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SOME PROBLEMS ARISING OUT OF DEPOSITS TO PAY
PRINCIPAL AND INTEREST ON BONDS

*Paul P. Lipton**

SINCE *Lawrence v. Fox*¹ contracts students have been puzzled by the numerous and varying relations that may arise when *A*, the debtor, delivers money to *B* to pay *C*, his creditor. Equally puzzling and much more complicated are the rights and relations of the obligor, trustee and bondholders with respect to sums deposited with the trustee to pay principal and interest on bonds.

The insolvency during recent years of many large trust companies that had been named as trustees in indentures securing corporate bonds, having on hand at the time of their failure large sums of money which were to be used in making payments to bond and coupon holders, has brought to the forefront the very important problem of determining where the loss occasioned by the insolvency of the trustee must fall. Until recently, however, it was the insolvency of the corporation or other depositor that gave rise to difficulty, a controversy generally arising when a receiver attempted to claim for the benefit of all the creditors of the depositor the moneys on deposit. Analysis of the rights of the parties in this situation is essential to a proper understanding of the rights arising on the insolvency of the trustee and will therefore be attacked first.

I

RIGHTS ON THE INSOLVENCY OF THE DEPOSITOR

The problem presented here is one not difficult of statement. Where a receiver claims the deposits, the ultimate question is simply, has the depositor intended to confer irrevocable rights upon the bondholders? Its determination, however, has been troublesome.

Particular attention must be given to the provisions in the bonds and trust deed relating to the payment of bonds and coupons, for it is the intention of the depositor, to be ascertained in the light of all the facts and circumstances surrounding the making of the deposits, which will be controlling. Many trust deeds now explicitly require the mortgagor to deposit with the indenture trustee funds to meet maturing principal and interest installments. In the case of deposits pursuant to

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¹ 20 N. Y. 268 (1859).

such a provision, the right of the bondholders to the deposits has generally been recognized, and the controversy, if one arises, is between different classes of bondholders. For this reason cases involving such deposits will be treated separately. With respect to the so-called voluntary deposits, however, the courts have had considerable difficulty in determining when the bondholders have acquired irrevocable rights of which they may not be deprived.

A. *Voluntary Deposits*

Even where the trust deed does not require the making of the deposits, it may be somewhat inexact to classify them as voluntary. Bonds and coupons are generally made payable at the office of the indenture trustee or at the "office or agency" of the mortgagor, and the typical trust indenture will require the mortgagor to maintain an office or agency in a designated city, usually New York, for the payment of principal and interest on bonds. These provisions at least contemplate the making of deposits.

Controversies on the insolvency of the depositor have invariably involved deposits to pay interest coupons. This might be expected in view of the comparatively greater number of deposits for this purpose than for payment of principal on bonds. But more important, perhaps, is the fact that bondholders are diligent in securing payment of their bonds, whereas it often happens that coupons are not presented for payment until considerable time after the making of the deposit has elapsed, thus increasing the likelihood of the mortgagor's becoming insolvent in the interim.

That it was possible for the depositor to so act as to put a fund beyond its control out of which interest should be paid and thus give the bondholders rights in the funds superior to those of the general creditors of the depositor was indicated in two early New York cases. In *Rogers Locomotive & Machine Works v. Kelley*,² one of the leading cases on the status of funds deposited to pay interest on bonds, the mortgagors deposited with brokers in New York funds to meet interest coupons and received a receipt reciting that the money was received "in trust to apply the same to an equal amount of the coupons . . . the said money not to be subject to the control of said company otherwise than for the payment of said coupons." An attachment in favor of certain creditors of the mortgagor was issued, but the brokers disregarded the attachment and continued to make payments to the coupon holders.

² 88 N. Y. 234 (1882).

An action was then brought to determine the effect of the levy under the attachment. The New York Court of Appeals, reversing the decision in the lower court,³ held that the brokers were justified in paying the coupon holders, as the corporation, having intended to devote the fund deposited exclusively to the payment of the coupons, had no interest in the deposits subject to attachment. The express declaration in the receipt was said to evidence an intention to create a trust for the coupon holders.

In the other case, *Coe v. Beckwith*,⁴ a decision of the Supreme Court of New York in 1860, it was held that funds deposited for the payment of interest on bonds had passed beyond the control of the depositor even though there was no agreement or other intimation of the status of the funds deposited. In this case remittances had been made by the mortgagor to the trustee under the trust indenture, the mortgagor having previously indicated by letter that all funds thereafter remitted were "to be deposited to the credit of George S. Coe, trustee of our first mortgage bonds, for the purpose of paying the coupons of our bonds secured thereby." Subsequently a creditor of the mortgagor procured a warrant of attachment which was served on the trustee, who thereupon filed a bill for instructions from the court as to his duty with respect to payments out of the funds so deposited. A demurrer to the complaint was overruled, the court holding that the depository had title to the funds as trustee for the bondholders and could maintain the suit and declaring that the bondholders had obtained irrevocable rights in the funds deposited.

Subsequent cases, however, have been thought firmly to establish the doctrine that the simple deposit of money in a bank or with the trustee under the trust indenture with instructions to pay maturing coupons as they are presented will merely constitute the depository the agent of the depositor to make the payments, and that the bondholders will not be entitled to the funds on the insolvency of the depositor.

In *Staten Island Cricket & Baseball Club v. Farmers' Loan & Trust Co.*⁵ interest was apparently payable at the office of the mortgagor, but the mortgagor made annual remittances to the trustee under the trust mortgage of the amount of the interest due on the outstanding bonds, and requested the trustee to make payments to the coupon holders. For this service the mortgagor paid the trustee a small commission. The trustee, a general banking institution, opened a special

³ 19 Hun 399 (N. Y. S. Ct. 1879).

⁴ 31 Barb. 339 (N. Y. S. Ct. 1860).

⁵ 41 App. Div. 321, 58 N. Y. S. 460 (1899).

account with the mortgagor in respect to these deposits, crediting the plaintiff with the amount received and debiting it with the amount paid out to the coupon holders. The correspondence between the parties merely indicated that funds had been remitted for the payment of interest due on stated dates, and that the moneys had been received and credited to the mortgagor's account to pay the coupons under a given date. This course of dealing continued for about thirteen years. Apparently, not all of the coupon holders presented their coupons for payment and it came about that the trustee had in his hands about \$500 over and above the amount paid upon the matured coupons. The mortgagor, who was not insolvent, sought to recover this balance, but the trustee resisted his claim on the ground that irrevocable trusts for the benefit of the coupon holders had been created. The court held that the only effect of the deposits was to constitute the trustee the agent of the mortgagor to distribute the moneys; that it did not constitute the defendant a trustee or impress the money with a trust for the benefit of the bondholders; and that hence the balance could be reclaimed though all the coupon holders had not been paid.

The *Rogers* case was distinguished on the ground that there was there an express declaration of trust, whereas in the present case "there is no declaration of trust by the plaintiff, nor *words* from which a trust could be spelled out."⁶ It was also pointed out that "nothing appears tending to show that the method adopted for making payment of interest was intended for any other purpose than mere convenience."⁷

The court did indicate in the *Staten Island* case that "There may be cases of insolvency and deposit under circumstances as will clearly show an intent to pass title to the money and secure it to meet the requirements of a particular purpose."⁸ And from statements in the opinion to the effect that the mortgagor continued to remain liable to the coupon holders it is apparent that the court was influenced by the fact that a recovery by the mortgagor, who was not insolvent, would not prejudice the coupon holders.

The right of the receiver of an insolvent mortgagor to reclaim deposits made to pay interest on bonds was first presented in *Noyes v. First National Bank of New York*.⁹ The opinion does not state where the coupons were payable. The mortgagor, a railroad, made payments for about three years at its office in New York. Thereafter coupon

⁶ *Ibid.*, 41 App. Div. at 323 (italics supplied).

⁷ *Ibid.*, 41 App. Div. at 324.

⁸ *Ibid.*

⁹ 180 App. Div. 162, 167 N. Y. S. 288 (1917).

holders were paid on presentation of their coupons at the defendant bank, payment being made from sums which had been deposited by the defendant in two special coupon accounts. This practice continued for about ten years. No deposits had been made in one of the accounts for eight years, but the account was not closed and the sums deposited were held to meet coupons which had matured but which had not been presented for payment. The mortgagor then became insolvent and the receiver demanded that the bank turn over to him the amounts remaining on deposit. The bank resisted this claim on the ground that the deposits created a trust in favor of the holders of outstanding coupons. The Appellate Division of the Supreme Court of New York thought, however, that the case was controlled by the *Staten Island* case, which was "not to be distinguished so far as the material facts are concerned,"¹⁰ and judgment was rendered for the receiver. No other reasons were advanced in support of the decision. On appeal, the court of appeals affirmed the decision without opinion.¹¹

While the *Noyes* case is entitled to more weight than the *Staten Island* case inasmuch as a recovery by the receiver would prejudice the rights of holders of outstanding coupons, it should be noted that the funds in the *Noyes* case, as was probably true in the *Staten Island* case, had, apparently, been on deposit and unclaimed for a number of years, and that the coupon holders were not represented in the litigation. In a Pennsylvania case¹² reaching the same result, the opinion clearly indicated that the fund involved had been on deposit for fourteen years, and the bank's only defense to an action by a receiver of the insolvent depositor was its claimed duty to hold the funds for the coupon holders. The reluctance of a court to hold in favor of the depository in such a case should be readily apparent. Quite often bonds are lost, destroyed or misplaced, and it is possible that the coupons may never be presented for payment. Certainly under such circumstances it is reasonable that the funds be distributed among all the creditors of the mortgagor.

One of the few cases in which it actually appeared that the known bondholders would be prejudiced by the order of the court turning deposits over to a receiver is *In re Interborough Consolidated Corp.*¹³ the leading case in the federal courts on the status of funds deposited to

¹⁰ *Ibid.*, 180 App. Div. at 166.

¹¹ *Noyes v. First Nat. Bank of N. Y.*, 224 N. Y. 542, 120 N. E. 870 (1918).

¹² *Homan v. First Nat. Bank*, 316 Pa. 23, 172 A. 647 (1934).

¹³ (C. C. A. 2d, 1923) 288 F. 334, affg. (D. C. N. Y. 1921) 277 F. 249, cert. denied 262 U. S. 752, 43 S. Ct. 700 (1923).

pay interest on bonds. The bonds in that case were payable at the mortgagor's "office or agency in the City of New York." For a number of years the coupons were paid at the offices of the trustee, a general banking institution, which had been designated as agent for the payment of interest on bonds. A resolution was then passed directing that interest should be payable at the offices of the mortgagor in New York. Thereafter deposits were made semi-annually with the trustee, the deposits being placed in an account entitled "Interborough Consolidated Corporation, Interest on Interborough Metropolitan Company 4½% Bonds," and on presentation of coupons at the office of the mortgagor, checks stating on their face that they were to be paid out of a fund entitled as above were given to the coupon holders. Subsequently, proceedings in bankruptcy were taken against the mortgagor, and application was made by certain bondholders for an order directing that the deposits be held applicable to the payment of interest on their bonds.

The federal district court did make some analysis of the problem involved before deciding in favor of the receiver,¹⁴ but stated that reference to the *Noyes* case "would have been sufficient, but for the amount involved and the desire of the court to find some sound reason, if such there were, to assist those whose tardy presentation was due to delay occasioned by war."¹⁵ On appeal to the United States Circuit Court of Appeals for the Second Circuit, however, the question received thorough consideration, but the decision was affirmed.

In the earlier cases no mention had been made of the doctrine prevailing with respect to deposits to pay declared dividends, namely, that stockholders are entitled to the funds on the insolvency of the corporation.¹⁶ The distinction between deposits to pay interest coupons

¹⁴ "It may be, and it will be assumed for the purposes of the argument, that the corporation could so act as to put a fund beyond its control out of which the interest should be paid (although, *quaere*, whether the corporation had such power); but such disposition must be clearly evidenced by acts or transactions which show, in effect, the creation of a trust fund over which the corporation has relinquished control. Nowhere can there be found anything, either in correspondence or in vouchers, which indicates that at any time, if the corporation so desired, it could not have withdrawn the deposit from the Empire Co. and deposited the funds elsewhere, or retained them and paid the coupon holders, if it pleased, with currency over its own counter." *Ibid.*, 277 F. at 255.

¹⁵ *Ibid.*, 277 F. at 256.

¹⁶ See 3 SCOTT, TRUSTS, § 531.1 (1939), and cases cited; 28 COL. L. REV. 477 (1928); 11 N. C. L. REV. 111 (1932). Bogert states: "If the corporation which has declared the dividend sets apart a fund to pay the dividend, as by opening a dividend account with a bank, it makes itself trustee of the claim against the bank for the persons entitled to the dividend, and such persons are entitled to the proceeds of the claim against the bank, even though the corporation may fail before the dividend is

and deposits to pay declared dividends has been the subject of much criticism. One writer has declared it to be "without reason."¹⁷ Judge Learned Hand has declared:¹⁸

"I cannot conceive any legal distinction between a fund deposited in a bank to meet a declared dividend, and called a 'Dividend Account,' and a similar fund deposited to meet coupons and called a 'Coupon Account.' A declared dividend is universally regarded as a debt, and a coupon is, of course, no more than a secured debt. How it can be thought, *ceteris paribus*, that one account should be a trust fund, and another not, passes the limit of my discrimination."¹⁹

Some cases have emphasized the fact that a declaration of a dividend creates a debt and that the setting apart of the money to pay it creates a trust, but there is no good reason why the creation of a debt plus the setting apart of the money to pay it should be held to create a trust while the setting apart of money to pay a debt already in existence does not.

actually paid." 1 BOGERT, *TRUSTS AND TRUSTEES* 88-89 (1935). The courts in granting priority to the stockholders on the insolvency of the corporation usually speak of the deposits as being held in trust for the stockholders by the bank. This is perhaps inaccurate, as there will generally be nothing to indicate that the bank is to keep the money deposited segregated and to use it only to pay dividend claims. See SCOTT, *supra*.

¹⁷ 35 *YALE L. J.* 634 at 635 (1926). It is stated in 24 *VA. L. REV.* 579 (1938): "The attempted distinction between the two types of cases is unconvincing and tenuous at best, and has been severely criticized by commentators and text writers." See also Grinnell, "Status of Funds Deposited for Payment of Interest on Bonds," 19 *ILL. L. REV.* 429 at 434 (1925): "Granting that these two lines of cases are in conflict, the decisions in the cases involving interest deposits are convincing; the others are not."

¹⁸ *Guidise v. Island Refining Corp.*, (D. C. N. Y. 1923) 291 F. 922.

¹⁹ A law review commentator, however, had little difficulty in rationalizing the apparently conflicting results. See 28 *COL. L. REV.* 477 at 481 (1928): "The apparent confusion of thought resultant upon the efforts of the bondholders to have the courts impress a trust upon funds deposited for the payment of interest on bonds by analogizing their situation to that of the stockholder may be traced largely to a focusing of attention upon this similarity of the mere form of the obligation upon the corporation immediately preceding the setting aside of funds. Such a narrowing of the perspective overlooks the fact that the right of the bondholder, unlike that of the stockholder, rests upon an express promise of the corporation to pay so much interest in consideration of so much money received. The position of the bondholder appears at all times to be that of a creditor dealing at arm's length with the corporation rather than that of a co-adventurer retaining as a result of his investment an ownership interest in the corporate property from which, *ipso facto*, a fiduciary or trust relation to the corporation might be evolved with respect to specific property set aside to meet his maturing claims."

In the *Interborough* case it was contended that in principle no distinction existed between dividend moneys and interest moneys. The court, however, dodged this issue by inquiring "whether the courts of New York sustain the proposition . . . that in principle no distinction exists," and then flatly declared that the "cases clearly show that a distinction does exist."²⁰

In holding that the bondholders were not entitled to the funds on deposit in preference to the general creditors of the depositor, the court relied heavily on the *Staten Island* and *Noyes* cases, declaring that they could not be distinguished from the instant case. It does appear, however, that there was one important respect in which the cases may be distinguished. In the *Staten Island* and *Noyes* cases the funds were remitted at once with directions to pay the same to the coupon holders on presentation of their coupons, and payments were in fact made directly to the coupon holders by the depository. But in the *Interborough* case the mortgagor paid the coupon holders by its own check issued when the coupons were presented at its office. Without in any way referring to the *Staten Island* and *Noyes* cases, the court did emphasize this difference in saying:

"The fund here in controversy and deposited in the Empire Trust was not received by the latter under instructions to distribute it among specified creditors, or to the coupon holders. It was received by the Empire Trust to be paid out on account checks to be drawn by the Interborough and directed to be charged against the separate account which had been created."²¹

And at another place the court declared:

"... in the instant case the trust company assumed no obligation to the petitioner as respects the debt herein involved—its only obligation, under its contract with the bankrupt, being to pay such checks as the bankrupt might draw against the fund and the petitioner had no such checks."²²

There was thus in the *Interborough* case considerable indication that the result would have been different if the depository had been directed to make payments directly to the coupon holders on presentation of their coupons.

The distinction was apparently much relied upon in *Guidise v.*

²⁰In re *Interborough Consolidated Corp.* (C. C. A. 2d, 1923) 288 F. 334 at 341, discussed supra, at note 13.

²¹*Ibid.*, at 346.

²²*Ibid.*, at 347.

*Island Refining Corporation*²³ which was decided shortly after the decision in the *Interborough* case in the same district in which that case arose. In the *Guidise* case the coupons were payable at the office of the trustee, and the mortgagor customarily made deposits to meet maturing coupons with the trustee, a banking institution. The remittances were credited to accounts entitled "Island Refining Corporation Coupon Account," and as the coupons were presented the bank paid them out of this account by cashier's check. On the insolvency of the depositor, a receiver brought an action to recover a balance in various coupon accounts arising from the failure of some of the holders to present their coupons. Here again most of the funds had apparently been on deposit for a considerable period. Judge Learned Hand thought that "each remittance was sent on with the understanding that the obligor should not have anything more to do with it, and that the bank should distribute it to those who were entitled" and that "That . . . might well have been treated as an irrevocable release of control, and so a valid declaration of trust."²⁴ The *Interborough* case, it was suggested, could be distinguished on the ground that the fund remained subject only to the obligor's order and that this might be deemed sufficient to rebut the inference of a trust. But inasmuch as in the *Noyes* case no trust arose though the bank paid the coupons out of the fund by its own checks, and as that case was apparently approved in the *Interborough* case, Judge Hand felt obligated to follow these decisions, it being "more important," he stated, "that the law should be certain than that ideal justice should be done."²⁵

A recent case in the Circuit Court of Appeals for the Fourth Cir-

²³ (D. C. N. Y. 1923) 291 F. 922.

²⁴ *Ibid.*, at 923. A few years later Judge Hand, dissenting in *Steel Cities Chemical Co. v. Virginia-Carolina Chemical Co.*, (C. C. A. 2d, 1925) 7 F. (2d) 280 at 284, declared: "It seems to me to make no difference whether the mortgagor makes a deposit on which he draws checks in favor of the bondholders when coupons are presented at his office or whether he directs the bank to issue cashier's checks where the coupons are presented to itself. In the first case, each check is a separate order on the depository to pay the payee, who has previously presented the coupon to the mortgagor; in the second, the letter remitting the funds is a single order to pay to any one who presents a coupon. I can see no distinction between the two, except that in the one case the whole thing is done at once, while in the other it is done piecemeal. . . . It does not advance matters to say that in the second case the mortgagor has parted with control over the funds, for that is just the question that we are to decide. In the case at bar, the mortgagor may be said to have parted with control if one likes, but so he may, though he reserves the right to draw checks in favor of coupon holders."

²⁵ *Guidise v. Island Refining Corp.*, (D. C. N. Y. 1923) 291 F. 922 at 923.

cuit, *Schloss v. Powell*,²⁶ denied the right of a bondholder, after the insolvency of the depositor, to claim funds which had been deposited to pay interest on his bond. The coupons were payable at the mortgagor's "office or agency in the city of New York." In the trust deed the mortgagor covenanted to maintain an agency in New York, and there was a further provision that if the mortgagor failed to maintain such an agency, it would be deemed to be at the office of the trustee. The mortgagor did not designate any particular agency, but on or before April 1 and October 1 in each year from 1900 until 1930, the mortgagor deposited funds with the trustee instructing it to place the funds to the company's credit in its coupon account and "authorizing and requesting" it to pay the coupons as presented. In 1930 the mortgagor became insolvent and a receiver was appointed. The bank turned over to the receiver a balance in the coupon account arising from the fact that many coupons had not been presented for payment. The holder of three bonds with coupons running back until 1910 still attached then sued the receiver for payment out of the funds obtained from the bank. Recovery was denied, the court holding that "the deposit of money in a bank by a corporate debtor, with instructions to use it to pay maturing coupons as they are presented by the bondholders, no more appearing, is not sufficient to show an irrevocable intention so to apply the fund and to impress it with a trust."²⁷

That the courts have at times paid more attention to form and fortuitous use of legal expressions than to substance is illustrated by another recent case, *Sinclair Cuba Oil Co. v. Manati Sugar Company*.²⁸ In that case the trust deed contained no provisions for deposits of principal or interest, but in a separate instrument the mortgagor designated the trustee as the agent of the company for the payment of principal and interest. In making deposits the practice followed was for the mortgagor to send to the trust company a check for the entire amount of interest payable on a certain date with a covering letter stating that the check was "to meet payment of" or represented the "amount required to pay" the installment of interest presently to become due, and asking the trust company to receipt and return an enclosed voucher. After this practice had continued for some time, the trustee in returning the voucher wrote: "This money is received by us as a trust fund for the payment of interest as it matures, and we would thank you to confirm

²⁶ (C. C. A. 4th, 1938) 93 F. (2d) 518, noted 24 VA. L. REV. 579 (1938).

²⁷ *Ibid.*, 93 F. (2d) at 519.

²⁸ (D. C. N. Y. 1932) 2 F. Supp. 240.

our understanding." The company replied confirming this understanding, but from then on the procedure in making deposits was as indicated above.

On the insolvency of the mortgagor the receiver moved to compel the trustee to turn over the unapplied bond interest moneys, but the court refused to so do, declaring that "a trust established for one payment would, in the absence of proof to show a subsequent contrary intention, indicate a trust relation for the later payments."²⁹

Though the writer has no quarrel with the result in this case, it seems somewhat artificial that it should depend on this chance communication between the mortgagor and the depository.³⁰ Probably any mortgagor would have made a similar reply to such an inquiry and it hardly seems possible that deposits subsequent to such a communication were made with any different intent than if no such communication had been had. It should be noted, however, that unlike most of the

²⁹ *Ibid.*, at 242.

³⁰ Another illustration of how a court relied on somewhat tenuous grounds to reach a result in favor of the bondholders is found in the case of *Steel Cities Chemical Co. v. Virginia-Carolina Chemical Co.*, (C. C. A. 2d, 1925) 7 F. (2d) 280, noted 10 MINN. L. REV. 178 (1925), 35 YALE L. REV. 634 (1926). In that case the bonds provided that the company would pay principal and interest at its office or agency in the borough of Manhattan. The trust deed did not contain provisions requiring deposits to pay principal or interest, but did provide that "any moneys at any time deposited by the company with the trustee for the redemption or other payment of bonds or for the payment of interest thereon shall be and are hereby assigned, transferred and set over unto the trustee in trust for the holders of the bonds or coupons intended to be paid therewith." Subsequently, the mortgagor appointed the trustee as its agent for the payment of interest on bonds. The usual procedure of the mortgagor in transmitting funds to the trust company was to inclose a check and voucher receipt in a letter stating that a check was inclosed with which to pay the coupons due on a given date "covering six months interest on the 7% first mortgage gold bonds of this company, as per trust agreement dated June 1st, 1922."

On the insolvency of the depositor, receivers sought an order to show cause why the balance on deposit with the trustee should not be turned over to them. The court held, however, that under the provision of the indenture quoted above, the deposits gave rise to a trust in favor of the bondholders, and the receivers' petition was dismissed. While, literally construed, the provision of the trust deed might be held to cover the deposits, it is more probable, as pointed out by Judge Hand in a dissenting opinion, that this provision did not cover such deposits, but was intended to apply only to redemption deposits with respect to which such provisions are often found. Moreover, it is doubtful that by the appointment of the trustee as paying agent rather than some one else the mortgagor intended that the effect of the deposits should be any different. "The ground of distinction, therefore, seems rather tenuous; but the result is desirable and its achievement on so slight a ground may indicate the beginning of judicial attrition of the seemingly groundless distinction between deposits to pay dividends declared and deposits to pay interest coupons." 35 YALE L. J. 634 at 635 (1926).

cases that have been discussed above, substantially all of the funds had been on deposit less than two years, and the likelihood that the coupons would yet be presented was not remote but very real.

The picture the above cases present is far from satisfactory. Most of them seemingly hold that funds deposited to pay interest on bonds are held by the depository as agent of the depositor and that the bondholder will not be entitled to a preference in such funds. Closer examination, however, reveals that in many of these cases the bondholders were not represented in the litigation, and that the funds involved were deposits that had been unclaimed for years. There can be little doubt but that the courts have been reluctant to permit the depository to retain the funds for the benefit of coupon holders who have unreasonably neglected to present their coupons and who may never do so.

Moreover, there is considerable indication in the decisions that the courts have been influenced by the fact that the risk of loss of such deposits would be on the mortgagor and not on the bondholders.³¹ The feeling seems to be that it would be inconsistent to allow the bondholders to claim the money on the insolvency of the depositor if they would not be chargeable with the loss of the funds on the insolvency of the depository. There is, however, no inconsistency in legal theory between these results. It is well-established that a debtor may, if he so intends, confer rights on his creditor as beneficiary of a trust, or otherwise, which will be in addition to, and not in discharge of the personal liability of the debtor, and that the creditor may enforce either or both of his claims, subject, however, to the limitation that he will be entitled to no more than one satisfaction of the debt.³²

³¹ "If it [the bank] had become insolvent, is there any doubt that the coupon holders could, nevertheless, have recovered from Consolidated?" In *re Interborough Consolidated Corp.*, (D. C. N. Y. 1921) 277 F. 249 at 256. "It may well be asked in the instant case: Had the Bank failed after the Railroad made the deposit in question but before the holders presented their coupons and received payment thereof, would the Railroad or the coupon holders have sustained the loss of said fund resulting from the Bank's failure? There can hardly be any serious question that such loss would have fallen on the Railroad." From the unreported opinion of the District Judge [Transcript of Record, p. 34] in *Schloss v. Powell*, (C. C. A. 4th, 1938) 93 F. (2d) 518. "If the bank had failed under the situation here existing, with coupons unpaid, it is clear that the loss would have fallen on the Lake Superior Corporation, not on the coupon holders." *Homan v. First Nat. Bank*, 316 Pa. 23 at 28, 172 A. 647 (1934).

³² 3 SCOTT, TRUSTS, § 330.6 (1939). See also *Silver v. Park-Lex Holding Corp.*, 222 App. Div. 40 at 43, 225 N. Y. S. 394 (1927): "Nor did the fact that the plaintiff sought to establish his claim in bankruptcy against the estate of Miller & Co. amount to an acceptance of Miller & Co. as his sole debtor or an election to look only to the funds in its hands for the satisfaction of his claim. Such act was consistent with his rights to look also to the principal debtor, and his remedies were consistent and concurrent."

Undue emphasis has, it seems, been placed on the presence or absence of technical terms. The net effect of the decisions is that unless the word "trust" is used in some writing between the parties the bondholders will have no claim to the funds deposited on the insolvency of the depositor. There is, however, no reason why an intention to confer irrevocable rights on the bondholders might not be found in the course of dealing between the depositor and depository or in other circumstances surrounding the transaction. It is probably true that, where a debtor on one isolated occasion deposits funds in a bank with instructions to pay a certain creditor, the proper inference is that the disposition thus voluntarily made is made for the debtor's own purposes and convenience,³³ and that hence the depository is merely the agent of the debtor to make the payment to the creditor. But where a mortgagor has covenanted to maintain an agency for the payment of coupons, has designated its fiscal agent and then makes deposits to the credit of special coupon accounts, upon which no interest is credited, instructing the depository to pay the coupons on presentation, the proper inference, it would seem, is that the depositor has parted with all control over the funds deposited, intending the funds to be appropriated exclusively and irrevocably to the payment of coupons, and that it has thus conferred upon the coupon holders rights of which they may not be deprived.³⁴

In the cases that have recognized the right of the bondholders to funds on deposit, the court has declared that a trust for the benefit of the bondholders has been created.³⁵ Though there was no clear indication of the precise nature of the trust, what the court probably had in mind was a trust of the funds. An intention to grant the bondholders irrevocable rights in the deposits may be manifested by the creation of an irrevocable trust for their benefit, but in such a case it must clearly appear that the parties intended that the depository was to keep the money separate and use it only in the payment of coupons.³⁶ In none

³³ Cf. 3 SCOTT, TRUSTS, § 330.6 (1939).

³⁴ "While the principal decision [*Schloss v. Powell*, (C. C. A. 4th, 1938) 93 F. (2d) 518] seems to be supported by the weight of authority, the result seems undesirable and offends the lay mind. Moreover, it is doubtful if it reflects the true intention of the corporate depositor." 24 VA. L. REV. 579 at 580 (1938). See 1 BOGERT, TRUSTS AND TRUSTEES, § 20 (1935).

³⁵ *Steel Cities Chemical Co. v. Virginia-Carolina Chemical Co.*, (C. C. A. 2d, 1925) 7 F. (2d) 280; *Sinclair Cuba Oil Co. v. Manati Sugar Co.*, (D. C. N. Y. 1932) 2 F. Supp. 240; *Rogers Locomotive & Machine Works v. Kelley*, 88 N. Y. 234 (1888).

³⁶ 3 SCOTT, TRUSTS, § 531.1 (1939). In *Lyon County Bank Mortgage Corp. v. Walker River Irrigation District*, 57 Nev. 485, 67 P. (2d) 1010 (1937), where funds were deposited in a bank for the purpose of paying interest and principal on a

of the cases referred to was there any indication that this in fact had been the understanding of the parties. Where, as in these cases, the depositor has manifested an intention to surrender all control over the deposits, it would not be unreasonable to hold that the depositor is a trustee for the coupon holders of its claim against the depository.³⁷

It has been suggested that where a corporation deposits money in a bank for the payment of interest on its bonds neither the corporation nor the bank becomes trustee for the bondholders, but that the transaction is a contract between the corporation and the bank for the benefit of the coupon holders.³⁸ The coupon holders would be entitled to a preference on the insolvency of the depositor only if the depositor intended the contract to be irrevocable. Where the depository is directed to make payments directly to the coupon holders, as is generally true, it might be contended that the depository by accepting the deposits impliedly agrees to make the payments to the coupon holders. The New York Court of Appeals, however, in reversing a decision permitting recovery by a coupon holder against the depository declared: "We find no such agreement to pay contained in the agreed statement of facts in this case. Directions standing alone to a bank or to an agent do not constitute an agreement by the bank or the agent for the benefit of a third party."³⁹ And in the *Staten Island* case, where it was contended that the doctrine of *Lawrence v. Fox*⁴⁰ applied, the court pointed out that "The defendant has entered into no agreement to pay the bondholders, nor has it made any promise that it would pay them."⁴¹

In view of the unsatisfactory state of the authorities with respect

bond issue, accompanied by a letter stating that the sum deposited "shall be deemed and considered as a special trust fund for the aforesaid purpose and not as a deposit in which the relation of debtor and creditor exists," the court nevertheless refused to grant the depositor a preference on the insolvency of the bank on the ground that "there was no understanding that the fund deposited in the bank for a special purpose was not to be used by the bank for its own purposes." 57 Nev. at 505.

³⁷ 1 SCOTT, TRUSTS, § 12.12 (1939). See also 1 BOGERT, TRUSTS AND TRUSTEES 87 (1935): "It would seem clear that the corporate debtor ought to be held to have declared itself a trustee of its claim against the depository on the coupon account, for the benefit of the coupon holders. The corporation has clearly set apart a portion of its assets to meet a debt."

³⁸ 1 SCOTT, TRUSTS, § 12.12 (1939).

³⁹ *Erb v. Banco Di Napoli*, 243 N. Y. 45 at 48-49, 152 N. E. 460 (1926) (action to recover amount of three lost coupons; neither the depositor nor the bank was insolvent).

⁴⁰ 20 N. Y. 268 (1859).

⁴¹ *Staten Island Cricket & Baseball Club v. Farmers' Loan & Trust Co.*, 41 App. Div. 321 at 323, 58 N. Y. S. 460 (1899).

to the right of the coupon holders to funds deposited to pay coupons, the recently proposed Uniform Trusts Act⁴² might offer a satisfactory statutory solution of the problem. The provisions of that act, which were designed "to do away with a few obsolete and unjust rules of trust law which have come about through unfortunate judicial decisions or are survivals of ancient property law,"⁴³ would in effect grant the bondholder a preference if he presented his claim within one year after the deposit was made. Section 2 provides as follows:

"1. Whenever a bank account shall, by entries made on the books of the depositor and the bank at the time of the deposit, be created exclusively for the purpose of paying dividends, interest or interest coupons, salaries, wages, or pensions or other benefits to employees, and the depositor at the time of opening such account does not expressly otherwise declare, the depositor shall be deemed a trustee of such account for the creditors to be paid therefrom, subject to such power of revocation as the depositor may have reserved by agreement with the bank.

"2. If any beneficiary for whom such trust is created does not present his claim to the bank for payment within one year after it is due, the depositor who created such trust may revoke it as to such creditor."

Under this section the depositor would be deemed to hold its claim against the bank in trust for the bondholders unless the depositor at the time the account is opened expressly declares that the deposit is not to have this effect. As the coupon holder is given one year to "present his claim to the bank," the section probably applies not only where the bank makes payments directly to the coupon holders, but where, as in the *Interborough* case, the depositor itself pays the coupon holders by checks drawn on the account.⁴⁴ Revocation of the trust created by the depositor is permitted if the claim is not presented within one year, and on the insolvency of the depositor the trustee in bankruptcy or

⁴² The Uniform Trusts Act was adopted by the National Conference of Commissioners on Uniform State Laws in 1937, and up to the end of 1939 had been adopted only by Louisiana and North Carolina. The Louisiana statute, however, omitted section 2. See 9 UNIFORM LAWS ANNOTATED (Supp. 1939), p. 239. The act may also be found in 1 BOGERT, TRUSTS AND TRUSTEES, § 7 (Supp. 1938). See Vanneman and Rowley, "The Uniform Trusts Act," 13 UNIV. CIN. L. REV. 157 (1939); Nylund, "The Uniform Acts Relating to Trusts," 16 CHI-KENT. REV. 81 (1938).

⁴³ See prefatory note to Uniform Trusts Act.

⁴⁴ See Vanneman and Rowley, "The Uniform Trusts Act," 13 UNIV. CIN. L. REV. 157 at 161 (1939).

receiver could undoubtedly exercise the rights of the insolvent. This provision was very likely designed to cover the situation where the bank might otherwise be entitled to retain funds indefinitely for beneficiaries who may never present their claims.

The above section was drafted, in part at least, with a view toward abolishing the distinction that now exists between deposits to pay declared dividends and deposits to pay interest on bonds.⁴⁵ The provisions of the act were extended to cover accounts to pay wages and other benefits to employees on the theory that they are governed by the same considerations, but it should be noted that deposits to pay principal on bonds have not been covered. Though controversies over deposits to pay interest have caused the most difficulty, it would seem that deposits to pay principal should be governed by the same considerations, and the act might well have included them.

Before turning to a discussion of the problems arising when the deposits are required by the terms of the trust deed, it is interesting to note that the Trust Indenture Act of 1939⁴⁶ provides that an indenture to be qualified⁴⁷ "shall provide that each paying agent shall hold in trust for the benefit of the indenture security holders or the indenture trustee all sums held by such paying agent for the payment of the principal of or interest on the indenture securities."⁴⁸ Such a provision would undoubtedly enable the bondholders to claim funds deposited to pay principal or interest on the insolvency of the depositor.

B. *Deposits Required by the Trust Deed*

The deposits provided for in the trust indenture may be of various sorts. The indenture may simply require the mortgagor to deposit with the trustee a specified number of days in advance funds sufficient to

⁴⁵ See prefatory note to Uniform Trusts Act: "1. Bank Account for Special Debts. Under the common law decisions it has been held that if a debtor sets up a bank account to pay dividends, he is trustee of that account for the stockholders, but if he sets up a bank account to pay bondholders' coupons, he is not a trustee for the bondholders. It is generally admitted that this is a distinction without justification and that all such accounts, including pay roll accounts, should be deemed to be held in trust for the special class of creditors named. Section 2 of the Uniform Trusts Act so provides. This does not make the bank a trustee for anybody."

⁴⁶ 53 Stat. L. 1149 (1939), 15 U. S. C. (Supp. 1939), § 77aaa et seq.

⁴⁷ In general, the act applies only to trust indentures required to be filed with the Securities and Exchange Commission as part of a registration statement under the Securities Act of 1933. For a thorough discussion of the purposes and provisions of the Act, see 25 CORN. L. Q. 105 (1939). For a discussion of the act as originally proposed, see Banks, "Indenture Securities and the Barkley Bill," 48 YALE L. J. 533 (1939).

⁴⁸ 53 Stat. L. 1173, § 317 (2)(b) (1939), 15 U. S. C. (Supp. 1939), § 77qqq (2)(b).

meet maturing principal and interest installments.⁴⁹ In recent years bond issues with serial maturities have been extensively employed, and in connection with such issues it has been customary to provide in the trust deed for periodic deposits with the trustee of a certain percentage of the principal and interest installments due at the next interest date.⁵⁰ Where the serial maturity device has not been employed, many trust deeds, especially in connection with industrial bond issues, require payments to the trustee for sinking fund purposes. While sinking fund provisions have variegated and divergent characteristics, the most common requirement is that the funds be used to purchase bonds of the same issue, either by redemption by lot at the call price or by purchase in the open market.⁵¹

The rights of the bondholders with respect to any such deposits will depend on the proper construction to be given to the provision in the trust deed authorizing or requiring the deposit. The terms of the trust deed may be so specific as to leave no doubt of the right of the bondholders to the funds in the event of the insolvency of the depositor. With respect to deposits for redemption before final maturity at the option of the mortgagor or those which are to operate by way of final defeasance of the mortgaged property, the trust deed usually provides that the deposit with the trustee is to be deemed a full payment of the bond or coupon and that the bondholder is to look for the payment of such bond or coupon only to the sums so deposited.⁵² The right of the bondholders to such deposits in preference to the general creditors of the depositor can hardly be denied. And this would be equally clear where the trust deed stipulates that the funds deposited are to be held in trust for the bondholders or contains other language indicating an intention

⁴⁹ *Morley v. University of Detroit*, 269 Mich. 216, 256 N. W. 861 (1934), discussed in detail *infra* beginning at note 97.

⁵⁰ *Equitable Trust Co. v. Green Star S. S. Corp.*, (D. C. N. Y. 1922) 291 F. 650, *affd.* (C. C. A. 2d, 1924) 297 F. 1008.

⁵¹ See DEWING, *FINANCIAL POLICY OF CORPORATIONS*, 3d ed., 668 et seq. (1934), for a classification and discussion of sinking fund provisions. See also 24 VA. L. REV. 293 (1938); McCLELLAND AND FISHER, *CORPORATE MORTGAGE BOND ISSUES* 543 et seq. (1937).

⁵² The following provision is typical: "Such deposit shall be in full payment of such bonds and coupons belonging thereto and thereupon and thereafter said bonds and coupons belonging thereto shall be precluded from participating in the lien and security offered by these presents and the holder or holders shall look for the payment of the said bonds and interest accrued to the time fixed for their retirement only to the sum so deposited in the hands of the said trustee." *Silver v. Park-Lex Holding Corp.*, 222 App. Div. 40 at 44, 225 N. Y. S. 394 (1927). See *Andrews v. Missouri State Life Ins. Co.*, (C. C. A. 5th, 1932) 61 F. (2d) 452 at 454; *Morley v. University of Detroit*, 269 Mich. 216 at 219, 236 N. W. 861 (1934).

that the depositor is to have no interest in or control over the deposits.⁵³

But even in the absence of any language in the trust deed specifically indicating such an intention, it would seem that the bondholders should be entitled to the funds in the hands of the trustee on the insolvency of the depositor. The deposits are unquestionably intended for the benefit of the bondholders and the provisions requiring them should be construed to give the bondholders the maximum amount of security and protection.⁵⁴ Moreover, the right of the bondholder to a preference in respect to such deposits might be sustained upon the theory that the bondholders acquire an equitable lien on the funds on the making of the deposits. In the *Interborough* case,⁵⁵ where the court denied the existence of an equitable lien, the opinion emphasized the fact that "the interveners clearly did not contract with the bankrupt upon the credit of the particular fund in controversy, there being no agreement either with the bondholders or with the trustee of the mortgage that this or any other special fund should be set apart from the general assets to pay interest as it matured."⁵⁶ A provision in the trust deed requiring deposits to pay principal and interest on bonds does constitute such an agreement.

The right of the bondholders to such deposits in preference to the general creditors of the depositor has in fact been sustained. The really troublesome problems with respect to these deposits involve the determination of the specific bondholders entitled to the deposits.

In *Equitable Trust Co. v. Green Star S. S. Corporation*,⁵⁷ the trust deed provided that the mortgagor would "pay to the trustee" every two months, "as and for a sinking fund for the payment of maturing bonds and interest accruing at the next succeeding interest date, an amount equivalent to thirty-three and one-third per cent of the principal amount of the outstanding bonds next maturing hereunder, together with an amount equivalent to thirty-three and one-third per cent of the semiannual interest accruing at the next succeeding interest date on all outstanding bonds."

On December 10, 1920, the mortgagor made a deposit of one-third of the principal due on the next maturing bonds, series C, and one-third of the interest due at the next interest date, but failed to

⁵³ In re National Public Service Corp., (D. C. N. Y. 1933) 3 F. Supp. 262.

⁵⁴ McCLELLAND AND FISHER, CORPORATE MORTGAGE BOND ISSUES 556 (1937).

⁵⁵ In re Interborough Consolidated Corp., (C. C. A. 2d, 1923) 288 F. 334, discussed supra, note 13.

⁵⁶ Ibid., 288 F. at 350.

⁵⁷ (D. C. N. Y. 1922) 291 F. 650, affd. (C. C. A. 2d, 1924) 297 F. 1008.

make the second and third payments. Series C fell due on April 15, 1921, but two days before this maturity date the mortgagor became in default and under the trust indenture the trustee was empowered to take possession, accelerate the maturity of all outstanding bonds, and foreclose. The trust deed further provided that in case of default and sale of the mortgaged premises "The purchase money, proceeds and avails of any sale of the trust property, together with any other sums which then may be held by the trustee under any provisions of this indenture as part of the trust property or of the proceeds thereof" should be distributed equally among the bondholders to the extent necessary to satisfy their claims. No action was taken until after the due date of Series C, however, but shortly thereafter a receiver was appointed. In a subsequent proceeding the receiver claimed the funds on deposit and the trustee claimed the right to apply the money equally to the payment of all outstanding bonds.

The case was heard by Judge Learned Hand, who had no difficulty in determining the status of the deposits. "That the sinking fund as a whole is a trust fund seems to me too plain for discussion," he declared, merely citing two cases,⁵⁸ and "Therefore the question is only as to who are the beneficiaries, whether the whole bondholders or Series C."⁵⁹ The court pointed out that the holders of Series C bonds would have been the beneficiaries of the fund in the normal course of events, that the fact that the subsequent deposits were not made could not affect their rights to the sum already deposited, and that as nothing had been done to divest the rights of the holders of Series C before maturity date, they were entitled to the funds. But the court went further and

⁵⁸ *Rogers Locomotive & Machine Works v. Kelley*, 88 N. Y. 234 (1888), and *Holland Trust Co. v. Sutherland*, 177 N. Y. 327, 69 N. E. 647 (1904). The *Rogers* case, which has been discussed *supra*, note 2, did not involve a sinking fund, but only a deposit to pay interest on bonds. Because of a recital in the receipt issued by the depository that the funds were received "in trust," the court held that the depositor no longer had an interest in the funds which could be reached by attaching creditors.

In the *Holland Trust Co.* case the trust deed required the mortgagor to transfer to the trustee certain rentals "to be used exclusively to pay the interest on said bonds and for no other purpose." A creditor of the mortgagor levied an attachment on funds in the hands of the trustee. The trustee then brought suit in equity against the attaching creditor asking for instructions as to its duties. All that the court of appeals actually was called upon to decide was whether or not the trustee could maintain the suit, and it was held that he could. In the course of the opinion the court said: "The legal effect of that special deposit not only created the plaintiff trust company a trustee for the coupon holders, but it changed the title to said moneys from the water company to the trust company, in whose possession it constituted a trust fund for the benefit of coupon holders as *cestuis que trust*." 177 N. Y. at 329-330.

⁵⁹ *Equitable Trust Co. v. Green Star S. S. Corp.*, (D. C. N. Y. 1922) 291 F. 650 at 651.

indicated that even under the terms of the indenture quoted above nothing could have been done at any time to divest the holders of Series C of their rights in the funds, as the provision was not intended to cover funds which had been specifically allocated to a class of bondholders.

The decision awarding the funds to the holders of Series C bonds is probably correct on the facts of the case, though this might have been somewhat doubtful if the trustee had in fact exercised his right to take possession and foreclose before the maturity date of Series C. The characterization of the sinking fund as a trust fund may not, however, have been accurate, as there was nothing to indicate that the trustee was to keep the very funds deposited segregated or was to assume any obligation other than to pay the bondholders out of its general funds. This, however, should not affect the right of the bondholders to the funds on deposit on the insolvency of the depositor, at least where the trustee is not insolvent as well. To bring the result within a convenient legal mechanism, if that is necessary, it might be said that the depositor holds its claim against the trustee in trust for the bondholders.

The *Equitable Trust Company* case has been followed in subsequent cases.⁶⁰ In *Armada State Bank v. Union Guardian Trust Co.*,⁶¹ the mortgagor had covenanted to make monthly deposits of an amount equivalent to one-twelfth of the principal falling due the next succeeding principal payment date, the intention being, the trust deed recited, that "said sinking funds deposited shall be sufficient to meet the respective interest, principal and tax requirements in full, when due." Though bonds amounting to \$6,000 matured on August 1, 1931,

⁶⁰ *Armada State Bank v. Union Guardian Trust Co.*, 262 Mich. 487, 247 N. W. 787 (1933); *Tucker v. Empire Trust Co.*, 242 App. Div. 380, 274 N. Y. S. 895 (1934). In *Tucker v. Empire Trust Co.* the mortgage provided for quarterly payments to the trustee of one-fourth of the respective installments of principal next to become due, the intention being, it was said, that such aggregate payments "shall be sufficient to meet such principal payments when and as they mature." The installment of principal due on May 1, 1932, amounted to \$44,000, but of this amount only \$22,000 had been deposited. On May 23, 1932, foreclosure proceedings were instituted and a judgment of foreclosure and sale was entered. A controversy then arose as to who was entitled to the sum on deposit with the trustee—the holders of the bond participation certificates to become due or the holders of all outstanding certificates. The Appellate Division, of the Supreme Court of New York held that the holders of the certificates next to become due were entitled to the funds, the reasoning in the *Equitable Trust Co.* case being persuasive and quite applicable. The court stated that had the full sum been deposited before foreclosure proceedings were begun there could be no doubt as to the result and concluded that the fact that the full sum had not been deposited should not change the result.

⁶¹ 262 Mich. 487, 247 N. W. 787 (1933).

there was at the time in the sinking fund only about one-half of that amount. The plaintiff, one of the holders of the maturing bonds, sought a pro rata share of said funds, but the trustee denied his request on the ground that the mortgage was in default and that this would give a preference to one bond over another. The court, however, relying on the *Equitable Trust Company* case, pointed out that the preference was provided for by the trust instrument and that the bondholders were entitled to their pro rata share.

The rights of bondholders in a sinking fund of a somewhat different nature were involved in *Truby v. M. & T. Trust Co.*,⁶² a decision of the Supreme Court of New York for Erie County. In that case the trust deed provided for deposits quarterly with the trustee of an amount equal to five cents for each ton of sand or gravel shipped from the mortgaged premises, and that the "sums so paid shall be held by the trustee as a sinking fund and used by it from time to time, and at least annually, for the payment and retirement of said bonds pro tanto in the manner and upon the terms provided for the redemption of bonds" in the indenture. Unlike the cases that have been discussed above, the bonds were not of serial maturity, but the particular bonds to be redeemed in a given year were to be determined by lot. In compliance with the provisions of the indenture, the trustee made a determination of bonds to be called, and notice was given the holders that their bonds would be redeemed on April 1, 1931. On that day the mortgagor defaulted in an interest installment, and when the plaintiff presented bonds which had been called for payment, the trustee declined to redeem them on the ground that the moneys in the sinking fund should be used to pay the defaulted interest upon the entire series of bonds.

In an action against the trustee to determine the rights of the parties, it was held that the holders of the bonds which had been called were entitled to the funds on deposit. The court emphasized the fact that the agreement provided that the funds were to be used for this specific purpose, and that nothing in the trust indenture gave the trustee the right to use the funds for the payment of interest on other bonds.⁶³ In answer to the contention that the result was inequitable,

⁶² 141 Misc. 507, 253 N. Y. S. 108 (1931), noted 3 *FID. L. CHRON.* 5 (1932).

⁶³ "The bondholders all entered into the arrangement that for every ton of sand or gravel sold 5 cents was to be deposited in the fund to be used for the redemption of those particular bonds that fate destined to be drawn in the lottery. The agreement provided that the funds were to be used for a specific purpose. There was no agreement that if the interest was not paid upon the other bonds the sinking fund could not be

the court stated that the other bondholders "purchased the bonds with full knowledge of the conditions of the mortgage and, therefore, they are not in a position to complain of the better luck of those who were fortunate enough to own the bonds that were drawn."⁶⁴

As the determination of the bonds to be called took place before the default, it would seem that the right of the holders of the called bonds to the funds on deposit became fixed at that time, and there is no reason why the subsequent default of the mortgagor should divest their rights. The determination in effect put the holders of the called bonds in the same position they would have been in had the maturity date been fixed in advance, and the principle of the *Equitable Trust Company* case is quite applicable.

If no determination of the bonds to be called has been made at the time of the default of the mortgagor, it would obviously be unjust to permit the trustee to use the funds for the redemption of bonds and thus prefer some bondholders over others. The bondholders as a class should be entitled to the funds. In *First Union Trust & Savings Bank v. Bernardin*,⁶⁵ a receiver sought to obtain the amount of a sinking fund, which was to have been used for the purchase or redemption of outstanding bonds, to use in the payment of taxes on the mortgaged premises, contending that as the fund could no longer be used to redeem outstanding bonds the fund should be considered as part of the general assets of the mortgagor. The court, in overruling his contention, pointed out that "if the beneficiaries were not changed by substituting a certain group of bonds prior to default as provided by the mortgage, the original beneficiaries, i.e., the bondholders, as a class, remain as the sole beneficiaries of the fund."⁶⁶

used to pay the interest. The trustee has no right to divert the funds because some one may regret the bargain. Under the terms of the mortgage or deed of trust, the moneys deposited ceased to be the property of the corporation and became a trust fund for the benefit of the fortunate bondholders and no one else has a right to them." *Ibid.*, 141 Misc. at 510.

⁶⁴ *Ibid.*, 141 Misc. at 509-510.

⁶⁵ (C. C. A. 8th, 1932) 60 F. (2d) 419, noted 32 MICH. L. REV. 80 (1933).

⁶⁶ *Ibid.*, 60 F. (2d) at 423. Cf. *In re Hotel Governor Clinton*, (D. C. N. Y. 1936) 15 F. Supp. 519. In this case the court granted a motion that a fund in the hands of a trustee which was to have been used for the purchase or redemption of Series A bonds be applied to the payment of back taxes on the mortgaged premises. The court felt that the fund was held as part of the collateral security behind the bonds generally, and not for the benefit of any particular class of bonds. It appears, however, that Series A bonds had priority over the other bonds, and that practically all of the holders of Series A bonds favored application of the fund to this purpose rather than a pro rata distribution of the fund which would only have netted about 2% to each bondholder.

II

RIGHTS ON THE INSOLVENCY OF THE DEPOSITORY

If it was the understanding of the parties that the funds deposited were to be kept segregated and held in trust, either for the depositor or the bondholders, and if the funds may still be traced in the hands of the depository, the insolvency of the depository will give rise to no real difficulty, for the funds will be safe from the general creditors of the depository and neither the bondholders nor the depositor will suffer any loss. But it is usually difficult to find that there was any understanding that the funds were to be kept segregated; and assuming that there was such an understanding, it is very likely that the deposits have either been dissipated or mingled with the other assets of the depository so that no preferred claim may be established. Consequently, any rights that either the depositor or the bondholders may have against the depository, while not to be disregarded, will as a practical matter generally prove to be of little value. Either the bondholders or the depositor will have to bear the loss, and litigation arising on the insolvency of the depository usually necessitates a determination of where this loss will fall.

It is clear that the obligor may not discharge his obligation to the bondholders by depositing funds in a bank or with the trustee even though the bonds are payable at the bank or at the office of the trustee.⁶⁷ This is true even if the effect of the deposit is to confer upon the bondholders irrevocable rights, unless the bondholders have agreed that the making of the deposit will discharge the personal liability of the

⁶⁷ *Adams v. Hackensack Improvement Co.*, 44 N. J. L. 638 (1882); *First Nat. Bank of Paterson v. Jersey Central Power & Light Co.*, 115 N. J. Eq. 242, 170 A. 209 (1934), reversed on other grounds, 117 N. J. Eq. 508, 176 A. 582 (1935); *Williamsport Gas Co. v. Pinkerton*, 95 Pa. 62 (1880); *Mershon v. Millerstown Borough*, 128 Pa. Super. 248, 193 A. 328 (1937); *Lusk State Bank v. Lusk*, 48 Wyo. 547, 52 P. (2d) 413 (1935).

In *Adams v. Hackensack Improvement Co.*, supra, bonds were payable at a bank and prior to maturity the mortgagor deposited funds for this purpose, but the plaintiff did not present his bonds for payment until after the suspension and insolvency of the bank, which had occurred 11 days after the due date of the bonds. In holding that the plaintiff might nevertheless recover, the court said: "The naming of a bank in a promissory note as the place of payment, does not make the banking association an agent for the collection of the note or the receipt of the money. No power, authority, or duty is thereby conferred upon the banker in reference to the note; and the debtor cannot make the banker the agent of the holder by simply depositing with him the funds to pay it with." 44 N. J. L. at 646-647.

depositor.⁶⁸ Where there is no provision in the bonds or trust deed requiring the mortgagor to make deposits to pay principal or interest, there is generally no basis for contending that the bondholders have agreed to discharge the mortgagor from personal liability, for an actual collateral agreement to this effect, though conceivable, would be rare. The troublesome cases have been those where the deposits have been made pursuant to a provision in the trust deed.

It is, of course, possible that the trust deed may spell out the rights of the parties on the insolvency of the depository or contain provisions that in some way clearly indicate what the intention of the parties is. With respect to deposits in case of redemption before maturity or those that are to operate by way of final defeasance of the trust indenture, it has not been uncommon to provide in specific terms that the obligation of the depositor is to be discharged on the making of the deposit and that the bondholders must look for payment only to the sums deposited.⁶⁹ Generally, however, the provision in the trust deed will merely set forth the mechanics of making the deposits.

The question whether deposits made pursuant to a provision requiring periodic deposit of a given percentage of the amount of principal and interest due at the next interest date will discharge the mortgagor, though payment to the bondholders is never effected due to the supervening insolvency of the depository, has been presented in a number of cases. In *Silver v. Park-Lex Holding Corp.*,⁷⁰ a decision of the Appellate Division of the Supreme Court of New York, the trust deed provided as follows:

“To secure the prompt payment of the bonds maturing in each of the years 1927 to 1937, both inclusive, the Company agrees to pay to G. L. Miller & Co., Inc., one-twelfth of the aggregate amount payable in each of said years above mentioned, monthly in advance in cash . . . to be applied in the retirement

⁶⁸ *Andrews v. Missouri State Life Ins. Co.*, (C. C. A. 5th, 1932) 61 F. (2d) 452; *Silver v. Park-Lex Holding Corp.*, 222 App. Div. 40, 225 N. Y. S. 394 (1927); *First Wisconsin Trust Co. v. Saxe*, 211 Wis. 397, 247 N. W. 456 (1933). See also 3 SCOTT, TRUSTS, § 531.1, p. 2540 (1939): “Ordinarily, it is clear, a debtor cannot discharge his liability to his creditor by depositing funds in a bank with instructions to pay the debt. The debtor continues to be liable for the debt until it is paid or unless a novation is effected whereby the creditor accepts the liability of the bank in place of the liability of the debtor. Where a corporation deposits money in a bank to meet interest or principal due on its bonds, the question whether the corporation thereby ceases to be liable and the bondholders can look solely to the bank depends upon the terms of the trust indenture.”

⁶⁹ See note 52, *supra*.

⁷⁰ 222 App. Div. 40, 225 N. Y. S. 394 (1927).

of the bonds maturing in that year . . . and in order to accumulate a fund sufficient to insure the prompt semi-annual payments of interest on all of said bonds as they respectively mature, the Company agrees to pay G. L. Miller & Co., Inc., one-twelfth of the amount of the interest which shall accumulate in each year on all bonds at the time outstanding, monthly in advance in cash . . . to be applied semi-annually in the payment of the interest coupons above mentioned."

Proper deposits had been made with Miller & Co., whose president was trustee under the trust indenture, when the latter went into an equity receivership. In a subsequent foreclosure suit, the mortgagor contended that payments to Miller & Co. constituted payment of principal and interest to the bondholders, and that their obligations had thus been discharged pro tanto. The court held, however, that the payments did not discharge the mortgagor pro tanto, but that "They were merely additional security to the bondholders and *cestuis* under the trust agreement."⁷¹ The court stated that nothing in the bonds or mortgage indicated that the bondholders were looking to the fund in the hands of the depository except as security; that the mortgagor was primarily liable for payment of the bonds and coupons; and that if it had been the intention to release the mortgagor to the extent of the deposits, "it would have been simple so to provide."⁷² The fact that the provision with respect to bonds called for redemption did so provide was thought to confirm the conclusion that the mortgagor was not discharged by deposits to meet regularly maturing principal and interest installments. The judgment of the trial court in favor of the defendant was reversed, but a new trial was ordered because the provisions of a certain paragraph of the trust deed were not before the court. The defendants then appealed, but the New York Court of Appeals affirmed the order below without opinion.⁷³

⁷¹ *Ibid.*, 222 App. Div. at 43.

⁷² *Ibid.*, 222 App. Div. at 44.

⁷³ 248 N. Y. 537, 162 N. E. 515 (1928). An interesting case involving the same problem as that under consideration, though not strictly within the scope of this paper, is *La Salle Hotel Realty Co. v. Taft*, (C. C. A. 7th, 1936) 85 F. (2d) 339. In that case an underwriting agreement provided for the purchase by the bank at a discount of preferred stock to be issued by the defendant corporation and contained a provision requiring the corporation to deposit with the bank monthly "so much of its rental receipts as constitutes one-twelfth of the obligations for the ensuing year to its preferred stockholders, to be withdrawn solely for the purpose of meeting such obligations." The preferred stock when issued contained a like provision. The bank then resold the stock to its customers. Deposits sufficient to meet the stock maturing on June 1, 1931,

In *Andrews v. Missouri State Life Ins. Co.*⁷⁴ the bonds and coupons were payable at a bank in New York, but the trust deed provided for deposits by the mortgagor with the trustee, a Tennessee bank, at least thirty days prior to each semiannual interest date of a sum sufficient to meet such interest payments. The trust deed then authorized the trustee to collect all rents and profits and provided that "the trustee shall retain one-twelfth of the annual sum due in each of the respective years . . . for the purpose of meeting payment on principal and interest of the bonds secured hereby." A sum sufficient to pay the coupons due on a certain date had been retained by the trustee under the latter provision, but the funds were not forwarded to the New York bank, as was the customary practice, and a few days later the trustee failed.

In a subsequent suit against the mortgagor by an unpaid coupon holder, the mortgagor contended that the trustee held the money as agent of the bondholders and that its possession of it on the due date of the interest coupons operated as a payment of the coupons. The court held, however, that the coupon holders could recover from the mortgagor, pointing out that though the fund in the hands of the trustee might be considered to be a deposit by the mortgagor, there was "nothing in the language of either covenant to make the money thus in the hands of the trustee at the maturity of the coupons to be ipso facto payment" and that "The absence of such language is in strong contrast with the explicit provisions to that effect when deposit is made to pay called bonds." The fund was said to be "a security for the payment of the coupons about to mature."⁷⁵

were made by the corporation, but the bank became insolvent and preferred stockholders whose certificates matured on that date were unable to obtain payment. In an action against the corporation, judgment was rendered in favor of the stockholders, and this was affirmed on appeal to the Circuit Court of Appeals for the Seventh Circuit. The court said that "payment for stock which was the satisfaction of contractual obligations did not occur until the bank paid the money to the stockholder entitled to it" and that "Until this satisfaction occurred the money in the bank did not pass to the preferred stockholders." 85 F. (2d) at 341.

⁷⁴ (C. C. A. 5th, 1932) 61 F. (2d) 452.

⁷⁵ *Ibid.*, at 454. In the *Andrews* case the funds involved were rental moneys collected monthly by the trustee from mortgaged property, and the trustee after making certain required payments was to retain one-twelfth of the sums due in each year for principal and interest payments. In *Schwartzburg v. Rahtjen*, 227 Wis. 525, 279 N. W. 19 (1938), the trust deed authorized the trustee to take possession of and manage the mortgaged property, and provided that rents and profits collected by the trustee should be applied to the payment of operating and maintenance expenses, taxes, insurance, and other expenses, and out of the sum remaining to the payment of principal and interest on bonds, "Provided, always, if the sum so received by the trustee shall not be sufficient to pay all of the above-mentioned payments when and as they become due, the first

In a Wisconsin case, *First Wisconsin Trust Co. v. Saxe*,⁷⁶ it was held that periodic deposits did not discharge the mortgagor, but emphasis was placed on a phrase that did not appear in either of the above cases. In the *Saxe* case funds which were to be used in paying bonds and coupons due on a certain date had been deposited with the trustee, but payments to the bond and coupon holders were not made and shortly thereafter the trustee was adjudicated a bankrupt. These bondholders claimed a right to be paid out of subsequent deposits with the successor trustee, but the mortgagor, contending that the deposits constituted payment pro tanto of the bonds and coupons to become due, instructed the trustee not to pay their claims. The trustee then brought an action for a declaratory judgment to have the court construe the trust deed.

parties [mortgagors] hereby covenant and agree to pay to the trustee a sum sufficient to pay the same. . . ." The trustee went into possession of the mortgaged premises, managed the same, collected the rents and profits and made various disbursements. Though the receipts and disbursements indicated that the trustee should have had sufficient funds, it failed to pay the bonds and coupons due on a certain date, and shortly thereafter was adjudicated a bankrupt. Subsequently the mortgagor brought an action for declaratory relief to establish that these bonds and coupons had been fully paid and to discharge the lien thereof. The trial court granted the relief prayed for and the Supreme Court of Wisconsin affirmed the judgment. At the outset, the court pointed out that the "arrangement was in the interest of the bondholders" and that "To the investor in bonds it might well be considered as additional security." 227 Wis. at 533. But in the next paragraph the court said: "The only obligation assumed by the mortgagors was to pay 'if the sum so received by the trustee shall not be sufficient,' etc. If the sum received was sufficient to make the payments, there was no further or additional liability on the part of the mortgagors." 227 Wis. at 534. The court also attached significance to the fact that the trustee was in possession of the premises, saying that his rights, powers, and liabilities were those of a mortgagee in possession.

The construction placed on the clause in the trust deed requiring additional deposits if the sums received in rents and profits were not sufficient as relieving the mortgagor from further liability if the funds received were sufficient seems utterly unwarranted. Characterizing the trustee as a mortgagee in possession disregards the obvious fact that the trustee acts for the mortgagor as well as for the bondholders, and unrealistically stretches that concept. As the court admitted, the arrangement was undoubtedly additional security for the bondholders; it would have been more consistent with this purpose to have construed the arrangement as not relieving the mortgagor from personal liability to the bondholders. In substance the transaction differs little from that in the *Andrews* case, but that case was not even cited in the opinion.

Prior to the decision in the *Schwartzburg* case, the Wisconsin Supreme Court had consistently protected the bondholders in the controversies arising on the insolvency of the trustee. See *Connell v. Kaukauna*, 164 Wis. 471, 159 N. W. 927, 160 N. W. 1035 (1917); *First Wisconsin Trust Co. v. Saxe*, 211 Wis. 397, 247 N. W. 456 (1933); *First Nat. Bank & T. Co. v. Vegel*, 215 Wis. 359, 254 N. W. 537 (1934); *In re Church's Will*, 221 Wis. 472, 266 N. W. 210 (1936); *Wasielewski v. Racke*, 225 Wis. 245, 272 N. W. 846, 273 N. W. 819 (1937).

⁷⁶ 211 Wis. 397, 247 N. W. 456 (1933).

The trust deed contained a covenant whereby the mortgagor agreed to "pay to and deposit with the trustee" on the first day of each month an amount equal to one-sixth of the total amount of principal and interest which was to become due and payable semiannually and then provided that

"Moneys so paid or deposited with the trustee shall be held by it as additional and collateral security under the provisions hereof for the payment of principal and interest on the bonds at any time issued and outstanding, and shall be paid and applied by the trustee to the payment of the installments of interest and principal in the order of their maturity, until such funds are exhausted."

The trial court held that the deposits constituted payment pro tanto of the bonds and coupons and discharged the mortgagor to the extent thereof. Inasmuch as the trust deed stated that the deposits were to be held as "additional and collateral security," the Wisconsin Supreme Court could not see how they could be considered payment of the bonds and coupons, but decided that the trustee in holding the moneys deposited as additional and collateral security was the agent of the mortgagor and the judgment was reversed.⁷⁷

It would seem that the fact that the periodic deposits are to be held as "additional and collateral security" merely expresses what would otherwise be implied. The purpose of requiring such deposits is to make more certain the availability of funds for payment to the bondholders at the actual maturity date—they are merely an added protection for the bondholders. In essence the transaction is a security one, and the deposits are in reality a sinking fund to secure payment. The

⁷⁷ "Giving to that language its plain ordinary meaning, and in the absence of language providing that the money deposited should be deemed a payment to the trustee as agent of the bondholders, it must be held that the money so deposited was additional collateral security, not a payment to the bondholders or their authorized agent. Prior to June 1, 1931, the money deposited was not even available for payment to the bondholders. So long as the money had to be held as collateral security, it is impossible to see how it could be considered as a payment *pro tanto* of the bonds or coupons. It seems fairly clear that the trustee, in holding the deposit as collateral security pending the due date of the bonds, was acting as agent of the mortgagor." 211 Wis. at 402.

The court had some difficulty with a statement which it had made in *Connell v. Kaukauna*, 164 Wis. 471 at 496, 159 N. W. 927 (1917), to the effect that a "payment to the trustee merely as trustee cannot be held to be a payment to the bondholders, *unless made when and as prescribed by the terms of the deed.*" (Italics supplied.) The court, however, said that the money in the instant case was deposited with the trustee, not as payment, but as additional and collateral security until an installment of the bonds matured and could be paid.

periodic deposits in connection with bonds of serial maturities accomplish essentially the same purpose as payments into a fund which is called a sinking fund and which is used to redeem bonds called by lot or purchased in the open market. And clearly the loss of a sinking fund will not extinguish the obligation of the maker of the bonds unless the bondholders have agreed specifically to look only to the fund for payment.⁷⁸ Where the provision in the trust deed merely sets forth the mechanics of the making of the deposits, which may be treated as payments into a sinking fund, there is no basis, it would seem, for assuming that the deposits are to discharge the mortgagor. If that is intended, it would be a simple matter so to provide. The inference that no such result is intended in the absence of specific language is especially strong where the same trust indenture does so specifically provide with respect to other deposits such as those for the purpose of redeeming called bonds, as was true in two of the above cases.

That the deposits, which are made monthly for periods of from six to twelve months in advance of the maturity date, are not intended to be a payment pro tanto of the bonds and coupons seems obvious. In determining who must bear the loss of such deposits, the important question is not whether there has been payment of the bonds, but whether the provisions of the trust deed can be said to be an arrangement on the part of the bondholders that the making of the deposits will discharge the personal liability of the mortgagor. Nevertheless, the defense in the cases that have been discussed seems to have been that the deposits constituted payment pro tanto to the trustee as agent for the bondholders, and there is considerable talk in the opinions about payment and whether the trustee in holding the deposits is the agent of the mortgagor or the bondholders. Such talk merely throws confusion about the real issues and serves as a convenient cloak to cover any result that might be reached.

A number of courts have held that such periodic deposits are a discharge pro tanto of the mortgagor's obligation, generally on the theory that by making the deposits the mortgagor has paid its debt. The

⁷⁸ "A sinking fund may be, and generally is, intended as a cumulative security for the payment of the debt with which it is connected." *Tennessee Bond Cases*, 114 U. S. 663 at 698 (1885). See also *Heider v. Hermann Sons Hall Assn.*, 186 Minn. 494 at 499, 243 N. W. 699 (1932): "It is very common for corporations to provide a sinking fund to be used in retiring its [sic] bonds. But if unconditional bonds are issued by it, the bondholder is entitled to payment of his bonds at maturity, irrespective of whether or not there is money in the sinking fund for the payment thereof. The corporation may if it sees fit make its bonds payable only out of the sinking fund, by so providing in the bonds."

Kansas Supreme Court in *McCormick v. Johnson*⁷⁹ was, perhaps, the first court to express this idea. In that case the mortgagor, who had made deposits with a trustee that had become insolvent, sued to establish a preferred claim to the assets of the trustee in the hands of the receiver, and to recover the money. The trial court sustained a demurrer to the complaint, saying that the mortgagor had lost all interest in the money, except perhaps the right to see that it was paid to the beneficiaries, and that it would not suffer any loss. The mortgagor seized on the suggestion that it might have a right to see that the beneficiaries were paid and appealed, contending that the lower court by sustaining the demurrer had denied it this right. The judgment was affirmed. The court thought it unnecessary to reproduce the provisions of the "concatenated voluminosity called a trust deed," but stated that the instrument "contained provisions for payment . . . to the trustee of funds for principal and interest, and for distribution by the trustee to bond and coupon holders of funds so paid."⁸⁰ The denial of recovery to the mortgagor was affirmed on the ground that the mortgagor was "not the donor of an express trust," but was "an ordinary debtor which has paid its debt by deposit of money with a depository who received and held it for the account of the bonds and coupons, to the payment of which the depository was obligated to apply it."⁸¹ In view of the peculiar manner in which this case arose and the failure of the court to set forth the pertinent provisions of the trust deed, the case is unsatisfactory as an authority; but it is clear from the opinion that the court felt that the mortgagor was discharged to the extent of the deposits made and that any loss would fall on the bondholders.⁸²

⁷⁹ 134 Kan. 153, 4 P. (2d) 421 (1931).

⁸⁰ *Ibid.*, 134 Kan. at 154, 153.

⁸¹ *Ibid.*, 134 Kan. at 154.

⁸² In a subsequent Kansas case, *Hall v. Goldsworthy*, 136 Kan. 247, 14 P. (2d) 659 (1932), the mortgagor had deposited the sum of \$1671.31 to be applied on bond interest as it matured, but the trustee became insolvent and failed to apply the money to this purpose. Shortly thereafter the mortgagor defaulted, and in an action by the receiver of the trustee to foreclose the mortgage the mortgagor contended that the bondholders should bear the loss with respect to this deposit with the trustee. The court so held on the theory that "the plain intent of the parties was to vest the trustee with the power to receive payment and to make distribution thereof." 136 Kan. at 253.

There is no indication in the opinion that there was a provision in the trust deed requiring deposits with the trustee. The court merely pointed to provisions in the bonds and trust deed making the bonds payable at the office of the trustee, that the trustee had power on payment of the indebtedness to release the mortgage lien, etc., and stated that as a result the trustee "is more than a depository." The court admitted that the language in the trust deed in *McCormick v. Johnson* was "much stronger with reference to payment than the language contained in the trust deed under consideration," but

In *Fidelity & Columbia Trust Co. v. Schmidt*⁸³ the Kentucky Court of Appeals was faced with the problem of deciding whether the loss of periodic deposits should fall on the mortgagor or the bondholders in a case that would be of far reaching importance. The case grew out of the insolvency of the Louisville Title Company, which should have had on hand about \$1,100,000 in monthly deposits, made by numerous borrowers. These deposits were intended to be applied to the payment of bonds and interest, but had been commingled with the company's own funds and dissipated. The court, recognizing that the problems presented were "difficult," "new," and "interesting and important," stated the facts "fully and with precision, in order to avoid a contracted view of the case,"⁸⁴ and carefully analyzed what it considered to be the substance and effect of the transactions involved.

In the *Schmidt* case a borrower, in order to obtain funds to finance the construction of a residence, had made application to a mortgage loan company for its "deed of trust and bond sales services." The loan was approved, and bonds, secured by a mortgage deed of trust to the loan company as trustee and guaranteed by the loan company, in the aggregate sum of \$5,700 were executed and delivered to the loan company. In the bond the maker agreed to pay to the "Louisville Title Company, Trustee, or bearer" principal and interest when due "at the office of the Louisville Title Company." The bond recited that it was secured by a mortgage deed of trust and that "The covenants of said Mortgage deed of trust securing this Bond and its interest coupons are made a part hereof as if herein written in full." The trust deed, which was executed coincidentally with the execution of the bonds and which was entitled "Sinking Fund Mortgage Deed of Trust," contained the following two covenants:

"First: That he will pay the bonds and coupons hereby secured according to the terms thereof at their respective maturities and that in order to provide for the payment of same he will deposit with the Trustee at least three days in advance of the time when such coupons and bonds respectively mature, a sum of money in gold coin or its equivalent as hereinbefore provided sufficient to pay all of said maturing bonds and coupons.

decided that "there is a similarity in the two instruments and they attempt to reach the same end." 136 Kan. at 253.

⁸³ 245 Ky. 432, 53 S. W. (2d) 713 (1932), noted 42 YALE L. J. 756 (1933).

⁸⁴ *Ibid.*, 245 Ky. at 433, 434. "The importance of the case lies in the fact that there are many others like it pending for determination by the receiver." *Ibid.*, 245 Ky. at 442.

“Second: That in addition to the covenants last above written and other covenants and undertakings in this instrument, and in order to create a fund to be applied on the indebtedness secured by this instrument and the interest on same, the Mortgagor will deposit with the Trustee monthly before the close of business on the even date of each month from this date until the maturity of said indebtedness the sum of \$52.27.”

The mortgagor made the monthly payments as required by the trust deed, and the first four bonds were canceled by the trustee and returned to the mortgagor. The remaining bonds had been sold by the trust company, and when they matured the trustee was insolvent and in the hands of a receiver. The money deposited had been mingled by the trustee with its private funds and was not available for payment to the bondholders. The mortgagor desired to pay the balance due on his bonds and a controversy arose as to the amount of money required to discharge the debt. In a proceeding between the receiver of the trustee, the mortgagor, and the bondholders, the trial court held that the loss must be borne by the bondholders. The decision was affirmed on appeal.

The court pointed out that the provisions of the trust deed had been specifically incorporated into the bonds by reference, that the negotiability of the bonds had been destroyed by the character of this reference, and that hence the covenants of the mortgage were binding on the bondholders. It was then held that the “title company was the trustee, agent, and representative of the bondholders to receive payment of the debt in whole or in part,”⁸⁵ and that the loss resulting from the default of the trustee must fall upon the bondholders.⁸⁶

The court stated that the relationship between the borrower and the title company (the trustee) was that of debtor and creditor, and that “the debt was to be paid to the title company in a particular manner, regardless of the use made of the bonds.”⁸⁷ The monthly payments, it was said, were made a condition of the continuance of the loan, and the title company did not surrender its control over the bonds or over the collection and disbursement of the money even though the bonds were sold. The title company was the “dominant authority throughout

⁸⁵ *Ibid.*, 245 Ky. at 448.

⁸⁶ One justice dissented on the ground that “the monthly payments created a sinking fund or security, and the unexercised authority conferred on the trustee on which the opinion lays stress did not abrogate the status of such funds nor constitute a payment on the bonds in any sense. . . .” Richardson, J., 245 Ky. at 449.

⁸⁷ *Ibid.*, 245 Ky. at 445.

the life of the bonds.”⁸⁸ “It was either the bondholder or the representative of bondholders at all times, and all that it did, and everything that it was authorized to do, was on behalf of and for the benefit of the bondholders.”⁸⁹ It was then pointed out that the mortgagor had performed the contract in accordance with the terms of his obligation, and that the bondholders who had acquired their rights from the trustee legally consented that the borrower discharge his contract in the manner required by his mortgage.⁹⁰

⁸⁸ *Ibid.*, 245 Ky. at 444.

⁸⁹ *Ibid.*, 245 Ky. at 448.

⁹⁰ The case which goes to the farthest extreme in placing a loss occasioned by the insolvency of a depository upon the bondholders is *Benjamin Franklin Holding Co. v. Clise*, 174 Wash. 425, 24 P. (2d) 1065 (1933). In that case, the trust deed in addition to requiring monthly deposits to pay principal and interest installments provided that the mortgagor would deposit with W. D. Comer & Co., the president of which was trustee under the trust deed, on the first day of each month “an amount equal to one-twelfth (1/12) of the estimated annual charge for taxes, assessments, insurance premiums, and all other expenses and charges to be paid by the Mortgagors under any of the terms of this Indenture” and that the depository would pay these charges so far as the said deposits were sufficient. Deposits which were to have been used in paying general property taxes had been made by the mortgagor, but the depository became insolvent and the taxes were not paid. The mortgagor then brought action to determine upon whom the liability for this loss should fall. The trial court held that the depository received the money as agent for the bondholders, and that the latter must sustain the loss. The judgment was affirmed by the Supreme Court of Washington. The court pointed out that this plan of monthly payments in advance was for the benefit of the mortgage creditors, and then said: “How, then, shall it be held that the one to whom such payments are made is the agent of him who makes the payment? Shall the one making the payment be considered as a principal and have the right to withdraw from the one to whom the payment is made . . . the money intended by the terms of the contract and the act of the parties to be for the benefit of him to whom the payment is made? We think not.” 174 Wash. at 430-431. It seems that the deposits were intended as security only. The court, however, said, in distinguishing *Silver v. Park-Lex Holding Co.*, 222 App. Div. 40, 225 N. Y. S. 394 (1927), discussed *supra* at note 70, that the “payments in controversy here were in no sense intended as security for the payment of the primary obligations secured by the mortgage.” 174 Wash. at 432-433. True, they could not have been used to pay the bondholders if payment to them had not been made; yet the bondholders necessarily have an interest in the discharge in due course of paramount liens such as taxes on the mortgaged premises. The fact that the mortgagor could not withdraw the deposits would, of course, be entirely consistent with their purpose to provide security for the bondholders. But the court could only think in terms of agency. Because the mortgagor could not withdraw the deposits, it followed that the depository did not hold the deposits as agent of the depositor. Hence, the court thought, the depository must be the agent of the bondholders, and the principal must stand the loss caused by his agent—deceptive reasoning, but fallacious.

Much emphasis was placed in the opinion upon the fact that W. D. Comer & Co., the depository, was the original purchaser of the bonds. If the depository had still

In *Masonic Widows' & Orphans Home v. Title Ins. & T. Co.*⁹¹ the Kentucky court was presented with additional questions as to the rights of the mortgagor and the bondholders in a case which grew out of the insolvency of the same trust company. The bonds and trust deed in this case were almost identical with those in the *Schmidt* case, and the court reaffirmed the position taken in that case.

A question not presented in the former case grew out of the fact that the mortgagor had made eighty-five payments prior to the insolvency of the trustee though only sixty-eight payments would in fact have been required. It was held that the loss of these anticipatory payments must fall on the mortgagor, as by the terms of the trust deed the trustee was only entitled to collect the regular monthly deposits as the agent of the bondholders. The trust deed did, however, contain a provision obligating the mortgagor to provide for payment of the indebtedness by depositing a sufficient sum at least three days in advance, but this, the court said, "only contemplated a mode of payment different from the monthly payment plan in the event the latter plan failed to produce the required amounts at least three days before the maturities."⁹²

In addition, a controversy between the bondholders was presented. Holders of bonds with the latest maturity dates contended that the loss should fall on the bonds next maturing after the failure of the trustee, whereas the holders of the latter bonds contended that the loss should be pro-rated among all of the bonds regardless of their maturity. If the mortgagor had become insolvent instead of the trustee, under

held the bonds, obviously, it would have had to "bear the loss." But it was contemplated that the bonds would be resold; and it is impossible to believe that it was intended that the deposits to pay taxes, etc., were in any way to affect the rights of the subsequent purchasers to payment in full at maturity, which is in effect what the court must have held in placing the "loss on the bondholders," for obviously the terms of the trust deed could hardly be said to impose an affirmative liability on subsequent purchasers of the bonds to pay the taxes if the depository failed to do so.

Because the trust deed specifically provided that the deposits to pay maturing principal and interest installments were to discharge the mortgagor as against the rights and claims of the bondholders, it was contended that inasmuch as the provisions for monthly deposits for taxes did not provide to the same effect, it was not intended to relieve the mortgagor from liability for the moneys so paid. The unresponsive answer of the court, however, was that the provision for advance payments of taxes "was meant for the safety and benefit of the bondholders, having in it no element of agency for the mortgagors." 174 Wash. at 432.

⁹¹ 248 Ky. 787, 59 S. W. (2d) 987 (1933).

⁹² *Ibid.*, 248 Ky. at 795. Justice Rees, who wrote the opinion, did not concur

the decision in *Equitable Trust Co. v. Green Star S. S. Corp.*⁹³ and other cases that have been discussed, the holders of the bonds with the earliest maturity dates would have been entitled to the funds on deposit. It would seem to follow, assuming that the loss must fall on the bondholders, that the holders of these bonds should bear the loss. Moreover, the court in the *Schmidt* case indicated that the deposits constituted payment pro tanto of the bonds. If the deposits did constitute payment, they could only be construed as being payment of the bonds which were to directly benefit from the deposits, and these would be the bonds with the earliest maturity dates. But the court in the instant case quoted only the portions of the *Schmidt* case that indicated that the borrower having performed the contract in accordance with the terms of his obligation should be discharged, and held that the loss should fall equally on all outstanding bonds irrespective of their maturities.

“Certainly there is no principle of equity,” it was said, “which requires the holders of obligations of equal rank in their right of resort to the mortgage security, but of differing maturities, with regard to their payment by the debtor, to be so unequally treated merely because the trustee of the security and the collector of part payments on the debt becomes insolvent and loses a part of the payments theretofore collected by it.”⁹⁴

The court then referred to the rule that the holders of bonds of different maturities secured by the same mortgage were required to share ratably in the proceeds of the mortgage security where there was a deficiency, and indicated that “by a parity of reasoning the pro rata rule should apply in allocating this loss.”⁹⁵

The writer has suggested above that ordinarily the monthly deposits are merely additional security for the benefit of the bondholders, and should not be construed as being a discharge of the mortgagor. But the mortgage loan company type of transaction presented in the Kentucky cases appears to be unlike that involved in the issuance of industrial bonds. The loan company, though trustee under the bond

in the conclusion that the loss of the pre-payments should fall on the borrower on the ground that under the ruling in the *Schmidt* case the loss should fall on the bondholders.

⁹³ (D. C. N. Y. 1922) 291 F. 650, affd. (C. C. A. 2d, 1924) 297 F. 1008, discussed supra, beginning at note 57.

⁹⁴ *Masonic Widows' & Orphans' Home v. Title Ins. & T. Co.*, 248 Ky. 787 at 796, 59 S. W. (2d) 987 (1933), quoting the lower court's opinion.

⁹⁵ *Ibid.*

issue, was not a mere intermediary, but was, so far as the borrower was concerned, the real creditor. The borrower had no interest in floating a bond issue; that was a mere device by which the loan company, if successful in selling the bonds, could raise additional funds. What the borrower contracted for primarily was a loan. The deposits, instead of being merely additional protection for the bondholders placed in the hands of a disinterested intermediary, appear to be a repayment of that loan to the lender. In view of these circumstances the proper inference to be drawn may well be that the deposits are intended to be in discharge of the personal liability of the borrower. And as the provisions of the trust deed were incorporated by reference into the bonds, which were held to be non-negotiable, there is no great difficulty in holding that the rights of the bondholders may be limited by the provisions of the trust deed.⁹⁶

The cases discussed thus far have involved periodic deposits with the trustee of a certain percentage of maturing principal and interest installments. There remains to be considered the rights of the parties where the trust deed merely requires the mortgagor to deposit before maturity funds necessary to pay maturing bonds and coupons.

In *Morley v. University of Detroit*⁹⁷ bonds of an issue aggregating \$2,400,000 were secured by a single trust mortgage to the Fidelity Trust Company as trustee. The bonds, which were payable at the office of the trustee, contained a reference to the trust mortgage "for the amount of bonds which may be outstanding, a description of the property thereby mortgaged, the nature and extent of the security thereby created, and the rights of the holders of said bonds with respect to such security."

The trust deed provided that the mortgagors will "promptly and punctually pay the principal and interest of every bond . . . and will deposit the necessary funds for such purpose with the trustee at least five days prior to the respective due dates." Deposits sufficient to meet principal and interest payments due on a given date had been made by the mortgagor with the trustee. Not all of the coupons and bonds

⁹⁶ See CAMPBELL, CASES ON BILLS AND NOTES 107, note 1 (1928): "If the instrument provides that the mortgage (or other document creating the security right) is a part thereof as if written therein, or uses equivalent words of incorporation, the law must give effect to the provision." Citing *Babbitt v. Read*, (C. C. A. 2d, 1916) 236 F. 42 at 44.

⁹⁷ 263 Mich. 126, 248 N. W. 570 (1933), noted 32 MICH. L. REV. 232 (1933) (appeal from order denying plaintiff summary judgment on the pleadings); 269 Mich. 216, 256 N. W. 861 (1934), noted 33 MICH. L. REV. 432 (1935) (appeal on merits).

were presented for payment on that date, and shortly thereafter the trustee became insolvent and receivers were appointed. The plaintiff, who had failed to present his bonds and coupons, sought to enforce payment from the mortgagor.

The case was first presented to the Supreme Court of Michigan on appeal from an order denying the plaintiff summary judgment on the pleadings. The order was affirmed. The court pointed out that the fact that the plaintiff had delayed presentment did not defeat his right of recovery, for presentment of a negotiable instrument is not necessary to charge the party primarily liable. It was said that the "decision must rest on the question of agency. Whose agent was the Fidelity Trust Company? If it was the plaintiff's agent in collecting payments, there can be no recovery."⁹⁸ The fact that the bonds were trust mortgage bonds payable through the agency of a trustee was emphasized, and it was said that "It is generally known by those who invest in this class of securities that it is the duty of a trustee to receive payments from the mortgagor and distribute them among the bondholders."⁹⁹ The terms of the trust deed, though not expressly made a part of the bonds, were to be considered as embodied therein and binding on the bondholders because the provisions of the trust deed were referred to in the bonds. The reasoning of the court from that point is best illustrated by the following excerpt from the opinion:

"These provisions of the trust mortgage and the terms of the bonds together constitute the holder's contract with the mortgagor and the trustee and show the conditions which the plaintiff accepted when he purchased them. They show authority of the trustee to receive payments and distribute them among the bondholders. The mortgagor made its deposit with the trustee for the payment of principal and interest, as required by the bonds and mortgage. It did all it was required to do. It paid as it had agreed with the bondholders. If it had not done so it would have been in default. Once paid, it could not reclaim the money. Its title and control passed to the Fidelity Trust Company, which thereafter held it as trustee for the bondholders awaiting maturity of the bonds and their presentment for payment. The money belonged to them. The Fidelity Trust Company was their agent and trustee to receive it and apply it in payment of their bonds and interest coupons."¹⁰⁰

Subsequently the case was tried on the merits and the plaintiff

⁹⁸ *Ibid.*, 263 Mich. at 128.

⁹⁹ *Ibid.*, 263 Mich. at 128.

¹⁰⁰ *Ibid.*, 263 Mich. at 129.

again appealed from a judgment discharging the defendant from liability. The Supreme Court of Michigan, "on account of the importance of the questions involved,"¹⁰¹ thoroughly reconsidered the case but came to the same conclusion.¹⁰² On this appeal attention was called to the fact that the trust deed in case of redemption of the bonds at the option of the mortgagor before maturity provided that the deposits with the trustee "shall be deemed a full payment of such bond and the coupons belonging thereto . . . and the mortgagor shall in no event be liable upon such bonds or coupons after deposit has been made as herein provided." This was, of course, in sharp contrast with the provision for ordinary deposits, which in no way indicated what the legal effect of the deposit should be. But the court held that the

"failure . . . to use equally effective language as to payment of bond and coupons, as they mature, does not vitiate the effect of the provision of the indenture obligating the mortgagor to deposit funds with the trustee at least five days prior to the respective due dates for the purpose of paying such maturing bonds and coupons."¹⁰³

The court examined in detail the provisions of the trust deed. It was pointed out that the insurance policies on buildings were payable to the trustee; that the trustee gives notice of default; that it was under a duty to make every endeavor to secure payment if the deposits were not made; that on default sole right of action is vested in the trustee and it could recover judgment against the mortgagor; and that the mortgagor could not refuse to make the payments prior to due date and could not withdraw them once made. The court concluded that the "indenture shows beyond any question that the duties of the

¹⁰¹ *Ibid.*, 269 Mich. at 217.

¹⁰² Though the decision on the first appeal was unanimous, on this appeal Justice Potter dissented. He thought that the language of the first opinion went too far in assigning reasons why the case should not be disposed of upon motion for summary judgment and that the language should be eliminated or overruled.

¹⁰³ *Ibid.*, 269 Mich. at 219. In stating that the failure to use equally effective language did not vitiate the effect of the provision, the court merely assumed the question in issue. Justice Potter, dissenting, said: "A similar provision might have been made in relation to the payment of the bonds and coupons in question as they matured. Not having been made, we think it a fair construction of the trust mortgage it was not intended to be made. . . ." *Ibid.*, at 239. And this is the inference that has generally been drawn. See *Andrews v. Missouri State Life Ins. Co.*, (C. C. A. 5th, 1932) 61 F. (2d) 452 at 454; *Silver v. Park-Lex Holding Co.*, 222 App. Div. 40 at 44, 225 N. Y. S. 394 (1927); but see *Benjamin Franklin Holding Co. v. Clise*, 174 Wash. 425 at 431, 24 P. (2d) 1065 (1933).

trustee are for the benefit of the bondholders and adverse to the mortgagor.”¹⁰⁴ It was clear then, the court indicated, that the mortgagor was not making the deposits to its own agent for its own benefit. Pointing out that the bonds were payable at the office of the trustee and reiterating the view expressed in the first opinion that investors in this class of securities know that it is the duty of the trustee to collect payments, the court asserted that “the trustee was the agent of the bondholders to collect payments for them.”¹⁰⁵

While it is hardly possible that deposits made periodically from six to twelve months before maturity are received in payment by the trustee as agent for the bondholders, where, as in the *Morley* case, the deposits are made only a few days prior to maturity, such a contention is more plausible. Much of the discussion in both opinions in the *Morley* case centers about the question of payment. In the second opinion the court said that the deposits “were made for the very purpose of payment, and constituted payment” and that the trust indenture “unquestionably constituted” the trustee the bondholders’ agent to receive payment.¹⁰⁶

Agency to receive payment must, however, be affirmatively established, either expressly or by implication by the party asserting the benefit thereof.¹⁰⁷ In the case of negotiable bonds, it has been said that where payment is made to one not in possession of the bond, the burden is upon the party making the payment to show by clear and satisfactory evidence that the person to whom payment is made is authorized to receive it.¹⁰⁸ The mere fact that the bonds or interest coupons or both are payable at the office of the trustee will not constitute the trustee the agent of the bondholders to receive payment,¹⁰⁹ and it is difficult to see how a provision in the trust deed requiring deposits with the trustee for this purpose, which was the only additional circumstance of importance

¹⁰⁴ *Morley v. University of Detroit*, 269 Mich. 216 at 222, 256 N. W. 861 (1934).

¹⁰⁵ *Ibid.*, 269 Mich. at 224.

¹⁰⁶ *Ibid.*, 269 Mich. at 220.

¹⁰⁷ 2 JONES, BONDS AND BOND SECURITIES, 4th ed., § 1043 (1935).

¹⁰⁸ See *Connell v. Kaukauna*, 164 Wis. 471 at 496, 159 N. W. 927, 160 N. W. 1035 (1917).

¹⁰⁹ “The fact that the bonds and interest coupons were made payable at the office of the Trust Company did not make the Trust Company the agent of the bondholders to receive payment. Money deposited with the Trust Company for that reason remained the property of the payor, and if lost it was the loss of the payor. . . . The authority of the trustee to act for the bondholders is prescribed and limited by the terms of the trust deed, and a payment to the trustee merely as trustee cannot be held to be payment to the bondholders. . . .” *Connell v. Kaukauna*, 164 Wis. 471 at 496, 159 N. W. 927, 160 N. W. 1035 (1917). See also cases cited note 67, supra.

in the *Morley* case, does affirmatively show that the trustee has authority to receive payment. If this in fact had been intended, the trust deed would undoubtedly have provided, as was done with respect to deposits in case of redemption prior to maturity, that the deposit "shall be deemed a full payment of such bond."

In both opinions the court emphasized the fact that it is generally known by investors in this class of securities that it is the duty of the trustee to receive "payments" and make distribution among the bondholders. In using the word payment the court begged the question in issue. Investors may know that it is the duty of the trustee to receive deposits, but this does not appear to be relevant on the issue of whether or not such deposits are received in payment. Nor is the fact that the "indenture shows beyond any question that the duties of the trustee are for the benefit of the bondholders and adverse to the mortgagor" of any particular significance. If anything, the inference to be drawn would be that no agency to receive payment is established, for such an agency would be of no additional benefit to the bondholders and might, if the trustee becomes insolvent, result in the loss of their entire investment.

The "agency to receive payment" approach, however, seems rather unrealistic even when applied to deposits shortly before maturity. If the trustee in the *Morley* case had become insolvent during the three day period before the actual maturity of the bonds, it seems quite clear that the court would nevertheless have placed the loss upon the bondholders, but it could hardly be said that the bonds had been "paid" by reason of deposits made prior to maturity when the bondholders would not be entitled to the deposits until maturity.

To discharge the mortgagor it is not necessary to hold, as the court seemed to think, that the bonds have been paid. If by virtue of the provisions of the trust deed it could be said that the bondholders had agreed to look only to their rights in the funds deposited or to their rights against the trustee personally, if any, that would be sufficient,¹¹⁰ assuming that the provisions of the trust deed are binding upon the bondholders.¹¹¹ This approach would require the court to go to the

¹¹⁰ At one place in the opinion the court did in the *Morley* case say that "The moneys so deposited were impressed with a trust of which the bondholders were the beneficiaries." 269 Mich. at 222-223. To a certain extent this seems inconsistent with the position taken in the case that the deposits were payment to the trustee as agent of the bondholders, and may indicate that all the court really had in mind was that the bondholders had agreed to look only to their rights in the funds deposited with the trustee.

¹¹¹ On the question whether a provision in the trust deed discharging the mort-

root of the matter—to really analyze the transaction involved instead of playing with concepts which merely becloud the basic inquiries. But some courts have insisted that the sole question involved is one of agency—to determine whether the trustee holds the money as agent for the mortgagor or as agent for the bondholders.¹¹² With this as a premise, it is almost certain that the loss will be placed on the bondholders. Obviously the deposits are for the benefit of the bondholders and may not be reclaimed or controlled by the mortgagor. Therefore the trustee does not hold the deposits as agent of the mortgagor; hence he must be agent for the bondholders and they must bear the loss occasioned by the insolvency of their agent. That, in effect, is the way the argument in the *Morley* case proceeded.¹¹³

It will be recalled that the periodic deposits were found upon analysis to be in reality a sinking fund to secure payment of the bonds. While the security nature of the transaction is not as apparent where the entire sum due at a given time is deposited with the trustee a few days in advance of maturity, even the court in the *Morley* case recognized this in saying: "This provision is for the security of the bondholders for it enables the trustee who is guarding their interests to have the required moneys on hand for the payment of the bonds and coupons as they become due and to take prompt action in case such moneys are not paid."¹¹⁴ In the absence of language compelling a different result, the conclusion seems inescapable that a provision for such deposits in connection with a typical bond issue¹¹⁵ should not be construed in a fashion that may seriously impair the right of the bondholders to payment when such provision is admittedly for the purpose of making such payment more secure.

gagor from further liability on the making of deposits with the trustee will be binding upon the bondholders, see note 116, *infra*.

¹¹² Cf. the following: "There is but one question, to wit: Whose agent was the trustee at the time the money was paid to it by appellant?" *Commercial Credit Co. v. Seymour Nat. Bank*, 105 Ind. App. 524 at 526, 15 N. E. (2d) 118 (1938), discussed note 115, *infra*. "... [The] decision must rest on the question of agency. . . . If it [the trustee] was plaintiff's agent in collecting payments, there can be no recovery." *Morley v. University of Detroit*, 263 Mich. 126 at 128, 248 N. W. 570 (1933).

¹¹³ Cf. *Benjamin Franklin Holding Co. v. Clise*, 174 Wash. 425, 24 P. (2d) 1065 (1933), discussed in note 90, *supra*.

¹¹⁴ *Morley v. University of Detroit*, 269 Mich. 216 at 222, 256 N. W. 861 (1934).

¹¹⁵ A recent Indiana case, *Commercial Credit Co. v. Seymour Nat. Bank*, 105 Ind. App. 524, 15 N. E. (2d) 118 (1938), should be compared with the *Morley* case. The same result was reached in this case, which involved notes secured by a trust deed instead of bonds, as was reached in the *Morley* case, but the case deserves special

If any moral may be gathered from the cases that have been discussed, it is simply that trust deeds, long and complicated as they may already be, have been inadequate in an important respect and should specifically spell out the rights of the parties on the insolvency of the trustee or other depository. But even if the trust deed specifically provides that the mortgagor is to be discharged upon the making of the deposits, unless the provisions of the trust deed are incorporated into the bonds or referred to for a statement of the terms and conditions

attention in view of the possible distinguishing circumstances surrounding the transaction. In the Commercial Credit Co. case the borrower to procure working capital executed a trust agreement transferring certain contracts and notes to a trust company as trustee, which for a consideration guaranteed payment of an issue of \$60,000 in notes secured by the trust deed. The notes when issued were turned over to a securities company, an affiliate of the trust company, which then resold them to various purchasers. The notes, which merely recited that they were secured by a trust deed and that the holders were "entitled to all the benefits accruing to said note holders under the terms of said indenture," were payable at the office of the trustee and bore maturities of from one to six months. In the trust deed the borrower covenanted to deposit with the trustee \$10,000 on or before the 21st day of April, 1930, the first maturity date, and a like sum on or before the same day of each calendar month thereafter for a period of five months. The exact language of the provision requiring the deposits is not set forth in the opinion, but the trust deed did provide that the "said amount so paid to the trustee by the company shall be applied by the trustee on the payment of the notes secured hereby in the order of their maturity."

The borrower made all the deposits required by the trust deed, but 36 days after the final maturity date the trustee became insolvent and at that time the plaintiff had not as yet presented his note for payment. In an action against the maker on the note, judgment was rendered for the plaintiff in the trial court, but the Appellate Court of Indiana reversed with instructions to enter judgment for the defendant. The court pointed out that this was not merely a case of depositing money in a bank to pay a note, but that the deposits were made with a trustee under a specific trust agreement; that the provisions of the note together with the trust agreement constituted the holders' contract with the maker; that the contract specifically gave authority to the trustee to receive payment for the note holders (by this the court apparently meant that there was specific authority for the making of the deposits); that when the deposits were made, the borrower was discharged and the money was then held by the trustee in trust for the holders of the notes. Emphasis was placed, as in the Morley case, on the fact that the holder knew or should have known that it was customary for the trustee to receive such payments for the holders of the notes.

The transaction between the borrower and the trustee in the instant case had many of the characteristics of the type of transaction in the mortgage-loan bond issue cases, which have already been discussed. The real creditor here, so far as the borrower was concerned, was probably the trust company, which guaranteed the loan granted through an affiliate. As has already been indicated (see *supra*, pp. 93-94), there may be

upon which the bonds are issued, as distinguished from a mere reference to the trust deed for security matters, it is at least questionable whether the provisions in question will be binding upon the bondholders.¹¹⁶ Assuming that the provisions of the trust deed will bind the bondholders, where the trust deed merely requires the deposits to be made without in any way indicating the effect thereof, the writer has attempted to show that consideration of the purpose of provisions requiring such deposits will generally clearly indicate that the proper inference is that the mortgagor is not to be discharged from further liability on the making of the deposits. Moreover, considerations of equity and fairness warrant the conclusion that the ambiguity arising from the fact that the mortgagor, who, unlike the bondholders, is a party to the trust indenture and presumably has the benefit of experienced legal counsel, has failed to insert provisions protecting himself should be resolved in favor of the bondholders.

more reason, viewing the transaction in its proper light, to hold that such deposits are intended to discharge the borrower.

¹¹⁶ The problem which the statement in the text suggests is one that should not be disregarded in any controversy arising between the mortgagor and the bondholders, but it will be possible here to indicate but a few of its many ramifications.

As has already been indicated, if the provisions of the trust deed are incorporated into the bonds, or if the bond contains language which has that effect, the provisions of the trust deed are unquestionably binding upon the bondholders, though even in this case the result may seem a bit harsh on the bondholders, few of whom, if any, ever see the trust deed. See note 96 *supra*. Incorporation of the extrinsic instrument has, however, generally been held to be fatal to negotiability. *King Cattle Co. v. Joseph*, 158 Minn. 481, 198 N. W. 798, 199 N. W. 437 (1924); see 42 HARV. L. REV. 115 (1928). As a result, bonds generally merely refer to the indenture as a means of ascertaining the nature and extent of the security and the rights of the holder with respect thereto. In the case of instruments not incorporating the document of security, there has been considerable confusion as to the effect of the provisions of the trust deed on the rights of the bondholders. At least three general views have been taken. See CAMPBELL, *CASES ON BILLS AND NOTES* 118, note 3 (1928). (1) That since the note (or bond) and mortgage are parts of one transaction, pertinent terms of the latter are imported into the former, often upon the theory that they constitute one instrument. (2) That while the "note" and mortgage are parts of one transaction and therefore each must be interpreted in the light of the other, they are separate instruments, so that the terms of the mortgage may affect the rights arising upon the note, either by way of enlargement or restriction. (3) That the note and mortgage are separate instruments, and that the provisions in the mortgage, however explicit, cannot legally effect the rights on the note. Under the first two views, a provision in the trust deed discharging the mortgagor from further liability on the making of the deposits would effectively bind the bondholders. Not so, however, under the third view.