Denver Law Review

Volume 13 | Issue 2 Article 2

January 1935

The Estate of Black

Edward C. King

Recommended Citation
Edward C. King, The Estate of Black, 13 Dicta 31 (1935).

THE ESTATE OF BLACK

By EDWARD C. KING, *Trust Officer, International Trust Co.*

THE story that follows is fiction. Neither the facts nor the characters are real, but all the things that are described as happening have happened, and may happen again. The rules of law are in accordance with what the writer believes to be the weight of authority. This is the story:

John Black, of Denver, died in 1920, leaving a will which read as follows:

> "I, John Black, of Denver, make this my will. I give and devise my entire estate to Sam Jones, of Denver, in trust to hold, manage, sell, mortgage, convey, transfer, invest, and reinvest the same, as he in his discretion deems best, and free from the jurisdiction of the probate court; to pay the income to my son John as long as he lives, and, as soon as practicable after my son's death, to distribute the entire remainder of the estate to my said son's descendants *per stirpes.* I appoint my friend, Richard Roe, executor, with the same powers and discretion with respect to my estate as I have above conferred upon my trustee.
>
> "In witness whereof, etc."

The estate consisted of the following items:

1. A farm in Illinois worth $100,000.
2. A farm in Colorado worth $50,000.
3. Stock of a local dry goods company worth $25,000.
4. High-grade telephone company stock worth $25,000.

The four items had a total value (as of the date of death) of $200,000.

The will was admitted to probate in Colorado and subsequently in Illinois; Roe qualified as executor in both states.

Claims amounting to $100,000 were filed in the Colorado court and duly allowed. Fees and costs were estimated at $4,000.

No claims were filed in Illinois, where expenses and taxes were estimated at $4,000.

The executor, like a good bridge player, looked over the situation before he made a play. The stock in the Dry Goods Company had paid 10% for many years; it seemed very safe, so he decided to hold it if possible. The telephone stock was considered a high-grade investment stock. He decided to hold it also. The Illinois farm was increasing in value very rapidly but it was too distant to be easily managed and he decided to sell it as soon as a purchaser could be found. The Colorado farm, which was declining in value because of litigation over water rights, he decided to hold as a home for the testator's son, but to mortgage it to raise additional money with which to pay debts. He talked all his plans over with the testator's son, who was of age, and he approved the plan, so the executor proceeded as follows:

(1) He borrowed $25,000 from a mortgage company and secured the note by a mortgage on the Colorado farm. He was careful to sign the note and mortgage "Richard Roe, as executor of the estate of John Black, deceased."

(2) He sold the Illinois farm for $100,000 net. From this sum he paid fees, costs, and taxes in Illinois amounting to $4,000 and turned over to himself, as the domiciliary executor in Colorado, the $96,000 balance.

(3) From the $25,000 derived from mortgaging the Colorado farm and the $96,000 from Illinois he paid all claims, costs, and fees in Colorado and had a cash surplus in the principal account amounting to $17,000. His administration seemed complete, except for the routine of closing and turning over the residue to the trustees.

He now reviewed the situation. Six months had elapsed. In six more he could close the estate. The original estate had been appraised at $200,000. He had paid claims and expenses amounting to $108,000 and he had on hand:

(1)	The equity in the Colorado farm now estimated to be worth	$25,000
(2)	The dry goods company stock, not looking quite as safe as before, but still worth	25,000
(3)	The telephone stock now worth	30,000
(4)	Principal cash	17,000
	A total of	$97,000

He congratulated himself. He had been honest and had exercised his best judgment throughout. He had charged a small fee. The value of the estate had increased during his administration, and the son and beneficiary of the testator was well pleased.

He held a conference with the testator's son John, and they decided to invest the $17,000 in some oil stock on a tip that it was due for a rise. They bought. The stock went up. The executor sold for $24,000 and put the money in U. S. Government bonds. Again he had a tip on the oil stock, sold the governments, bought the stock again, this time $24,000 worth, and it dropped. He sold at $22,000 (still $5,000 ahead), and bought governments. At this juncture, a little more than two months before the closing date, the Dry Goods Company (the stock of which he had held) suddenly failed and its stock was worthless.

Made cautious by this loss, the executor sold his telephone stock, which had continued to rise, for $35,000 and put this money into governments.

In due time he published notice of final settlement in Colorado and Illinois, filed his final reports, asked that they be approved, and that, upon turning over the property in his hands to Jones, as trustee, he be discharged.

In the Illinois report he asked to be credited with $100,000 as evidenced by vouchers showing payment of $4,000 in expenses, fees, and taxes, and $96,000 paid to himself as domiciliary executor in Colorado. This seemed unobjectionable.

In his Colorado report he asked to be credited with:

(1) The government bonds, worth $57,000.

(2) The Colorado farm, in which there was an equity of $25,000.

(3) Interest earned during administration represented by cash on hand, $4,000.

(4) Claims and expenses paid (as per vouchers which he submitted) amounting to $104,000.

He was satisfied with this report, too, although there had been some loss. He felt that no one could have anticipated the failure of the Dry Goods Company and he had made up some of the loss in other ways.

At this stage the executor began to encounter trouble. The trustee objected to the Illinois report on the ground that the Illinois executor had wrongfully applied the $96,000 paid to the Colorado executor. The trustee claimed that the money, being the proceeds of the Illinois land and, from the equitable point of view, still being Illinois land, could be reached by creditors only by the method provided in the Illinois statute; that is to say, by filing claims in apt time in the Illinois Probate Court. The Illinois Probate Court, on the authority of a case decided by the Supreme Court of Illinois, held that no claims having been filed in Illinois, the Illinois real estate, or the proceeds thereof, passed directly to the trustee, free from the claims of Colorado creditors, and directed the executor to make good the $96,000 deficit. This he did by selling the equity in the Colorado farm for $25,000, and the government bonds for $57,000, and by supplementing this $82,000 with the $4,000 interest and $10,000 of his own money. He was advised that an appeal from the decision of the Illinois Probate Court would be a waste of money —and he had none to waste. He took a receipt from the trustee and was discharged in Illinois.

He now had nothing left in the Colorado estate. He was in a bad spot and felt that he had been imposed upon. He had not asked for the job; he had used his discretion as the will said he might; he was out $10,000 of his own money and didn't know whether he could get it back from the creditors or not.

He filed an amendment to his Colorado final report in which he asked to be charged with the proceeds of the farm, $50,000; the proceeds of telephone stock, $35,000; a profit on the oil stock, $5,000, and interest of $4,000; and to be credited with payments of expenses, claims, etc., amounting to $104,000, leaving the estate indebted to him in the sum of $10,000.

The trustee, however, objected to the report, alleging that the executor had no authority to hold the stock of the Dry Goods Company, which was not a legal investment, except at his own risk, and was therefore chargeable with the sum which the stock would have brought at any time during the first nine months of the administration, namely $25,000.

The executor's answer was, first, that by the terms of the will he had discretionary power with respect to the retention or sale of investments; that he had exercised that discretion, and that he was not, therefore, chargeable with any loss; and, secondly, that even if he had no authority to hold the stock the loss was offset by a $15,000 profit in the telephone stock and oil stock and $10,000 paid by him in settlement of claims and expenses.

On the first point the court, in accordance with what is probably the weight of authority, held that power conferred upon a trustee to make investments "in his discretion" does not permit a trustee to invest in securities not authorized by statute, and, on the second point, that the executor could set off the $10,000 contributed by him, but must make good the other $15,000, the rule being:

"A trustee who is liable for a loss occasioned by one breach of trust cannot reduce the amount of his liability by deducting the amount of a gain which has accrued through another and distinct breach of trust; but if the two breaches of trust are not distinct, the trustee is accountable only for the net gain or chargeable only with the net loss resulting therefrom."

The trustee, Jones, also claimed that the executor was chargeable with a loss of $2,000 incurred when he sold $24,000 worth of government bonds and invested the proceeds in oil stock, which he subsequently sold for $22,000. Again the court sustained the objection and surcharged the executor an additional $2,000. In support of his ruling the court said:

"* * * If the trustee in breach of trust purchases property which he subsequently sells at a profit and he invests the proceeds for the trust in proper trust securities and subsequently he sells the securities and with the proceeds makes a purchase which is not a proper trust investment and which he sells at a loss, he is chargeable with such loss and cannot deduct the amount of the profit which resulted from the previous breach of trust."

The executor paid everything and was ultimately

Charged with		Credited with	
The dry goods company stock	$25,000	Payments as per vouchers	$104,000
The proceeds of the telephone stock	35,000	Cash	17,000
The profit in the oil stock	7,000		$121,000
The proceeds of the Colorado farm	50,000		
Interest	4,000		
	$121,000		

and the estate was closed and he was discharged.

The executor had acted in good faith and had been surcharged to the extent of $27,000, but he was not yet in the clear.

You will recall that Roe (as executor) had signed a $25,000 mortgage note. The holder ultimately foreclosed, took a $5,000 deficiency judgment against Roe personally, and collected. Roe sued the trustee for reimbursement. How he came out I don't know. The rule with respect to Roe's liability is as stated in Loring's *A Trustee's Handbook,* pages 92 and 93, where it is said:

> "If the trustee has the power to do the act which he contracts to do he may bind the trust estate in his hands and in those of his successors in the trust *by his express contract.*
>
> "Whether the trustee has the power to do the act or not, the contract will bind him personally unless he stipulates in the contract that he shall not be personally liable, or its equivalent that he shall be liable to the extent of the trust assets only."

Sam Jones, the trustee who caused Roe so much trouble, was much better informed on trust matters than Roe. When he took over the trust estate he did so with the intention of avoiding all of Roe's mistakes. The will conferred upon him power to invest and reinvest as he in his discretion deemed best, but he now knew that this confined him to Colorado legals and he acted accordingly.

The entire estate distributed to the trustee by the Illinois executor and the Colorado executor amounted to $113,000; $4,000 of which the trustee considered to be interest earned on the Colorado assets during administration. The trustee paid this $4,000 of income or interest to the life tenant, leaving in the principal account the sum of $109,000, which he invested as follows:

With $66,000 he bought sixty $1,000 5% General Obligation bonds of a southern Colorado municipality, due in 1935. The price was $1,100 for each bond.

With the balance of $43,000 he bought 6% first mortgages on Denver real estate, appraised in each case at twice the amount of the mortgage debt. From time to time as these mortgages were paid off he substituted other Denver mortgages.

During the entire administration the trustee paid the life tenant all the interest paid to the trustee on the bonds and mortgages, less the trustee's fee.

The administration of the trust was uneventful, except that in 1930 the trustee foreclosed a $20,000 mortgage, bought in the mortgaged premises for $21,000 (the amount of principal, interest, and taxes) and held the property, which was net unproductive, until January, 1935, when he sold it for $30,000. In February, 1935, the life tenant died, insolvent, leaving as his only heir a minor child. At this time the bonds were in default and worth $43,000. There had been no loss on the mortgages.

The trustee distributed the mortgages, worth about $23,000, $30,000 in cash derived from the sale of the land acquired on foreclosure, and the $60,000 par value of bonds, worth $43,000, to the guardian of the minor beneficiary. Had the trustee made any mistakes for which he could be held accountable? Had he paid too much or too little to the guardian? Had the administrator of the estate of the life tenant a right to any part of the estate?

A review of the administration of the trust indicates that the trustee made at least four mistakes.

The first was in the allocation of the $113,000 received by the trustee as between income and principal. You will recall that he paid the life tenant the $4,000 actually produced by the estate while it was being administered in court. The life tenant was entitled to income from the date of the death of the testator, not on the basis of what was actually earned, but rather on the basis of what should have been earned. In other words, there should have been allocated to principal that portion of the $113,000 which, with interest at a reasonable rate, say 5%, for one year, would have equaled $113,000. According to this formula the principal account should have received $107,619, and the income account $5,381. The life tenant was, therefore, underpaid to the extent of $1,381.

The second mistake made by the trustee was when he invested $66,000 in the bonds of a single Colorado municipality. It is true that the bonds were of a type authorized by law, but the rule is that although a trustee may properly invest in a particular type of security, he must use care, skill, and caution in selecting an investment within the type. Among the matters which he should consider in selecting an investment, in addition to those relating to safety of principal and the amount and regularity of income, are (1) marketability, (2) the length of the term of the investment, (3) the probable duration of the trust, (4) the probable condition of the market with respect to reinvestment at the time when the investment matures, (5) the diversification of risk, (6) the requirements of the beneficiaries, (7) in some cases, the other assets of the beneficiaries, and (8) the effect of the investment in increasing or diminishing liability for taxes.

When the trustee bought a single block of bonds equal to more than half of the value of the trust he was guilty of negligence in failing to properly diversify, and therefore probably could have been surcharged for the loss resulting from this investment. The trustee failed to diversify sufficiently with respect to the type of investment, geographical location, and date of maturity.

The third mistake made by the trustee was in paying all the interest from the bonds to the life tenant. You will recall that he paid $66,000 for $60,000 par value of bonds. He should, therefore, have amortized the premium by deducting from each interest payment and adding to principal a sum sufficient to repay the principal for the premium advanced by the date on which the bonds matured. In this connection, therefore, he overpaid the life tenant by about $6,000. The general rule in this connection is as follows: Unless it is otherwise provided by the terms of the trust, if property held in trust to pay the income to one person for a period and thereafter to pay the principal to another, is wasting property, the trustee is under a duty to the remaindermen to amortize or to sell the property. Wasting property includes leaseholds and other property yielding receipts only for a specified period of time; bonds purchased at a premium; royalties, patent rights; interests in mines, oil and gas wells; quarries, timber lands, etc.

The fourth mistake made by the trustee was in allocating to principal all the proceeds of the sale of the land acquired on foreclosure. You will remember that the trustee foreclosed a mortgage, bought in the foreclosed property at a foreclosure sale, held it for five years, during which he was under a duty to convert it to a legal investment as soon as reasonably possible, and sold it for $30,000. He added the entire $30,000 to principal. He should have allocated to principal that portion of the proceeds which, with interest at a reasonable rate, say 5%, for five years, would equal $30,000. That is to say, he should have allocated to principal the sum of $24,000 and to income the sum of $6,000.

This interesting rule, which has long been recognized, and which probably should be applied in thousands of cases where its very existence is unknown, has been stated in Restatement of the Law of Trusts as follows:

"Allocation on Delayed Conversion. (1) Unless it is otherwise provided by the terms of the trust, if property 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, or which is wasting property or produces an income substantially more 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) The net proceeds are determined by adding to the net sale price plus the net income received or deducting therefrom the net loss incurred in carrying the property prior to the sale."

There were probably other mistakes for which the executor or the trustee could have been held accountable. There are dozens of traps into which an unwary executor or trustee may fall. The law is complex and in many cases unsettled. The important thing is to know that dangers exist and where to expect them.