⁹ the company had not only transferred one of its own mortgages to itself as trustee, but had also purchased the property at foreclosure sale. Clearly, this decision cannot be said to apply to a trust company which has invested trust funds in a participating mortgage and has observed the strict rules of care in such cases.

Among the decisions which have approved the conduct of a trustee, who has mingled trust funds with his own and with the

⁴ *Estate of Sarment*, 123 Cal. 331; *Estate of Marre*, 127 Cal. 128.

⁵ *Graver's Appeal*, 50 Pa. St. 189; *In re Hess' Estate*, 68 Pa. St. 454; *Seguin's Appeal*, 103 Pa. St. 139; *Johnson v. Blackman*, 11 Conn. 342; *Nance v. Nance*, 1 S. C. (Rich.) 209.

⁶ *Graver's Appeal*, *supra*; *Nance v. Nance*, *supra*; *Barry v. Lambert*, 98 N. Y. 300.

⁷ *Re Edmund Hodges' Estate*, 66 Vt. 70.

⁸ 54 Misc. (N. Y.) 188.

⁹ 92 App. Div. (N. Y.) 1.

funds of others for the purpose of securing a good mortgage investment, is *Barry v. Lambert*.¹⁰ In this case an executor combined \$6,000, which belonged to an estate, with \$2,000, which was contributed by the plaintiff, and purchased a mortgage of \$8,000. An action by the plaintiff was brought to establish a right in the bond and mortgage to the \$2,000 which she had contributed. It was unnecessary, therefore, for the Court of Appeals to pass upon the question of the propriety of this particular method of investment by a trustee. To this extent the opinion of the court may, perhaps, be considered *obiter*, but nevertheless the statements found in the opinion indicate the attitude of the Court of Appeals at the time the case was decided. In referring to the practice of the trustee in combining the funds of the estate with the funds of strangers to secure a desirable mortgage, the court, after observing that the transaction was beneficial to both parties, said:

"No difficulty arises from the blending of the money of the estate with that of another person in the same loan, for the units of which it is composed being of equal value, it is clearly severable and distinguishable, and sufficient data are given to enable such severance to be made."

In discussing the duties of executors, the court continued:

"The duties of their office required the executors to seek for advantageous investments and keep the moneys of the estate employed. It was entirely within their power, if it was not their duty, in case a profitable investment offered itself larger in amount than the available assets of the estate, to supplement them with other funds, if they could be legitimately obtained from other parties."

This decision is of especial interest, when one remembers that the courts of New York have been strict in enforcing the rules which govern trustees in the making of investments, and have been slow in departing from the doctrines set forth in the early English cases.

There are two decisions, unreported, so far as we can find, except in the New York Law Journal, which relate directly to the legality of investments in participating mortgages. One of these,¹¹ from which we have heretofore quoted, sustains the

¹⁰ 98 N. Y. 300.

¹¹ *Real Estate Trust Co. v. White*, N. Y. L. J., Oct. 23, 1901.

investment upon the ground that it is of advantage to a small estate and is safe. The other case¹² is *contra*, but is perhaps distinguishable and not against the validity of such investments when they are properly made. In the latter case, it appears that the Title Guarantee & Trust Company owned a bond and mortgage upon certain unimproved realty. The bond and mortgage were deposited with the Bond and Mortgage Guarantee Company which was the guarantor. Participating certificates were issued by the Title Guarantee & Trust Company and a trustee invested trust funds in some of these certificates. By the terms of the bond and mortgage, the title company was appointed the absolute agent and attorney to collect the interest and principal of the bond and mortgage, and to satisfy and discharge the same in its own name. It was also given the power to decide when and how any provision of the bond and mortgage should be enforced, and the power of granting extensions. Furthermore, there was a provision in the bond and mortgage which seemed to give the title company the power to release the debt or security after making an assignment thereof, thus limiting the protection of the assignee to the unsecured obligation of the company and its guarantor. Naturally, the Surrogate refused to approve an investment which was burdened with so many restrictions upon the freedom of action of the investor that the investment was "practically an unsecured one." The decision rests, therefore, upon its own peculiar facts and cannot be construed as an authority against the legality of such investments when they are made in an approved manner and with due regard to the rights of the beneficiaries of the trust fund.

The Supreme Court of Minnesota, although observing generally the rule of leniency toward trustees who have acted in good faith, has evidently decided against the validity of participating mortgages as investments. In *Saint Paul Trust Company v. Strong*,¹³ it appeared that the trust company had been in the habit of transferring its own mortgages to trust estates and issuing certificates to the various participants. The decision does not indicate to what extent the trust company went in keeping separate books of account for such mortgages, or whether or not certain mortgages were designated and set aside especially for trust funds. Perhaps the method of making the investment had

¹² *Matter of Cheeseborough*, N. Y. L. J., Oct. 5, 1895.

¹³ 85 Minn. 1.

something to do with the decision of the court. Be that as it may, there is sound reason in the objection raised by the Court, that if such investments are permitted, an opportunity would be afforded trustees to transfer to trust estates mortgages which might depreciate in value or concerning which litigation might arise. It would seem, however, that the possibility of burdening estates by thus shifting securities might be overcome, at least in a measure, by proper statutory regulation. In any event, there must be a reasonable reliance upon the good faith of the trustee. No rules can be effective in restraining a trustee who deliberately plans to ruin an estate. He can dissipate funds as quickly by investing in single mortgages as he can by investing in participating mortgages. It is unreasonable, therefore, to condemn a whole class of investments simply because a dishonest trustee may use them for his own gain. On the other hand, if a trustee, whether trust company or individual, is faithful, the participating mortgage affords a convenient method of keeping small estates productive.

So far as the courts are concerned, the legality of such investments is an unsettled question. The few decisions which relate to the subject are not in agreement, and those which we have considered do not constitute a satisfactory guide, for the facts given are few and the methods employed in making the investment are not set forth with sufficient detail to indicate whether or not the trustee was investing in a participating mortgage as we have defined that term.

Recognizing participating mortgages as an advantageous form of investment for trustees, and realizing the unsettled state of the law on the subject, two states have passed statutes legalizing such investments. While Section 9788, of the General Code of Ohio, applying to trust companies, does not refer expressly to participating mortgages, it is evident that the provisions of the section are sufficiently broad to cover this form of investment. That statute reads as follows:

“In the management of money and property held by it as trustee, under the powers conferred in the foregoing sections, such trust company may invest them in a general trust fund of the corporation. But the authority making the appointment, upon the conferring of it, may direct whether such money and property shall be held separately or invested in a general trust fund of the corporation, except that such corporation always shall follow

and be governed by all directions contained in any instrument under which it acts."

The criticism of the Ohio statute is that it is too broad in its scope to be safe. There seems to be no limitation as to the manner of thus investing trust funds. If the door to this form of investment is to be thrown open by statute, it is the opinion, both of lawyers and trust company officials, that certain barriers should be interposed to prevent the too easy entrance of fraud.

The necessity for restriction, where the right to make such investments is granted by statute, is evident when one considers the care with which the recent statute, passed by the State of California, has been drawn. The statute, being the first of its kind, is given in full. Savings banks may invest in:

"Certificates issued by a corporation organized under the laws of this State with a paid-up capital stock of not less than one hundred thousand dollars, evidencing and conferring participation to an indicated amount in a first mortgage on real estate and the debt secured thereby, and guaranteeing the payment of the principal of the mortgage debt at its maturity or within some specified time thereafter and agreeing to pay interest on the amount of the participation at some specified rate, the mortgage however and debt thereby secured to be assigned to a trust company and held by it as security for the payment of said mortgage certificates and for the performance of all conditions imposed thereby upon the corporation issuing the same, provided the said first mortgage indebtedness shall not exceed sixty per centum of the market value of the real estate taken as security, and provided further that the trust company shall certify on each certificate that the aggregate amount of the certificates issued evidencing and conferring participation in any one such mortgage and mortgage debt does not exceed the principal of the said mortgage debt; but provided, nevertheless, that, unless such certificates are made legal investments for savings banks by other law of this State, no savings bank shall purchase any such certificates until the corporation issuing the same has first obtained the written approval of the Superintendent of Banks to such certificates as an investment for savings banks. The actual expense of investigating any issue of such certificates presented to the Superintendent of Banks for approval shall be paid by the corporation presenting the same, and the Superintendent of Banks, before making such investigation, may require a cash deposit of such amount as he may deem necessary to cover such expense. The Superintendent of

Banks may accept and act upon the opinions and appraisements of any title insurance or abstract company, attorneys or appraisers which may be presented by such corporations so applying, and the reports of any of the executive officers of the corporation issuing such certificates, on any question of fact concerning or affecting such certificates, the security thereof, or the financial condition of the corporation issuing the same. In lieu of or in addition to such opinions, appraisements and reports, the Superintendent of Banks may, if he deems proper, have any or all such matters passed upon and certified to him by attorneys, appraisers or accountants of his own selection at the expense of the applicant. The Superintendent of Banks shall keep an official list of all issues of such certificates approved by him."

The above statute is a part of the new savings bank law of California, and since trustees in that state are permitted to invest in securities which are legal for savings banks, it applies also to trustees generally. It should be observed that the law does more than merely authorize a trustee to combine several estates for the purpose of securing a good mortgage investment. It gives him the right to invest in participating certificates which have been issued by any corporation having a paid-up capital stock of not less than one hundred thousand dollars and which are secured by a first mortgage upon real estate; provided the indebtedness does not exceed sixty per centum of the market value of such real estate and provided that, unless such certificates are made legal by some other law of the State, the approval of the Superintendent of Banks shall have first been obtained. In other words, the participating certificates are similar to bonds, and when they are secured by real estate of a certain value, are made legal investments for trustees. In such a case the law against mingling of trust funds is disregarded, for the certificates in one mortgage may be purchased lawfully by the trustee for the benefit of the estate, or by himself individually, or by strangers.

We can see no serious objections to the liberal provisions of the California statute. It has greatly extended the field for legal investments by trustees, and when the restrictions provided for in the statute are observed, the investment is as safe, if not safer, than an investment in the ordinary small mortgage. In any case, it is the value of the security back of the investment which determines the prudence of the trustee and the safety of the investment, and the security is none the less valuable by reason

of a division into parts for the purpose of giving the small investor, be he trustee or individual, a chance.

It should be observed, however, that the term "participating mortgages," as used in the California statute, includes more than the definition given at the beginning of the discussion. In the statute, the term evidently refers to mortgages taken by any corporation and the participating certificates may be issued against a number of mortgages which have been combined into one fund, as well as against a single mortgage. On the other hand, the term, as it has been construed by trust companies, includes only such certificates as have been issued against a certain designated mortgage. Whether or not trustees should be permitted to invest generally in this form of security, issued by any and all corporations, may be doubtful. If this extensive right is given, the manner of its application must be carefully limited and there must be vigilant supervision by the banking authorities of the state.

Among the objections raised to investments by trustees in participating mortgages is the statement that in case of loss, it would be difficult to adjust the loss among the various trusts. This point was considered in the case of *Elkin v. Elkin*.¹⁴ The City Chamberlain of New York, who had invested several funds held by him in his capacity as trustee in one mortgage, was compelled to foreclose the mortgage at a loss. The court decreed that the loss should be borne *pro rata* by the estates which shared in the security. It would follow that, if the trustee were compelled to buy in the property to protect the investment, he could do so in his name as trustee and retain the property for the beneficiaries. It has also been suggested that if one of the trust estates should terminate before the others, there might be difficulty in distributing the shares to various beneficiaries. The answer is, that if the trustee has observed the law governing the selection of security in which the various trusts participate, a participating certificate would be as easily turned into money as a single mortgage.

Perhaps the most serious objection to legalizing participating mortgages as investments for trust funds is that suggested by the Court in the *Saint Paul Trust Company Case* to the effect that such a method of investment gives the trustee a chance to shift securities, which are likely to depreciate in value or over

¹⁴29 Misc. (N. Y.) 513.

which litigation may arise, to the trust estate and thus protect himself. There is point to the objection, but we believe that the manner of making the investment can be so regulated by statute as to meet this objection. The weakness of the contention is that it presupposes bad faith on the part of the trustee. If this is to be the controlling factor in determining what investments are proper, no investments in mortgages can be upheld, for it is always possible for a dishonest trustee to take advantage of a trust estate in the matter of mortgage security, whatever the rules by which he is limited.

It has also been stated that if a large trust company, when acting as trustee, is permitted to invest numerous funds in one mortgage, which is taken in its own name, the same practice would be legal for the individual trustee, for the poor as well as the rich, and that the consequences of such a practice are only too obvious. The difficulty with this argument is that it brushes aside all restrictions as to the manner of making such investments and assumes that it is necessary either to disapprove the investment entirely or to approve it without limitation and allow trustees to take mortgages in their own names. No one will contend that it is proper to permit trustees to take mortgages, which have been purchased with trust funds, in their own names; neither will any one argue that the mere taking of the mortgage in the name of the trustee is the dangerous thing. It matters not in whose name the mortgage is taken, provided the beneficiary of the trust fund is protected from loss or trouble because of ills which may befall the individual trustee.

Although there is a diversity of opinion, the general belief among trust companies and attorneys seems to be that the investment of trust funds in participating mortgages is so advantageous, especially in the large cities, that the practice should be sanctioned either by the courts or by statute, providing, of course, that the method of making the investments can be regulated in such a way as to afford safety and freedom from legal complications to the beneficiaries. The editor of the *New York Law Journal* expressed his belief in the advisability of such a statute for New York in an editorial published on March 6, 1911, and suggested that a law would place the propriety of investments in participating mortgage certificates beyond all question; and that the statute might provide rules and regulations for the proper assignment of the mortgage, and the control of the security.

The conclusion is, that the law is unsettled as to the advisability of permitting trustees to invest in participating mortgage certificates; that there are advantages which commend such investments, and that there are certain disadvantages which must be overcome by proper regulation if the practice is to receive the sanction of the courts. We believe, that since investments in participating mortgage certificates, especially when the certificates are issued against particular mortgages by banking corporations acting as trustees, are admittedly advantageous to small estates and are practicable, there should be a general statute legalizing the investments and at the same time regulating the methods of issuing the certificates in such a way as to afford adequate protection to beneficiaries.

In deciding upon the provisions of a statute, one would determine first, whether the right to invest in participating mortgage certificates should be extended to all trustees. As to this point, it would seem that the argument of the learned New York Surrogate, in his opinion in the *Union Trust Company case*,¹⁵ is sound. What is right for a corporation, he says, is right for an individual, and a proper investment for a rich trustee is likewise a proper investment for a poor trustee. In the second place, it would be necessary to determine whether such certificates should be considered valid investments, no matter by what corporation they may have been issued and whether or not they indicate participation in a particular mortgage or in a number of mortgages. Clearly, if the right to make investments in securities of this character is to be thus extended, careful supervision by the banking authorities of the state should be required. This seems to be the plan in California. The safer policy, we think, would be to extend the right to invest in mortgage certificates gradually, limiting it at the outset, at least, to certificates issued by banks and trust companies and by companies authorized by the laws of the particular state to guarantee mortgages.

Whether or not the states adopt statutes regulating this particular form of investment, sooner or later they must settle the question by determining the legality or illegality of a practice which has become general among trust companies. The subject is worthy of discussion in all of its phases, and for this reason we suggest that a law drafted along the following lines, permitting trustees to invest in participating mortgage certificates,

¹⁵ 86 Misc. (N. Y.) 392.

would sanction the practice and at the same time afford beneficiaries of estates adequate protection.

Trustees Generally. The law should permit trustees, whether individual or corporate, to invest funds of an estate in participating mortgage certificates, provided the certificates had been issued in accordance with certain conditions. Among the conditions and restrictions imposed by the statute, the following would seem to be important:

1. A provision permitting trustees to invest only in certificates issued by banks, trust companies, and corporations which are authorized to guarantee mortgages.

2. The assignment of the mortgage to a trust company to be held as security for the payment of the debt.

3. Certification by the trust company, on each certificate, that the aggregate amount of the certificates issued and conferring participation in any one mortgage does not exceed the principal of the mortgage debt.

4. A requirement that certificates, which are to be legal for trustees, shall be issued against particular mortgages only, and not against a number of mortgages taken together.

5. The mortgage to be taken only upon unencumbered, improved real estate and not to exceed sixty per cent of the appraised value of the property.

6. A provision giving the trustee the right to have the payment of the certificates guaranteed by paying a certain per cent of the income, not to exceed one-half of one per cent per annum on the par value of the investment, as a premium.

Trust Companies. Banks and trust companies which have the power to act as trustees should be given the further power to invest trust funds held by them in certificates evidencing and conferring participation to an indicated amount in a first mortgage on real estate, and bearing interest at the same rate as that provided in the mortgage by which the debt is secured, upon condition that:

1. The mortgage shall not exceed in amount sixty per cent of the appraised value of improved real estate.

2. The company certify on each certificate that the aggregate amount of the certificates issued and conferring participation in a mortgage does not exceed the principal of the mortgage debt.

3. The company be permitted to take such participating mortgages in its own name, provided each mortgage, in which trust

funds are to be invested, be kept separate and apart from the mortgages owned by the company, and be designated on the books as reserved for trust funds.

A statute drafted along the above lines and adapted to the laws of the particular state would open the way to investments by trustees in a form of security which, when properly taken, is safe.

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