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## Apportionment of Proceeds of Delayed Conversion Between Life Tenant and Remainderman of a Trust: Rate of Interest in Computing Income Loss

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## NOTES

### APPORTIONMENT OF PROCEEDS OF DELAYED CONVERSION BETWEEN LIFE TENANT AND REMAINDERMAN OF A TRUST: RATE OF INTEREST IN COMPUTING INCOME LOSS.

Since the economic debacle of 1929 many questions in the law of trusts have reached the courts which previously had demanded no consideration by them. Perhaps outstanding in perplexity have been those queries presented by trustees as to the distribution of proceeds of the sale of land which came into the trustees' hands through foreclosure of a trust mortgage in default. A typical situation is this: A dies, and by his will directs the investment of \$10,000 of his personal property to be held in trust by B, income therefrom to be paid to C during his lifetime and at C's death, the corpus of the trust to be paid to D. B properly invests the money in a mortgage on which subsequently the interest falls in arrears. On the foreclosure sale, the trustee buys in the property for the protection of the trust estate, holds it several years, and sells it at a loss. The

trustee is then faced with the distribution of proceeds of this sale. The difficulties and problems attached thereto are multiple and complex and quite sufficient to cause any capable and thoughtful trustee to ask the court's aid in the solution thereof. It was just such a situation which brought into court the case of *Nirdlinger's Estate*,<sup>1</sup> decided by the Pennsylvania Supreme Court on July 7, 1937. Out of such a situation may arise the necessity of determining as between the life tenant and the remainderman the incidence of costs of foreclosure, of delinquent taxes, of carrying charges during the period the property was held by the trustee, and concurrently their respective rights in the proceeds of the ultimate sale by the trustee. Recognizing the innumerable ramifications of the few problems above mentioned, the scope of this note will be confined to one feature of the allocation of the proceeds of the ultimate sale, which is peculiarly perplexing and upon which there is considerable divergence of judicial expression, — the rate of interest to be used in computing the loss of income to the life tenant, which latter sum must be found before proper allocation and apportionment can proceed.

By this time the weight of authority is overwhelmingly in favor of the view that as between the life tenant and the remainderman there should be an apportionment of the proceeds of this sale.<sup>2</sup> The investment by the trustee in the mortgage is for the benefit of both life tenant and remainderman. The security was given for the benefit of principal and income, the hazard of risk is borne by both the legatee for life and in remainder, and so when there is a loss sustained by reason of an unfortunate investment, the income as well as the corpus is thereby depleted and the loss falls on both.<sup>3</sup> At this point, however, the unanimity of decision ceases and each court proceeds upon its own theory, which may or may not be founded in reason or justice.

As to the rate of interest upon which the life tenant's share of the proceeds is to be computed there are five conceivable solutions, four of which have at least some claim to merit:<sup>4</sup> (1) From the date of default upon the mortgage until the date of ultimate sale the life tenant should be allowed no interest whatsoever; (2) the life tenant should be allowed interest at the mortgage rate until the date of foreclosure and no interest between that date and the date of the ultimate sale; (3) the life tenant should be allowed the mortgage rate of in-

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1327 Pa. 171 (1937). It might be noted here that the rules hereinafter discussed are equally applicable to the situation where the testator leaves to the trustee an unproductive mortgage and the situation where the trustee properly invests in a mortgage which thereafter becomes unproductive.

<sup>2</sup>Hagan v. Platt, (1891) 48 N. J. Eq. 259, 24 Atl. 1; Re Chapal, (1936) 269 N. Y. 464, 199 N. E. 762; Nirdlinger's Estate, (1937) 327 Pa. 171, 193 Atl. 30; Hudson Co. National Bank v. Woodruff, (1937) N. J. Ch., 194 Atl. 266. Annotation, 103 A. L. R. 1289.

<sup>3</sup>Graham's Estate, (1901) 198 Pa. 216, 218; 47 Atl. 1108, 1109.

<sup>4</sup>The American Law Institute's Restatement of Trusts, Tentative Draft No. 4, at page 221 apparently assumes there are but two methods in use. Bailey and Rice, "Duties of a Trustee With Respect to Defaulted Mortgage Investments," 84 U. of Pa. Law Rev. 157 at page 173, recognize three methods.

terest throughout the period of default until the date of sale; (4) the life tenant should be allowed the mortgage rate until the date of foreclosure and the prevailing rate for trust investments generally from the date of foreclosure until the date of ultimate sale; (5) the life tenant should be allowed the prevailing rate of interest throughout the period of default until the date of ultimate sale.

The first of these solutions is the only one which apparently has no claim of merit. Neither text writers nor case authority support this view which is obviously incorrect and inequitable, and which would result in benefit to the remainderman at the expense of the life tenant. This should not be, for as far as possible, the one should not profit at the other's expense.<sup>6</sup>

The second method propounded would seem to have some case law support. In the English case of *Moore v. Johnson, In re Moore*,<sup>6</sup> the trustees had invested 8000 pounds on mortgage, but interest was not regularly paid for some years, and the trustees foreclosed. There was 536 pounds arrears of interest due to the date of foreclosure. In 1852 the property was subsequently sold for 7900 pounds. The court held that the apportionment would be in the proportion that 8000 pounds of principal bore to 536 pounds of interest, and allowed the life tenant no interest between the time of foreclosure and the date of ultimate sale.<sup>7</sup> This case has been widely miscited.<sup>8</sup> One of the most recent cases discussing this rule is *In Re Pelcyger's Estate*.<sup>9</sup> Surrogate Wingate expresses the opinion that this is the correct rule, but in the actual decision of the case before him he is bound to follow prior New York cases from the court of last resort of that state, which latter decisions support another of these proposed solutions. In support of his reasoning the Surrogate necessarily applies a strict construction to the terms of the trust as usually created—that the "cestui que trust is by will given 'the income' of the trust estate 'as and when the same accrues'."<sup>10</sup> Therefore, he feels that the life tenant is not entitled to any interest after the date of foreclosure since in fact there has been no income. Further, he contends it is indulging in too much legal fiction to assert that in spite of the fact that the original investment in the bond and mortgage had ceased to exist by foreclosure, the income beneficiary is still entitled to interest thereon. As he argues,

"The right to receive interest either legally or equitably implies the indispensable correlative of a person obligated to pay it, but in the situation under discussion there is no such obligor. It is not the original mortgagor, since he has been permanently discharged from

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<sup>6</sup>In *Re Pelcyger's Estate*, (1936) 285 N. Y. Supp. 739.

<sup>6</sup>54 L. J. Ch. (N.S.) 432 (1885).

<sup>7</sup>As per report in *Re Pelcyger's Estate*, (Surr.) 285 N. Y. Supp. 739.

<sup>8</sup>See note 17 *infra*.

<sup>9</sup>285 N. Y. Supp. 723.

<sup>10</sup>*Id.* at 747.

any connection with the matter. On all primary rules it cannot be the remainderman or his property. The result of its allowance, therefore, is precisely what Judge Pearson refused to do in *Re Moore*, namely, to 'take it out of other people's money to pay him'.<sup>11</sup>

Persuasive as these arguments may sound, the learned Surrogate is completely ignoring the doctrine of equitable conversion as applicable here, and also the fact recognized by the Pennsylvania courts that in nearly all instances of long continuing trusts the life tenants are the primary objects of the bounty of the testators,<sup>12</sup> and their incomes should be preserved to them. For these reasons the arguments which he urges do not commend themselves to our best judgment.

The third proposed method is to allow the life tenant interest at the mortgage rate for the entire period of default until the ultimate sale. This rule has the following of a consistent line of cases in New Jersey,<sup>13</sup> and is the rule in use in New York.<sup>14</sup> The most recent New York case, *In re Otis' Will*,<sup>15</sup> decided by the Court of Appeals on November 23, 1937, is the first New York Court of Appeals case to discuss at any length the reasons for adopting this rule, and those reasons presented are not forceful. In this particular case the Surrogate court<sup>16</sup> and the Appellate Division<sup>17</sup> had applied a rule allowing interest at the mortgage rate until the date of foreclosure and at the "current rate" thereafter. (The application of this rule is more fully discussed later). The Court of Appeals suggests what is "doubtless the completely fair thing to do" which, however, they add is beyond the field of practicality.<sup>18</sup> Noting these difficulties they then apply the rule above set forth. Precisely the same objection can be raised to the decision as was stated concerning the arguments of the learned Surrogate in *Pelcyger's Estate* — it overlooks the doctrine of equitable conversion. An anomaly presents itself in the line of New Jersey cases. They all rely eventually on the authority of *Hagan v. Platt*,<sup>19</sup> which in turn finds its foundation in *In Re Moore*<sup>20</sup> wrongly read, which in fact denied to the life tenant any allowance for interest after the date of foreclosure.<sup>21</sup> The New

<sup>11</sup>285 N. Y. Supp. 723, at 746.

<sup>12</sup>*Nirdlinger's Estate*, 327 Pa. 171, 173.

<sup>13</sup>*Hagan v. Platt*, 48 N. J. Eq. 206, 21 Atl. 860; *Skinner v. Boyd*, 98 N. J. Eq. 55, 130 Atl. 22; *Trenton Trust & Safe Deposit Co. v. Donnelly*, 65 N. J. Eq. 119, 55 Atl. 92; *In re Tuttle*, 49 N. J. Eq. 259, 24 Atl. 1; *Hudson County National Bank v. Woodruff*, 194 Atl. 266.

<sup>14</sup>*In re Otis' Will*, 276 N. Y. 101, 11 N. E. 2d 556 (N. Y. Supp. Adv. Sh. January 4, 1938); *Meldon v. Devlin*, 167 N. Y. 573, affirming 53 N. Y. Supp. 172; *In re Pelcyger's Estate*, 285 N. Y. Supp. 723.

<sup>15</sup>276 N. Y. 101, 11 N. E. 2d 556 (N. Y. Supp. Adv. Sh. Jan. 4, 1938).

<sup>16</sup>287 N. Y. Supp. 758.

<sup>17</sup>295 N. Y. Supp. 754.

<sup>18</sup>276 N. Y. 101, at 112.

<sup>19</sup>48 N. J. Eq. 206, 21 Atl. 860.

<sup>20</sup>54 L. J. Ch. 432 (1885).

<sup>21</sup>Facts supra at note 8.

Jersey cases adopt the rule from precedent, without any discussion of the reasons for adopting it. The learned Surrogate in *Pelcyger's Estate*,<sup>22</sup> recognizing that prior New York decisions from the court of last resort of that state had granted to the life tenant interest until the date of ultimate sale, decided that in the case before him the rate should be consistent throughout, and should be the mortgage rate. In his words:

"The whole theory of the allowance of interest, as such, at all, is that the vanished obligation continues its existence until the date of the final liquidation. If this theory is to be considered valid in any connection, it should apply throughout, and the rate therein should govern."<sup>23</sup>

This is about the only discussion of the application of this rule which can be found in the reported cases. Based in the beginning on the erroneous reading of an early case, there seems to be little reasoning behind it. Fairness and justice demand rather the adoption of another policy yet to be discussed.

The fourth rule suggested is claimed to be the rule which should be adopted on principle.<sup>24</sup> Here interest is allowed to the life tenant at the mortgage rate until the date of foreclosure, and thereafter interest is allowed to him at the prevailing rate for trust investments generally. This view was adopted by the lower court in *Nirdlinger's Estate*.<sup>25</sup> Its cause can be argued with considerable effectiveness. As previously suggested, at first glance there might be entertained some doubt as to whether the life tenant should be entitled to any interest after the date of foreclosure. But it must be remembered that the mortgage was given as security for both principal and income.<sup>26</sup>

"When, therefore, it becomes necessary to foreclose on the security, the property thus acquired should continue to be treated like the debt which the trustees are trying to save. This is recognized in the doctrine of equitable conversion, according to which the land acquired on foreclosure by the trustees is regarded as personal property in their hands. If both principal and arrears cannot be saved, they both should bear the pro rata loss, because they are pro rata owners."<sup>27</sup>

<sup>22</sup>285 N. Y. Supp. 723.

<sup>23</sup>In *Re Pelcyger's Estate*, 285 N. Y. Supp. 723, 752. At page 746 Surrogate Wingate works out an example illustrating to his satisfaction the inequity of allowing any interest to the life tenant after the date of foreclosure.

<sup>24</sup>Bailey and Rice, *supra*, 84 U. of Pa. Law Rev. 176.

<sup>25</sup>26 D. & C. (Pa.) 3.

<sup>26</sup>Bailey and Rice, *supra*, 84 U. of Pa. Law Rev. 176.

<sup>27</sup>*Nirdlinger's Estate*, 26 D. & C. (Pa.) 3, 8.

The conversion doctrine is an application of the well-known maxim that "equity regards as done that which ought to be done." Unquestionably the life tenant is entitled to immediate liquidation of an unprofitable investment and the re-investment of the proceeds in income producing security. Yet the interests of the remainderman are to be considered on a par with those of the life tenant, and frequently because of conditions beyond the control of the trustee, immediate liquidation is impossible and may not occur for a considerable time. So, to protect the interests of the life tenant, equity regards as done that which ought to be done, and by virtue of the doctrine of equitable conversion finds the life tenant entitled to a share of the proceeds of the ultimate sale on the same basis as if the investment had been liquidated at the date of foreclosure. His share is computed at the rate allowed for trust investments generally, as if the proceeds had in fact been reinvested at the date of foreclosure. Under this analysis the rate of interest for trust investments generally is the only logical one to adopt for the period following foreclosure.<sup>28</sup> Furthermore, the adoption of such a doctrine seems to be justified in view of the not unwarranted probability that the income beneficiary was the primary object of the settlor's bounty.<sup>29</sup> The rule is the most meritorious of those yet considered, and from a practical standpoint is relatively easy of application. It is a matter of wonder that this rule has not acquired a greater following and the support of text writers. However, if it is accepted that in all fairness the doctrine of equitable conversion is applicable here, then the result achieved by the Supreme Court of Pennsylvania in *Nirdlinger's Estate*<sup>30</sup> seems even better than this fourth proposition.

The Pennsylvania Supreme Court adopted what is here termed rule number five. This rule allows interest to the life tenant at the rate for trust investments generally, from the "date of default" until the date of ultimate sale. It is the rule adopted by the American Law Institute in the Restatement of Trusts.<sup>31</sup> As pronounced in section 241 of the Restatement, the rule reads:

"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. The net proceeds

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<sup>28</sup>Bailey and Rice, *supra*, 84 U. of Pa. Law Rev. 177.

<sup>29</sup>*Nirdlinger's Estate*, 327 Pa. 171, 173.

<sup>30</sup>327 Pa. 171.

<sup>31</sup>Restatement of Trusts, sec. 241.

are determined by adding to the net sale price the net income received or deducting therefrom the net loss incurred in carrying the property prior to the sale."

Comment (b) of this section and Illustration 4 thereof say that trust mortgages are within the scope and operation of the rule. As is noted by the drafting committee of the Restatement of Trusts the result under this rule or under the third rule (allowing the mortgage rate for the entire period) will be identical if it should happen that the interest rate reserved in the mortgage is the "current rate" for trust investments generally. The Restatement committee itself found little case law to support their rule,<sup>32</sup> but on reason the rule can well be sustained. Its adoption by the Pennsylvania Supreme Court<sup>33</sup> carries one step further to its proper limit the doctrine applied by the lower court in *Nirdlinger's Estate*.<sup>34</sup> The lower court applied the doctrine of equitable conversion as of the date of foreclosure. The opinion of the Supreme Court recognizes this doctrine and the maxim "equity regards as done that which ought to be done," but adopts the logical conclusion that the doctrine should be applied as of the date when the interest on the mortgage fell in arrears. Certain it is that as soon as the interest fell in arrears the life tenant was entitled to have the trustee liquidate and reinvest the funds immediately in income producing securities. So, applying the equitable maxim, equity finds the life tenant entitled to a share of the proceeds of the ultimate sale equivalent to that sum which he would have received had the trustee liquidated the unprofitable investment and immediately reinvested it in income producing securities at the moment the interest on the mortgage fell in arrears. What could be more logical? If the doctrine of equitable conversion is to be applied to the situation, it seems only just and proper that it should be applied throughout the problem, not just in the limited use given it by the lower court in the same case. The objection has been made that if the rule of the American Law Institute were adopted, where the "current rate is adopted as of the date of default, the necessity arises of determining that exact date and needlessly presents a potential difficulty in the already complicated process of apportionment."<sup>35</sup> The objection seems academic. Although it is true that interest accrues from day to day, when a payment on interest is made it is made to cover a specific period, e. g. the quarter ending June 1, and if no interest is paid thereafter there would seem to be little difficulty in determining when the interest fell in arrears, and consequently when the duty to sell arose

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<sup>32</sup>Restatement of Trusts, Ten. Draft No. 4, Explan. notes, p. 221; *Parsons v. Winslow*, 16 Mass. 361; *Roosevelt v. Roosevelt*, 5 Redf. 264, (N. Y.); *Greene v. Greene*, 19 R. I. 619; *Cox v. Cox*, L. R. 8 Eq. 343.

<sup>33</sup>*Nirdlinger's Estate*, 327 Pa. 171.

<sup>34</sup>*Nirdlinger's Estate*, 26 D. & C. (Pa.) 3.

<sup>35</sup>Note: 86 U. of Pa. Law Rev. 109, at 110.



on the part of the trustee. The adoption of the rule laid down by the Restatement and the Pennsylvania Supreme Court has the added advantage of bringing into harmony the rule relating to delayed conversion of a defaulted mortgage investment held in trust and the rule relating to delayed conversion of unproductive trust property in the hands of a trustee, as pronounced in *Edwards v. Edwards*,<sup>36</sup> cited in discussion of the rule in sec. 241 of the Restatement of Trusts.<sup>37</sup>

In conclusion it might be added that the rule of the Restatement of Trusts as adopted by the Supreme Court of Pennsylvania is a close parallel to that adopted by the Uniform Principal and Income Act to cover a similar situation.<sup>38</sup> In fact, it has been asserted that the two rules are the same.<sup>39</sup> This last is a slight misstatement, however. The Uniform Principal and Income Act, section 11, adopts an arbitrary rate of 5%. The similarity of the two rules is that both adopt for the entire period of default a uniform rate, which is not the rate expressed in the mortgage, and, too, the rate used in the Uniform Act was chosen as the rate representative of the average investment return rate.

It is to be hoped that the result reached by the Supreme Court of Pennsylvania will be noticed and followed when the problem arises again in this and other jurisdictions. This is desirable not solely to achieve uniformity of judicial operation, although that is desirable as far as feasible, but also because it is the rule which stands up best under tests of reason and justice.<sup>40</sup>

Robert McK. Glass

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<sup>36</sup>183 Mass. 581, 67 N. E. 658.

<sup>37</sup>Restatement of Trusts, Ten. Draft No. 4, p. 220, Explanatory notes of sec. 233 (sec. 241 of the Final Draft).

<sup>38</sup>4 Bogert: "Trusts and Trustees", sec. 827, note 81.

<sup>39</sup>Note: 86 U. of Pa. Law Rev. 109.

<sup>40</sup>The case of *In Re Myers' Estate*, 161 N. Y. Supp. 1111 (1916), not otherwise reported, which is sometimes cited in discussion of this subject, has been studiously and purposely avoided because the reported case does not show whether the court adopted the "current rate" or mortgage rate of interest. Any statement as to which was used is conjecture. One recent New York case (*In Re Pelcyger's Estate*, 285 N. Y. Supp. 723, 741) says the court in the *Myers'* case purported to apply the "current rate" throughout. The most for which the case can be cited safely is the proposition that upon delayed conversion there should be an apportionment of the proceeds between life tenant and remainderman.