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## APPORTIONMENT BETWEEN PRINCIPAL AND INCOME OF A TRUST AFTER MORTGAGE FORECLOSURE

The twelve years that have followed the collapse of 1929 have seen many problems arise to plague the trustee in the administration of his trust. He has been faced on one side with a devaluation of corpus investment, and on the other side with a decrease in income return. To preserve the one without unduly jeopardizing the other has required an instinctive sixth sense not usually possessed by the ordinary fiduciary, whether corporate or individual; but his problem is two-fold when his investment suddenly fails both in its production of income and in its principal valuation. Such is the case when there is a default in the payments on a mortgage comprising a portion of the trust assets. The income, of course, stops immediately, and the total loss of the investment secured by the mortgage is a prospect of the not too distant future. The trustee then has the double duty of rescuing the investment, and returning it to income productivity. The rights of the life tenant entitled to the income and the rights of the remaindermen ultimately entitled to the corpus must both be given protection. If the grantor, or the testator, in the case of the testamentary trust, has been far sighted enough to direct his trustee in the rescue of the fallen investment, and has outlined the respective rights

of the life tenant and remainderman, the task of the trustee is greatly lightened. He need only follow his directions. The expressed intentions of the creator of the trust as set forth in the trust instrument will govern. The course however is seldom made so simple, for more often than not the grantor fails to disclose his intentions at all, and then the trustee must resort to a proper application of the rules of law to the particular set of facts confronting him.

It will therefore be assumed in discussing the treatment of this problem by the trustee that the trust instrument is silent with respect to the intentions of the grantor, or the testator, as the case may be. It will also be assumed that there is no negligence or breach of duty on the part of the trustee towards any of his cestui que trustents for which he might incur personal liability.

The failure of an investment such as a trust mortgage involving, as it does, loss of both principal and income is best approached by consideration of two fundamental questions which inevitably arise before ultimate liquidation. First, what becomes of the net proceeds finally realized? Secondly, how are these net proceeds determined? Although it may appear more logical to ascertain what the net proceeds are before considering their distribution, a thorough understanding of the ultimate rights of the life tenant and remaindermen will greatly simplify the application of the principles of accounting used to determine the net figure available for distribution.

### I. APPORTIONMENT OF NET PROCEEDS

It is universally accepted that the loss occasioned by the failure of a mortgage investment, affecting as it does, both life tenant and remainderman, should be borne by both.<sup>1</sup> The loss

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1. See 103 A.L.R. (1936) 1271; 115 A.L.R. (1938) 881; 116 A.L.R. (1938) 1354; 129 A.L.R. (1940) 1314; 2 SCOTT ON TRUSTS (1939) Sec. 241.3; 49 HARVARD LAW REVIEW (1936) 805; 84 U. OF PA. LAW REVIEW (1935-6) 157.

results from the fault of neither and to require either to sustain the full burden alone would obviously be inequitable. It is both logical and just that the burden be distributed between the parties in proportion to the respective interests which they have in the enterprise. From this proposition there is practically no dissent and the only difference of opinion is upon the method of computing these interests.

The method endorsed by the Restatement of Trusts<sup>2</sup> apportions the net proceeds by ascertaining the sum which with the interest thereon at the rate of return currently realized by trust investments will equal the net proceeds received. This sum becomes the share allocated to principal and the balance becomes that allocated to income. It is not surprising that this method should have the approval of Professor Scott,<sup>3</sup> the Reporter for the American Law Institute on Trusts, in his recent work, in which he argues convincingly its equitable treatment of both life tenant and remainderman. Some of our States, notably Pennsylvania,<sup>4</sup> Rhode Island<sup>5</sup> and Massachusetts<sup>6</sup> have followed this method consistently.

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2. AMERICAN LAW INSTITUTE, *RESTATEMENT OF THE LAW OF TRUSTS*, section 241 reads as follows: "(1) Unless it is otherwise provided by the terms of the trust, if properly held in trust to pay the income to a beneficiary for a designated period and thereafter to pay the principal to another beneficiary is property which the trustee is under a duty to sell, and which produces no income or an income substantially less than the current rate of return on trust investments, . . . and the trustee does not immediately sell the property, the trustee should make an apportionment of the proceeds of the sale when made, as stated in subsection (2). "(2) The net proceeds received from the sale of the property are apportioned by ascertaining the sum, which with interest thereon at the current rate of return on trust investments from the day when the duty to sell arose to the day of the sale, would equal the net proceeds; and the sum so ascertained is to be treated as principal and the residue of the net proceeds as income."

3. 2 SCOTT ON TRUSTS (1939) Sec. 241.3.

4. *Nirdlinger's Estate*, 327 Pa. 171, 193 A. 30 (1937).

5. *Greene v. Greene*, 19 R. I. 619, 35 A. 1042, 35 L.R.A. 790 (1896).

6. *Springfield Safe Deposit & Trust Co. v. Wade*, ..... Mass. ...., 24 N.E. (2d) 764 (1940).

The second method divides the net proceeds between the remainderman and the life tenant in the same proportion which the principal sum due on the mortgage bears to the interest due thereon.<sup>7</sup> It is this method which is of primary interest to the trustee in New Jersey, as our courts have applied it repeatedly since it was first laid down here in *Hagan v. Platt*.<sup>8</sup> In ascertaining the ratio between principal due and interest due, it is to be noted that there are two possible periods during which the investment may be unproductive of income. The first period is that from the date of the first default to the date of the foreclosure sale, and the interest due is computed at the rate which the mortgage bears on the unpaid balance of principal for the whole period. If the property is then purchased by a third person, the salvage is complete and the loss can be immediately computed and apportionment made. Often, however, there is no purchaser at the foreclosure sale, whereupon the trustee is forced to buy in himself to protect the investment until a favorable sale can be effected. In such a case a second period of unproductivity commences and interest is again computed at the mortgage rate on the principal balance until the date of final sale of the real property purchased on foreclosure. Thus interest is computed from the date of the first default to the date when salvage or liquidation is complete and the original mortgage investment as well as its security is converted into cash.

It is worth noting in passing that the mathematical result obtained by the two methods differs only to the extent that the current rate of return realized on trust investments differs from

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7. This rule was followed by the New York Courts (*Re Chapal*, 269 N.Y. 464, 199 N.E. 762, 103 A.L.R. 1268, and *Re Otis*, 276 N.Y. 101, 11 N.E. (2d) 556, 115 A.L.R. 875 (1937), rehearing denied, 277 N.Y. 650, 14 N.E. (2d) 203) until enactment of Chapter 452 of the Laws of New York, effective April 13, 1940, constituting sec. 17-c of the Personal Property Law.

Cf. Uniform Principal and Income Act, Sec. 11, adopted by the National Conference of Commissioners on Uniform State Laws in 1931.

8. 48 N.J.Eq. 206, 21 A. 860 (Ch. 1891).

the rate of return which the defaulted mortgage bears. The former of course is a variable figure, while the latter is constant. It has been argued that this flexibility of the first method results in a more equitable distribution, in that the life tenant should be entitled to no more than the current rate of return in the determination of his proportionate share.<sup>9</sup> It may be suggested, however, that a mortgage investment is not inherently speculative and that the advantages of a fixed return may have been the controlling factor in the selection of the investment. It is not entirely improbable that the collateral security of bond and mortgage was intended for the protection of the fixed income as well as the principal debt.

As stated before, the New Jersey method of apportionment was first laid down in *Hagan v. Platt*<sup>10</sup> in 1891 when the court not only established the principal but made the computation, saying,

"The amount involved in the loss is \$1,200; the amount of interest due when the mortgaged premises were finally realized upon was \$1,252. The amount realized was \$1,267.94. This must be so divided and apportioned that the amount set aside as principal shall bear the same proportion to the amount to be paid to the tenant for life that \$1,200 bears to \$1,252. The result is that the principal sum is to be restored to the extent of \$620.52, and the tenant for life will be paid \$647.42."<sup>11</sup>

The case involved a loss resulting from an investment of the trust fund in a mortgage, and where such a loss has ensued there has been no deviation from the rule. This is true whether the mortgage investment was part of the original trust estate,<sup>12</sup>

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9. See note 3, *supra*.

10. 48 N.J.Eq. 206, 21 A. 860 (Ch. 1891).

11. *Id.* at 48 N.J.Eq. 208.

12. *Equitable Trust Company v. Swoboda et al.*, 113 N.J.Eq. 399, 167 A. 525 (Ch. 1933).

whether it was a subsequent investment of the trustee,<sup>13</sup> or whether it represented a purchase money mortgage taken back upon the sale of real property which was a part of the original trust estate.<sup>14</sup> The principle is summarized by Vice-Chancellor Lewis in *Hudson County National Bank v. Woodruff et al.*,<sup>15</sup> as follows:

"The evidence discloses the trustee's freedom from negligence or bad faith in the administration of its stewardship and that any ensuing losses are attributable solely to causes beyond its control or that of the life tenant or remaindermen. The trust does not exempt the remaindermen from the visitation of the possible perils and losses occasioned by failure of investment, nor should such, in fairness and justice, be thrown entirely upon the life tenant. The properties having been held for anticipated, but unattained, appreciation, the delay should be held to be as a joint venture between the life tenant and the remaindermen because such an investment situation involves the salvage of a security, which, obviously, is a security not for principal alone but income as well. Hence, the ensuing loss, as was said by V. C. Reed in *Trenton Safe Deposit & Trust Co., v. Donnelly*, 65 N. J. Eq., 119, 55 A. 92, 93, should be apportioned between the life tenant and the remaindermen in the proportion that the debt due the first bears to the amount which should come to the second, namely, the amount of the corpus of the estate; or, conversely, the amount realized shall be set apart to the remaindermen and the life tenant in the proportion that the

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13. *Trenton Trust & Safe Deposit Company v. Donnelly*, 65 N.J.Eq. 119, 55 A. 92 (Ch. 1903).

14. *Fidelity Union Trust Company v. Murphy et al.*, 124 N.J.Eq. 201, 1 A. (2d) 201 (Ch. 1938).

15. 122 N.J.Eq. 444, 194 A. 266 (Ch. 1937), *aff'd*, 123 N.J.Eq. 585, 199 A. 399 (E. & A. 1938).

corpus bears to the unpaid interest due the life tenant.' Recognition and approval of this rule is to be found in *Hagan v. Platt*, 48 N. J. Eq. 206, 21 A. 860; *Tuttle's Case*, 49 N. J. Eq. 259, 24 A. 1; *Equitable Trust Company v. Swoboda*, 113 N. J. Eq. 399, 167 A. 525; and *In Re Chapal's Will*, 269 N. Y. 464, 199 N. E. 762, 103 A. L. R. 1926."<sup>16</sup>

The rule was affirmed once more in *Fidelity Union Trust Company v. Murphy et al.*<sup>17</sup>

The rule is not so clear however where the ultimate conversion produces a net profit rather than a net loss. In *Parker v. Seeley*<sup>18</sup> it was held that appreciation as well as depreciation should be apportioned according to the *Hagan* rule on the theory that the purchase of the foreclosed premises by the trustee represented an investment of income as well as principal, and hence the life tenant was entitled to enjoy the profits along with the remainderman.

The court here considered two earlier cases (*Parker v. Johnson*<sup>19</sup> and *Outcalt v. Appleby*<sup>20</sup>) in both of which it had been held that profits were to accrue to the fund or trust corpus. In the *Johnson* case as in the *Seeley* case final sale of the foreclosed premises resulted in a net profit over and above the principal, interest, and all costs and expenses. The *Johnson* case was distinguished on the ground that the court at that time did not have the *Hagan v. Platt*<sup>21</sup> rule to follow, and further that there were other mortgages upon which a loss could be anticipated and against which a reserve should be established in the trust fund, so that the profits of one investment could make up the losses of another. *Outcalt v. Appleby*<sup>22</sup> was distinguished on the

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16. *Id.* 194 A. 266 at 269.

17. 124 N.J.Eq. 201, 1 A. (2d) 201 (Ch. 1938).

18. 56 N.J.Eq. 110, 38 A. 280 (Ch. 1897).

19. 37 N.J.Eq. 366 (Ch. 1883).

20. 36 N.J.Eq. 73 (Ch. 1882).

21. 48 N.J.Eq. 206, 21 A. 860 (Ch. 1891).

22. 36 N.J.Eq. 73 (Ch. 1882).

ground that there was a sale of unproductive real property which had been held as a part of the original estate.

In *McCoy v. McCloskey*<sup>23</sup> the mortgaged premises were surrendered and conveyed by the mortgagor in lieu of foreclosure, but due to an appreciation in the value of the property an ultimate profit was anticipated. The court realizing that any increase in the asset upon conversion into money was prospective, held that the proceeds would be principal of the trust "subject to the payment of the interest on the mortgage."<sup>24</sup> This would appear to revert to the rule of *Parker v. Johnson*,<sup>25</sup> but the court then proceeded to cite *Parker et al v. Seeley et al*,<sup>26</sup> saying,

"If, however, the mortgage is to be regarded as merged in the legal title (the understanding as to this has not been made clear) then, upon a sale at a profit, the widow will be entitled to participate in the profits, proportionately, as her share of the accrued interest at the time of the merger bears to the principal debt."<sup>27</sup>

The question arose again in *Burnett et al v. Witschief*<sup>28</sup> where the testator left the residue of his estate to his widow for life. The executors, under a power of sale, sold a piece of real property, taking back a purchase money mortgage. This they later foreclosed, buying in the property, which was subsequently resold at an increase over the first sale price. The widow, citing *Parker v. Seeley*<sup>29</sup> and *Hagan v. Platt*,<sup>30</sup> claimed apportionment. Vice-Chancellor Backes held that the sale worked no conversion and that the widow was entitled only to the net yield of the

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23. 94 N.J.Eq. 60, 117 A. 473 (Ch. 1922).

24. *Id.* 117 A. 473 at 475.

25. 37 N.J.Eq. 366 (Ch. 1883).

26. 56 N.J.Eq. 110, 38 A. 280 (Ch. 1897).

27. 94 N.J.Eq. 60, 117 A. 473 at 475 (Ch. 1922).

28. 96 N.J.Eq. 71, 126 A. 23 (Ch. 1924).

29. 56 N.J.Eq. 110, 38 A. 280 (Ch. 1897).

30. 48 N.J.Eq. 206, 21 A. 860 (Ch. 1891).



land, whether in the form of rent or of interest on the mortgage. The increase in the sale price was held to be principal subject only to a payment to the widow of a sum equal to the income lost during the period of default.

The next case was *Skinner v. Boyd*<sup>31</sup> where the mortgaged premises, conveyed to the trustee pending foreclosure, were sold at a profit. It was held that,

"The profit is to be apportioned between the principal and income in the ratio which the principal sum involved bears to the interest due upon it at the time when the security was realized upon. *Hagan v. Platt*, 48 N. J. Eq. 206, 21 A. 860; *Tuttle's Case*, 49 N. J. Eq. 259, 24 A. 1; *Parker v. Seeley*, 56 N. J. Eq. 110, 38 A. 280; *Trenton Trust & Safe Deposit Co. v. Donnelly*, 65 N. J. Eq. 119, 55 A. 92."<sup>32</sup>

The last case to consider the question of a profit arose in 1933 in *Equitable Trust Company v. Swoboda et al*<sup>33</sup> where the court spoke as follows,

"Should it so happen that the trustee purchase the mortgaged premises at the foreclosure sale or sales, and subsequently sell at a profit over and above the amount of the principal, costs, etc. then the profit will belong to the corpus of the estate and not to the life tenant. *Parker v. Johnson*, 37 N. J. Eq. 366. On the other hand, should the final result be that the property is bought in by the trustees and subsequently sold at a loss, there will be an apportionment between principal and income in accordance with the principle laid down in the following cases: *Hagan v. Platt*, 48 N. J. Eq. 296, 21 A. 860; *Tuttle's Case*, 49 N. J.

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31. 98 N.J.Eq. 55, 130 A. 22 (Ch. 1925).

32. *Id.* 130 A. 22 at 23.

33. 113 N.J.Eq. 399, 167 A. 525 (Ch. 1933).

Eq. 259, 24 A. 1, 2; *Trenton Trust & Safe Deposit Co. v. Donnelly*, 65 N. J. Eq. 119, 55 A. 92."<sup>34</sup>

It is suggested that it is neither inequitable nor illogical that ultimate profit be treated differently from ultimate loss. In the latter case there is not enough realized upon final sale to pay both life tenant and remainderman their full shares, whereas in the former case there is surplus over and above their combined shares. It is to be noted that the full fixed return provided by the mortgage security is realized by the life tenant before there is any surplus and that the corpus is restored to the original amount for reinvestment in income producing assets. In addition to this there is a surplus available for investment, which is a new source of income. This provides a means whereby the life tenant can also participate in the profits in that the income will thereafter be increased by the return which the surplus produces. While he does not share any profits directly under the rule of *Equitable Trust Company v. Swoboda et al.*,<sup>35</sup> the tenant for life does share indirectly.

To summarize the rules of distribution upon final conversion in the light of the latest cases, it may be said:

If there is a net loss the net proceeds will be apportioned in the ratio which the share of income bears to that of corpus;

If there is a net profit after the payment in full of the shares due to both income and corpus, it will be added to the corpus of the trust.

## II. DETERMINATION OF NET PROCEEDS

We have seen that upon the default of a mortgage the trustee enters upon a salvaging process by which he hopes to restore productivity. Pending the restoration, what was previously an

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34. *Id.* 167 A. 525 at 526.

35. 113 N.J.Eq. 399, 167 A. 525 (Ch. 1933).

asset may become a temporary liability. At the foreclosure sale the property may be sold to a third party or it may be bought in by the trustee pending a more advantageous resale—in either event the problems are similar.

The foreclosing trustee must face any or all of various expenses before he can salvage his investment. Roughly these may be divided into two categories—those incident to the conversion, and those incurred in carrying or maintaining the property pending final conversion. The former include the costs of foreclosure, the costs of final sale, and the assumption of prior liens and encumbrances, and expenses required to make the property resaleable. The latter include the current expenses incident to the carrying or maintenance of any piece of real property.

Ordinarily the first expense to be met by the foreclosing trustee is that of the foreclosure itself. It is well established that these costs should be advanced from the corpus account when incurred, and that upon final sale corpus should then be reimbursed for the amount advanced, prior to apportionment.<sup>36</sup> In *Equitable Trust Company v. Swoboda, et al*<sup>37</sup> it was said,

“It seems to me to be clear that, no matter what the rule may be in other jurisdictions, the reasonable costs of foreclosure, under the circumstances of this trust estate, should be borne, in the first instance, out of the principal, and the final adjustment must abide the events following the foreclosures.”<sup>38</sup>

This was specifically approved in *Hudson County National Bank v. Woodruff et al*,<sup>39</sup> the court saying,

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36. See 103 A.L.R. (1936) 1271; 115 A.L.R. (1938) 881; 116 A.L.R. (1938) 1354; 129 A.L.R. (1940) 1314; 2 SCOTT ON TRUSTS (1939) Sec. 241.3.

37. 113 N.J.Eq. 399, 167 A. 525 (Ch. 1933).

38. *Id.* 167 A. 525 at 526.

39. 122 N.J.Eq. 444, 194 A. 266 (Ch. 1937), *aff'd*, 123 N.J.Eq. 585, 199 A. 399 (E. & A. 1938).

"Should foreclosure costs upon property acquired by the trustee at a foreclosure sale be paid, in the first instance, out of corpus? In accordance with the rule recognized in *Parker v. Johnson*, 37 N. J. Eq. 366, and *Equitable Trust Co. v. Swoboda*, 113 N. J. Eq. 399, 167 A. 525, which is in nowise here questioned, this question must be answered in the affirmative."<sup>40</sup>

Immediately upon foreclosure the question of removing prior liens, if there be any, arises. Where the question has appeared before the courts it has usually involved taxes accrued against the property prior to the foreclosure. In *Trenton Trust & Safe Deposit Company v. Donnelly*,<sup>41</sup> it was argued that such taxes should be borne by the life tenant. It was, however, held otherwise, the court saying,

"But it is insisted that the taxes paid by the complainant should be deducted from the life tenant's share thus ascertained. In my judgment this position is not tenable. I am aware that Chancellor Magill, sitting as ordinary did so order in *Tuttle's Case*, 49 N. J. Eq. 260, 24 Atl. 1, where the trustee had paid taxes which had been assessed upon real estate intervening the time of the trustee's acquisition of the land and the time of the sale made of the same by the trustees. Under the conditions presented in that case, the ordinary thought it equitable to deduct these taxes from the life tenant's share after it had been apportioned according to the rule already mentioned. In the present case the tax paid, so far as appears, was not assessed upon the property during the time it was held by the trustees under the title got by them at the foreclosure sale. The taxes were paid as a lien upon the property when it came

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40. *Id.* 194 A. 266 at 268.

41. 65 N.J.Eq. 119, 55 A. 92 (Ch. 1903).

to the hands of the trustees. The property could have been sold subject to this lien, but the trustees thought it advisable to discharge this lien so as to give an unincumbered title. The payment of the tax was therefore in reality one of the expenses incurred in transmuting the realty into cash to the best advantage."<sup>42</sup>

By referring to the removal of a prior tax lien as an expense of transmutation, and by ordering its payment from corpus it would seem that it was meant that such an item should be treated similarly to the other expenses, i.e., the costs of foreclosure and of final sale. This would mean of course that the necessary funds should be advanced from corpus; and then upon final sale of the premises corpus would be reimbursed and the balance apportioned.<sup>43</sup>

However, in *Hudson County National Bank v. Woodruff et al*<sup>44</sup> the court, although citing the *Donnelly*<sup>45</sup> case, confused the question when it said,

"That such taxes are properly payable out of corpus alone was held in *Trenton Trust Co. v. Donnelly*, 65 N. J. Eq. 119, 55 A. 92, and with that principle no quarrel is here found by any of the parties."<sup>46</sup>

As noted above<sup>47</sup> in this case, the court held that foreclosure costs should be paid "in the first instance" out of corpus. The omission of these words, "in the first instance", from the discussion of prior tax liens might indicate that these were to re-

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42. *Id.* 55 A. 92 at 93.

43. See note 36 *supra*.

44. 122 N.J.Eq. 444, 194 A. 266 (Ch. 1937), *aff'd*, 123 N.J.Eq. 585, 199 A. 399 (E. & A. 1938).

45. 65 N.J.Eq. 119, 55 A. 92 (Ch. 1903).

46. See note 44 *supra*, 194 A. 266 at 268.

47. See note 40 *supra*.

ceive different treatment and become a charge allocated to corpus without reimbursement upon final sale. The uncertainty resulting from the unfortunate wording of the Woodruff opinion was clearly removed however by Vice-Chancellor Bigelow in *Fidelity Union Trust Company v. Murphy et al.*,<sup>48</sup> when he said,

“If the mortgage be regarded as an ordinary investment of trust funds, then, clearly, the rule would apply that taxes accrued against the mortgaged property prior to its acquisition by the trustee should be paid in the first instance out of the corpus. And then on final disposition of the property, corpus would be reimbursed for the taxes advanced and the balance of the proceeds would be apportioned between income and corpus. *Parker v. Seeley*, 56 N. J. Eq. 110, 38 A. 280; *Hudson County National Bank v. Woodruff*, 122 N. J. Eq. 444, 194 A. 266, *affirmed* 123 N. J. Eq. 585, 199 A. 399; *Trenton Trust Company v. Donnelly*, 65 N. J. Eq. 119, 55 A. 92.”<sup>49</sup>

Bearing in mind the nature of a joint venture such as the salvage process here involves and the resultant sharing of loss between life tenant and remainderman, there is, of course, no logical justification for treating one expense of the salvage differently from another. As a matter of practical business it must be realized that the removal of such liens both increases the chances of disposing of the property and enhances its sale value. While their removal is optional with the trustee as the facts of the particular situation may indicate, once it is decided that the liens are to be paid, their cost is as clearly an expense of salvage as the cost of foreclosure.<sup>50</sup>

The last of the expenses incurred in the actual conversion of the property is the cost of final sale. That these should be de-

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48. 124 N.J.Eq. 201, 1 A. (2d) 201.

49. *Id.* 1 A. (2d) 201 at 201.

50. See note 36 *supra*.

ducted from the proceeds of the sale has apparently never been questioned.<sup>51</sup> In *In Re Tuttle*,<sup>52</sup> *Equitable Trust Company v. Swoboda et al*<sup>53</sup> and *Trenton Trust & Safe Deposit Co. v. Donnelly*,<sup>54</sup> it is clear that the proceeds of the sale were so reduced in arriving at the net figure available for apportionment. In no case is such procedure questioned; rather it seems to be assumed. To the writer its fairness to the parties and its soundness in logic and principles of accounting are unquestionable.

While the specific questions have not yet appeared before our courts for determination, it would seem that miscellaneous expenses incurred in effecting final conversion, whether expenses of the sale itself or those reasonably necessary to make the property saleable should be similarly deducted from the gross proceeds available for apportionment. These would include such items as transfer stamps, appraisals, searches, etc. Such expenses might be withheld and paid from the gross proceeds when received or they might be advanced prior to sale depending on the nature of the expense and when it is incurred. If advanced, the funds should come in the first instance from corpus which would then be reimbursed prior to apportionment.<sup>55</sup>

So far we have considered the costs involved in converting the mortgage into real property and those incurred subsequently in reconverting the real property into cash. There remain for consideration those expenses intermediately incurred during the period from the foreclosure sale to the final sale when the legal title to the real property is in the trustee. These are the current or carrying charges ordinarily accruing against any piece of real property. They include current taxes, insurance, etc. Fundamentally there is no reason why these should

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51. See note 36 *supra*.

52. 49 N.J.Eq. 259, 24 A. 1 (Prerog. 1892).

53. 113 N.J.Eq. 399, 167 A. 525 (Ch. 1933).

54. 65 N.J.Eq. 119, 55 A. 92 (Ch. 1903).

55. See note 36 *supra*.

play any different role in a salvage process than any other expense. It is just as necessary that they be met as the others if the property is to be disposed of at all. It must be borne in mind that some properties will produce no income while in the hands of the trustee, others will produce a little, and still others will produce substantially more than is necessary to meet the costs of carrying the property until final sale. It must also be borne in mind that the court as well as the trustee is in each case faced with a practical problem of meeting expenses by applying cash from one source or another. Availability of ready cash is a prime consideration.

The question of taxes assessed during the period when the trustee held the real property first arose in *In Re Tuttle*<sup>56</sup> where it was held that these should be borne by the life tenant to be deducted from her share upon apportionment on the theory that, "The reason of this rule lies in the fitness of the exaction of annual charges, which go to the maintenance of the fund, from him who has the produce of the fund; otherwise the principal would be exhausted in its self-support."<sup>57</sup> It was noted, however, that the taxes were "much less than the sum apportioned to her for income."<sup>58</sup>

The problem of meeting carrying charges was anticipated in the case of *Equitable Trust Company v. Swoboda et al.*,<sup>59</sup> where the court adopted the theory of advancement and reimbursement. It said,

"It may well be that after the foreclosure sales a question will arise which should be answered at this time, which is: Out of what fund, will the cost of carrying the property after foreclosure be paid, in the first instance,

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56. 49 N.J.Eq. 259, 24 A. 1 (Prerog. 1892).

57. *Id.* 24 A. 1 at 2.

58. *Idem.*

59. 113 N.J.Eq. 399, 167 A. 525 (Ch. 1933).



assuming that the property so foreclosed and bought in by the trustee is unproductive?

"The answer is that the expense will be paid, in the first instance, out of the principal of the trust fund, but this expense should be deducted from the gross proceeds realized upon a sale thereof."<sup>60</sup>

This theory was approved by Vice-Chancellor Lewis in *Hudson County National Bank v. Woodruff et al.*<sup>61</sup> A new factor however was introduced, namely, that first the income currently realized on the property be applied against current expenses. Any deficiency was to be met by an advancement from corpus pending reimbursement. This was affirmed by the Court of Errors and Appeals in its modification of the decree as follows: "If the income of any separate unit of property acquired by the trustee, at foreclosure sale, be insufficient to meet the carrying charges thereof, the deficiency should, in the first instance, be paid out of corpus."<sup>62</sup>

In *Fidelity Union Trust Company v. Murphy et al.*,<sup>63</sup> the property in question realized an income while in the hands of the trustee more than sufficient to pay current taxes. Vice-Chancellor Bigelow held that unpaid taxes should be charged against this rental income, saying, "Counsel agree that the taxes are payable out of income, at least to the extent of the income of the property taxed."<sup>64</sup>

The application of income to the payment of current charges brings us to the question of the proper method of accounting to be followed by the trustee upon the first default. As a practical matter of sound accounting principles it is obvious that a clear

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60. *Id.* 167 A. 525 at 526.

61. 122 N.J.Eq. 444, 194 A. 266 (Ch. 1937), *aff'd*, 123 N.J.Eq. 585, 199 A. 399 (E. & A. 1938).

62. *Id.* 199 A. 399 at 340.

63. 124 N.J.Eq. 201, 1 A. (2d) 201.

64. *Id.* 1 A. (2d) 201 at 202.

picture of the financing of the salvage process can only be shown by a separate account which isolates the transactions of liquidation from the general accounts of both income and corpus. This was well recognized by Vice-Chancellor Lewis in *Hudson County National Bank v. Woodruff et al.*,<sup>65</sup> when he said,

“Should the trustee set up separate accounts in its books for each unit of property acquired by it through foreclosure and continue such accounts until the particular parcel of property is sold? Practical good sense, as well as the current of authority in and out of this state, requires that in instances where the trust fund consists of mortgages originally placed therein by the settlor or representing investments made by the trustee, that the trustee treat as separate units properties acquired by him through foreclosure; for no two such parcels are likely to be brought in on the same basis or to be sold under similar conditions. *Hagan v. Platt*, 48 N. J. Eq. 206, 21 A. 860; *In Re Tuttle's Case*, 49 N. J. Eq. 259, 24 A. 1; *Equitable Trust Company v. Swo boda*, 113 N. J. Eq. 399, 167 A. 525; *In Re Chapal's Will*, 269 N. Y. 464, 199 N. E. 762, 103 A. L. R. 1268; *Furniss v. Cruikshank*, 230 N. Y. 495, 130 N. E. 625. Neither *Outcalt v. Appleby*, 36 N. J. Eq. 73, nor cases of similar import, has any application to the case under consideration, because the unproductive property there involved constituted a part of the original trust estate; a distinction clearly recognized in *Parker v. Seeley*, 56 N. J. Eq. 110, 38 A. 280. Hence the answer to this question must also be in the affirmative.”<sup>66</sup>

Not only can the trustee present a clearer picture by the use of a separate account, but he can also avoid pitfalls that may later

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65. 122 N.J.Eq. 444, 194 A. 266 (Ch. 1937), *aff'd*, 123 N.J.Eq. 585, 199 A. 399 (E. & A. 1938).

66. *Id.* 194 A. 266 at 269.

cause him much embarrassment. Such practice makes it easy to accumulate income in the special fund for application against current expense. Any surplus can be held until final sale and added to the proceeds thereof. The total of the two figures, less the reimbursements of advances made for costs of foreclosure, etc. will then represent the net figure available for apportionment.<sup>67</sup> If a separate account is not used and income is added to the general account, there is the danger that the trustee in making regular payments of income to the life tenant will pay over a greater sum from the proceeds of the particular property than that to which the life tenant ultimately becomes entitled when his share of the apportionment is computed. It is true that in *Burnett v. Witschief*,<sup>68</sup> Vice-Chancellor Backes held that the net income of the land was payable to the widow who had a life estate, but here the executors had taken the mortgage in payment upon sale of the land under a power. It was held that this worked no conversion and that upon subsequent foreclosures when the executors bought back the land, the widow was entitled to its average net income, as well as to rents collected pending foreclosure by a receiver. It would seem that this was one of the cases distinguished in the *Woodruff*<sup>69</sup> opinion.

In reality therefore income realized by a trustee while he holds title to the land is not income so far as the life tenant is concerned. It becomes part of the salvage fund and is treated more like corpus than income until apportionment.<sup>70</sup> In the

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67. See note 36 *supra*.

68. 96 N.J.Eq. 71, 126 A. 23 (Ch. 1924).

69. 122 N.J.Eq. 444, 194 A. 266 (Ch. 1937), *aff'd*, 123 N.J.Eq. 585, 199 A. 399 (E. & A. 1938).

70. See DODGE AND SULLIVAN, ESTATE ADMINISTRATION AND ACCOUNTING (1937) at page 293 as follows: "If a fiduciary holds mortgages which constitute part of the trust assets, the interest thereon is paid to the tenant. If the owner of the real property fails to pay the interest on the mortgage, the life tenant suffers a loss of income. The fiduciary may then foreclose the mortgage and buy in the property at a sale in

light of this, the application of such income to current expense in the *Woodruff*<sup>71</sup> and *Murphy*<sup>72</sup> cases really adds nothing new. It merely means that no additional funds need be advanced from corpus for current expenses until the income currently realized is exhausted.

While specific authority is lacking,<sup>73</sup> it is suggested by the writer that surplus income over and above current expenses, should be first applied to meet other expenses before advancements from corpus are made. When the time for apportionment comes the net proceeds will equal the proceeds of the sale plus surplus income less reimbursement for advancements made. Whether the surplus income is reduced, or even completely eliminated by its application to other than current expense, or whether funds are advanced instead from corpus, and then reimbursed, the net available for apportionment is the same. However, application of surplus income will permit the investment of the corpus in productive property whereas its advancement to meet expenses of salvage will produce no return. It

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order to protect the property originally invested in the mortgage, or he may take title in lieu of foreclosure, thus saving expenses of foreclosure. The expenses incidental to the foreclosure and the carrying charges of the foreclosed property are originally chargeable to principal.

"Where the property is rented, the expenses incidental to operating the property are deductible from the rent, and the net rent remaining is applied to reduce the expenses incurred to take over the property. If the rent does not equal the operating expenses, this additional outlay is temporarily taken from principal. Upon the ultimate sale of the property, the cash proceeds of sale must be used to repay any principal outlay which remains unpaid after applying the net rents collected. The remaining cash on the sale of the property, together with the purchase money mortgage received on the sale of the property, is then allocated between principal and income on the basis of the ratio which the aggregate principal of the mortgage bears to the total unpaid interest."

71. 122 N.J.Eq. 444, 194 A. 266 (Ch. 1937), *aff'd*. 123 N.J.Eq. 585, 199 A. 399 (E. & A. 1938).

72. 124 N.J.Eq. 201, 1 A. (2d) 201.

73. But see note 70 *supra*.

seems advantageous therefore to apply the surplus income first in order to realize the fullest benefits to all parties.

The application of income from the real property during the period when it is held by the trustee is also involved in connection with another expense commonly met by the trustee, namely that of repairs to the premises. Such repairs may concern merely ordinary wear and tear and as such their cost is in the nature of a carrying expense. On the other hand they may be much more extensive and may be designed as improvements or additions to the property. Whether the particular repair falls into the one category or the other is often a matter of degree. The dividing line between the two is not easily drawn.

However, either or both types of repair may be reasonably necessary before the salvage process can be completed. If the premises are permitted to deteriorate, both the resale value and the rental value until resale may be seriously affected. There seems to be no more justification for a trustee to neglect regular maintenance than for him to permit current taxes to accumulate. Moreover, many properties may require extensive renovation or additional improvements before they can be made attractive enough to command a satisfactory resale price. Once it is determined that the repair is reasonably necessary to the salvage process, the question arises as to how it is to be met.

It is perhaps surprising that this question has not more frequently appeared before our courts. It was considered in *Hudson County National Bank v. Woodruff et al.*,<sup>74</sup> and it was there

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74. 122 N.J.Eq. 444, 194 A. 266 (Ch. 1937), *aff'd.* 123 N.J.Eq. 585, 199 A 399 (E. & A. 1938). Paragraph Eighth of the opinion (194 A. 266 at 270) reads as follows: "Should the cost of rehabilitating properties owned by the trustee as distinguished from ordinary maintenance and repair costs be paid out of corpus? It follows, as a result of the life tenant's duty to do his part in maintaining the value of the properties, that the cost of repairs, consisting of such changes in the structure as are designed and required merely to keep it intact and in its original operating condition, are properly chargeable to and should be paid out of income. On the other hand, the life tenant ought not to be

held that ordinary repairs incurred in maintaining the property be paid out of income. Extraordinary repairs increasing the value of the property were held chargeable to corpus.

If, as to the former, it was meant that they should be paid from the income of the particular property, the rule is both equitable and logical. If, on the other hand, it was meant that income from other trust property should be applied, the rule is most inequitable. The life tenant has already lost the income from the defaulted mortgage—to deprive him of his other income as well throws an added burden on him that is disproportionate. Such an interpretation is contra to the whole theory of joint venture and of the salvage process and is inconsistent with the treatment of the other carrying charges met by the trustee. The better interpretation would seem to be that such expense should be paid from income to the extent of the income from the foreclosed property, and that the balance, if any, should be advanced from corpus, until it can be reimbursed upon final sale and before apportionment. This is consistent with other portions of the *Woodruff* opinion and with the modification thereof by the Court of Errors and Appeals.<sup>75</sup>

As to the extraordinary repairs enhancing the value of the property which were held chargeable to corpus, there is again uncertainty as to what the court had in mind. If it was meant that the necessary funds should be advanced from corpus and that corpus should subsequently be reimbursed before apportionment, then the treatment of this expense would be similar

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required to permit income due him to be used to enrich the remainderman. Bogert on Trusts and Trustees, vol. 4, par. 803, page 2326. If the changes to the property are of such a nature that they be increasing its utility and productivity, will add value to it, as turned over to the remaindermen, they properly should be paid for out of corpus."

75. 123 N.J.Eq. 585, 199 A. 399 (E. & A. 1938). On page 400 the decree was modified as follows: "If the income of any separate unit of property acquired by the trustee, at foreclosure sale, be insufficient to meet the carrying charges thereof, the deficiency should, in the first instance, be paid out of corpus."

to that of others incidental to effecting the final conversion. If, on the other hand, no reimbursement was intended and it was meant simply that corpus was to bear the burden alone, then it repudiates the salvage theory of joint venture and explodes the orderly process otherwise provided for the liquidation of the frozen mortgage investment.

Aside from the possible ambiguities of the *Woodruff* case, however, the rules for the determination of the net proceeds available for allocation between life tenant and remainderman are clear. If a separate account is established to record the entries of the entire salvage process, the accounting trustee should have little difficulty in the application of these rules. As a guide the following summary is suggested:

1. Income should be accumulated for the payment of all carrying charges as they accrue.
2. To the extent that income should prove insufficient therefor, the necessary funds for the payment of the balance of the carrying charges should be advanced from corpus.
3. Other charges incident to the salvage of the defaulted mortgage should be paid from funds advanced from corpus.
4. Upon final conversion all advances from corpus should be reimbursed to corpus.
5. The balance of the proceeds of the final sale after reimbursement, plus any income that may have been accumulated, should be allocated between income and principal in accordance with the rules of apportionment.

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