

ACCUMULATION OF DISCOUNTS

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We inquire: Is it the duty of trustees to accumulate discounts on bonds purchased at less than par?

For the first time in history there was decided by an Appellate Court the question propounded above. See decision rendered Feb. 23, 1926, by the Supreme Court of California in matter of estate of Gartenlaub.¹ By will testator placed in trust an estate valued at about \$476,000; in the will it is provided that the "net income, revenue and profits" of the estate should be paid to certain life-tenants. The trustee was directed as soon as may be to convert investments not of the kind approved by the testator and reinvest proceeds in particular bonds and other securities indicated by the testator. Testator thus expressly authorized investment in bonds.

I.

In the same estate, on a former appeal to the Supreme Court of California, the question was raised whether premiums paid by the trustee, in the purchase of bonds at prices in excess of par, should be charged against principal or income of the estate. The court held that such premiums paid must be amortized by charges to income of the estate, so that such bonds will stand in the accounts of the trustee at maturity at par,—par being the amount of principal then payable thereon. In this later appeal the court refers to the former appeal and to the fact that the court founded its decision in the former appeal on the proposition that the court should set forth the essential principles covering the administration of trusts of this character and hence covering this particular trust; that the court found the existence of a corpus as an essential element and the preservation of such corpus until the termination of the life estate indispensable to the fulfillment of the plans of the testator; that any depletion of the corpus tends to frustrate the fundamental purpose of the trust and should be avoided. Certainly the estate should be so managed by the trustee that there be no deliberate depletion of the corpus. Since the payment of the coupon rate of interest on a bond purchased at a premium would result in the payment of more than the effective rate of interest on the bond, such

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payment of the coupon rate in equity should not be permitted. By regular amortization of premiums out of coupon collections encroachment on the corpus is avoided. Amortization of premiums is now approved by the great weight of decisions of courts of last resort; unfortunately, however, there are still a few exceptions.

II.

The sole question presented in the later appeal involves the right of the life tenant to have discounts at which bonds are purchased by the trustee accumulated and paid over to the life-tenant. The court in the later appeal holds the life-tenant has no such right. As above noted, in the former appeal it was held that premiums should be amortized, in order that the integrity of the corpus of the estate may be preserved. This is an equitable rule. There is also another equitable rule, of equal force, namely: The corpus of an estate should not be unduly increased at the expense of the life-tenant. As all kinds of good bonds are purchased from time to time at prevailing rates of income for money, prices of such bonds fluctuate from time to time; sometimes they are at par, sometimes at a premium, and sometimes at a discount. It is a fundamental fact that premiums and discounts on bond investments affect the income basis of the investment and do not concern the corpus of the estate. In either case it is equitable to adjust the premium or the discount, so that such bonds will stand in the accounts of trustees at par at maturity. Such purchases are made at values shown in bond tables. Such tables show the price at which purchases must be made in order to earn the stipulated net income. Such tables are in constant use in this and all other commercial countries; they have been proven to be scientific and exact and of indisputable authority. To purchase bonds on the basis of such tables, and after purchase to ignore the basis of such purchase, is not equitable; it injures the remainderman in case of a premium bond and injures the life-tenant in case of a discount bond. Trustees must be impartial between life-tenant and remainderman. Since the court requires the adjustment of premiums, it is unfair not to require the adjustment of discounts.

Appreciation and depreciation of bonds held by trustees, independent of amortization of premiums and accumulation of discounts, affect corpus of the estates only, because such appreciation or depreciation is non-contractual and not inherent in the investment when made, and is accidental and unexpected. Students of finance and accounting know such appreciation or depreciation, occurring after an

investment is made, and being independent of the basis of the investment, affect corpus of an estate only, and not income; when annually realized the premium depreciation properly falls on corpus and the discount appreciation properly accrues to income, notwithstanding any immature finding of a court to the contrary.

III.

The life-tenant insists that discounts should be accumulated and paid to her. The court explains its views as follows: In the case of bonds purchased at a discount the amount of such discount remains in the hands of the trustee, in the form of uninvested corpus, and does not become any part of the income of the estate. (Of course any uninvested corpus remains in the hands of the trustee and does not become part of the income of the estate.) Income is entitled to only earnings on invested funds. The court misses the point at issue by assuming that the difference between par value of discount bonds and the price paid is in the hands of the trustee and remains. The trustee is able to buy more bonds when they are at a discount than when they are at a premium. Whatever the amount invested, the life-tenant is entitled to the income thereon at the prevailing rate of interest. Even if a trustee makes all the investments in bonds at par or at a premium, if the exact amount desired is not available, there will be a balance of corpus not invested. The situation is the same when investments are made in bonds at a discount. The court evidently is not experienced in such matters and therefore made the error. The court expresses another erroneous conclusion as follows: It does not follow, since the life-tenant must yield up a portion of the income, in order to maintain the integrity of the corpus, that the life-tenant must be entitled to the discount, which, if allowed, would impair the corpus of the trust. If allowing the discount would impair the corpus, then the court is correct; but allowing the life-tenant the accrued discount merely allows the life-tenant the accruing discount as part of the earnings of the investment, in addition to the contract rate of interest shown by the coupons; the accumulation of discounts scientifically was contemplated at the time of purchase; crediting income with the accumulating discount and writing up the investment value of the bond as it nears maturity is not losing anything for the estate. At maturity the discount bond will have been written up to par, the exact amount at which it will be paid. It is erroneous to assume something is lost; nothing is lost.

IV.

The court continues thus: The only possible basis upon which the life-tenant can rest the claim that she is entitled to receive the amount of unexpended corpus, represented by the discount on any particular bond purchased, consists in the assumption that the controlling reason why bonds of equal safety, with bonds selling at par or a premium, may be purchased at a discount, is because bonds at a discount yield lower interest rates (of course meaning they bear a lower contract rate of interest), and, this being so, the life-tenant is entitled to have the amount of the discount accumulated and paid over to her, in order to make up to her the amount of income which she would have received had the trustee invested in bonds at par, and hence in bonds bearing a larger (contract) rate of interest; and, in order to support this assumption, the life-tenant urges that in the purchase of bonds trustees are governed by bond tables, wherein the value of any bond is determined by the rate of interest which it carries; that the life-tenant argues from these premises, since the corpus of the estate can suffer no ultimate impairment from the investment in safe bonds at a discount, she is entitled to such discount. The court answers: This assumption is not true in point of fact. We answer: Nevertheless, accountants and students of finance and accounting know the assumption is true. If the court will test the proposition by making the calculations necessary to check out and verify any value of bonds given in a standard bond table, the court will find it is again in error. The value may be proven by quite simple arithmetical calculations. For the court to make the assertion, without making the test, is futile. The formula may be applied to a bond based on its contract rate of interest and will prove the bond to be worth par; the result will be self-proving. Surely the court will not ignore the correctness of the formula in such a case. The formula then may be applied to bonds at a premium and the value of premium bonds thus established; surely the court will not now gainsay the correctness of the proposition, having approved premium bonds in the former appeal involving the question of amortization of premiums. If the court will next apply the formula to bonds at a discount, the court cannot help but convince itself that bond tables may be relied upon, even where a purchase of bonds at a discount is involved. Further, if the court will stop to consider the millions of transactions each year between persons, firms and corporations experienced in investment matters, both between themselves and between their hundreds of thousands of customers, the court will not continue

its erroneous assertion. If a scientific fact is definitely established, even courts cannot by immature reasoning or fiat continue the error. Remember Columbus, Galileo and hosts of others, pioneers in their respective fields.

The United States Interstate Commerce Commission and State Public Service Commissions of the various states have much experience in connection with the question whether premiums and discounts affect principal or income. Such commissions hold premiums and discounts affect the interest rate at which bonds are sold by railroad and other public service corporations, and the commissions require the obligor corporations to treat premiums and discounts as affecting income accounts and not capital accounts of such obligor corporations. Such is also the rule of insurance commissioners of various states, in connection with accounts of the various classes of insurance companies; such rule is declared as to insurance companies by statute in some states and we believe by rule of insurance commissioners in all other states. Since bond tables in universal use are calculated on that basis, and are recognized as correct in the entire commercial world, their fundamental principles are beyond dispute. Corporate fiduciaries rely upon such rules and tables in their loan and investment departments, in transactions involving hundreds of millions of dollars per annum; how can their various officers, when they step into their trust departments, say such rules and tables must there be ignored?

V.

The court suggests that it is the duty of the trustee, in making investments of corpus, to determine questions of fact as to the safety of each investment, determinable by other conditions and considerations than those derived merely from the study or comparison of bond tables or the state of the money and bond market as shown thereby. We agree with the court in the proposition that the safety of an investment is not shown by reference to a bond table; the bond table is intended merely to show what will be the effective rate of return on a bond at a stated price, having a certain number of years to run and bearing a fixed rate of interest, or, will give information as to the effective yield of a bond having a certain number of years to run and quoted at a certain price. All other things being satisfactory, the trustee must needs inquire into these matters. If the effective rate of return is shown to be too low, considering a fair return for money for the time being, although all other questions are satisfactorily answered, the trustee must not make the particular investment presented. Apply-

ing high investment standards, the trustee should of course look for other investments yielding a fair return. The trustee is not limited to bonds selling at par or to bonds selling at a premium, but may invest in bonds selling at a discount. If the trustee invest in bonds at a discount, the trustee may not equitably ignore such discount as part of the earnings of the investment, as the discount accumulates. The bond was purchased on the basis that the trustee would consider the accumulating discount as a profit inherent in the investment at the time of purchase, and not as an accidental appreciation of property caused by conditions and influences outside of the investment when made. Such accumulating discount added to the contract rate of interest on the bond will represent the effective rate of return of the investment; the contract rate of interest allowed would represent merely the nominal or contract rate of return, not the actual return. From the language of the court, it might be implied it was thought that a bond table would indicate the state of the money market or bond market. Of course such thought would be absurd.

The court has taken an unaccountable misconception of the fundamental question involved in the case, by comparing an accidental and non-contractual increase in value of real estate (purchased by a trustee) with the increase in value of a bond purchased by the trustee at a discount and upon which the discount is cumulative from year to year as the bond approaches maturity, so that the bond will stand in the accounts of the trustee at par at maturity. In the former appeal, the court does not liken a decrease in value of real estate to the decrease in value of a premium bond purchased by the trustee, where the trustee decreased the value of the bond in the accounts of the trustee by annual amortization charges in gradually writing down the premium, so that the bond will stand in the accounts of the trustee at maturity at par. The court cannot now fairly justify the converse of the proposition in this later appeal—although the court unjustly attempts to do so.

VI.

The court seems to rely on the testimony of one witness in reaching its decision. The court refers to him as admittedly an expert in both knowledge and experience in respect of state of bond market and money market. His testimony was to the effect that in buying bonds as an investment safety is the first consideration; that it is the duty of the trustee to maintain the corpus of the estate intact, as far as the trustee can. Certainly that is true. Nevertheless, the trustee should

be fair and not unduly increase the corpus of the estate at the expense of the life tenant. If the trustee will not accumulate discounts for the benefit of the life-tenant, then the trustee should not make investments in bonds below par, but confine itself to bonds at par or at a premium. The witness is also quoted as saying: As between bonds which may be considered equally safe for investment purposes, he would purchase the one which yielded the higher (contract) rate of return; the fact that safe bonds will sell at a discount at any time is due very largely to general financial conditions and to the fact that other bonds, presumably as safe, pay a higher (contract) rate of interest on their par value. The effect of this testimony is that, as between two bonds of equal safety as an investment, selling at the same price, he would select the one selling at the higher (contract) rate of interest. Of course he would. It follows, to meet such competition, that a bond selling at the lower contract rate of interest would have to sell at a lower price or at a discount; if at a discount, the amount of the discount would automatically bear on the income basis of the investment. This is proven by the bond table and may be proven without a bond table. Why continue to assert that the accumulating discount does not increase the earning shown by the coupon rate? Just as well assert that amortization of premium does not decrease the coupon rate.

Whether a safe bond, bearing a given contract rate of interest, sells at par, at a premium or at a discount, depends always on the market rate for money at the time of the investment. A safe 5 per cent bond in a 5 per cent market will sell at par; a safe 6 per cent bond in a 5 market will sell at a premium; a safe 4 per cent bond in a 5 per cent market will sell at a discount. The premium or discount is taken into consideration by the investor, whether an individual, a firm, a corporation or a trustee, and the premium or discount represents the allowance necessary, considering the contract rate of interest, to bring the net return on the premium or discount bond to meet the market rate for money, thus establishing a market for the bond, notwithstanding its contract rate of interest does not coincide with the market rate.

VII.

The court, referring to the testimony of the one witness, says: The effect of the foregoing evidence is to negative the assumption that the controlling factor, in determining bond investments by trustees, is that of the state of the market as shown by bond tables and to affirm the right of trustees to invest the corpus of the trust estate in bonds which may at the time of the investment be obtainable at a premium

or at par or at a discount, regardless of the return in the way of (contract) interest provided for. The court must have written these thoughts inadvertently. The testimony speaks for itself. It is not claimed that bond tables show the state of the market for money or bonds; no testimony was necessary to refute the thought. Would any testimony establish the right of the trustee to invest in bonds at a premium or at par or at a discount, regardless of the contract rate of interest of the bond? Certainly not. The court continues: If this be true—referring to its remarks above—it shows, since the right of the life-tenant is measured by the duty of the trustee, the full amount to which the life-tenant would be entitled in the way of income would be none other than the amount actually provided for as income by the terms of the bond, regardless of the price at which it had been acquired. In the former appeal the court laid down the proposition that the premium must be amortized out of interest coupon collections. Bonds purchased at par need no adjustment of premiums or discount. Bonds purchased at a discount—shall we forget them? Certainly not; let us be just between the beneficiaries of estates.

VIII.

The term “income, revenue and profits” has been held in a uniform line of decisions as not to include increase from any cause in the value of the corpus of a trust estate. The court quotes the cases below mentioned as sustaining that proposition. We have examined each case, and find not one bears on the point at issue in the present appeal. The cases quoted all relate to ordinary appreciation of property and not to accumulating discount on bonds purchased by trustees below par. In the cases noted the increases are accidental increases, not inherent in the investment when made. The discount on bonds purchased below par shows an inherent profit, expected and relied on as a profit to the amount of the discount. We review the cases in the order of their publication, to-wit:

Townsend v. Trust Co. (1877), 3 Redfield N. Y. Rep. 220: The trustee invested three funds of \$5,000 each in government bonds; later sold bonds at profit of \$400 for each fund; trustee also made profit of \$37.50 on purchase of government bonds at a discount, which bonds increased in value. Question was—could the surplus received by the trustee be regarded either as interest, income or dividends? Decision: Court ruled the increase could not be taken as income; that life-tenant cannot be charged with depreciation; and converse of the proposition is true, that he cannot receive the increase of the capital;

that the general rule seems to be, the enhanced value of the principal goes to the remainderman. Note: This case applies to ordinary and non-contractual increase of securities; not to the point now at issue.

In re Gerry (1886), 103 N. Y. 445: Question arose between representatives of life-tenant and remainderman with reference to disposition of an increase in amount of trust fund, discoverable upon a sale of securities * * * * after life-estate terminated. In 1828 testator bequeathed \$70,000 in trust to invest in specified securities; a sale of the securities by the trustee after the death of the life-tenant resulted in a surplus of nearly \$23,000 over the amount of the original investment; will gave life-tenant annual interest, income and dividends of trust fund. Decision: All beyond this must from necessity have been intended to go to the remainderman, for there are no other persons who could lawfully take it; in this case the investment is directed to be made in securities bearing a fixed rate of interest; the increase in question seems to have been because of a depreciation in the rate of interest affected by natural causes and which gave an increased value to securities bearing higher rates of former times; this constituted in no sense a profit from the investment, but was an accretion to the fund itself arising from natural causes and was liable to be altogether lost by the approximation of the securities to the period of their maturity; if the will had required the trustee to invest in real estate, it cannot be questioned but that any increase in the value of land from natural causes would be an accretion to the capital and inure to the benefit of the remainderman; we can see no difference in principle between this case and the one supposed. Note: This case applies also to ordinary and non-contractual increase of securities; not to the point now at issue.

Duclos v. Benner (1891), 17 N. Y. S. 168: Trustee invested \$30,000 in government bonds; later sold bonds at profit of \$3465; profit claimed by life-tenant as income on trust fund, in addition to (contract) interest collected on bonds; under will life-tenant was entitled to income, interest, profits and earnings of the trust fund. Decision: Held the profit arising from the sale was accretion to the capital of the estate and must be held as such; that life-tenant was entitled to any increase of income by reason of the investment of the profit. Note: This case applies also to ordinary and non-contractual increase of securities; not to the point now at issue.

In re Vedder (1891), 2 Connolly N. Y. Rep. 548: Question was whether representatives of life-tenant entitled to receive increase in value of securities held by the trustee or should such increase be held

to be a part of the principal; the trustee realized by sale an excess of \$10,200. Decision: An increase from natural causes in the value of real and personal estate held as an investment does not constitute profit and go to the life-tenant; such increase becomes principal and goes to the remainderman. Note: This case applies also to ordinary and non-contractual increase of securities; not to the point now at issue.

In re Cutler (1898), 52 N. Y. S. 842: \$8,800 in par value of stocks, bonds and other securities constituted residue and formed trust estate; what actual value was of the securities does not appear; surviving executor realized \$12,000 from sale of securities; certain beneficiaries claimed difference between the two sums as income. Decision: Life-tenant was undoubtedly entitled to the income from the estate in remainder; if she succeeded in living without that income and saved for several years a part thereof, these savings undoubtedly belonged to her absolutely; it now becomes necessary to determine whether this apparent increase is a result of accumulation of income or whether it is simply an increase resulting from the sale of stocks, bonds and other securities. Decision: In investments and reinvestments of this kind, the gains realized are capital and not income; gains made on stock taken at par and sold above par are accretions to the estate in remainder. Note: This case applies also to ordinary and non-contractual increase of securities; not to the point now at issue.

In re Graham (1901), 198 Pa. 216: Trustee sold real estate and invested proceeds in certain bonds; trustee also purchased additional bonds of same issue; later sold bonds at a profit of \$17,750. Trustee also received certain shares at appraised value; property of company was condemned and trustee received \$50,288 in excess of appraised value of stock. Decision, first question: The profit of the sale of these bonds was realized by reason of the enhancement in value of the trust investments and is not income from them; that it is part of the corpus and should be so held by the trustee. Decision, second question: Where a corporation sells a part of its property and distributes the proceeds as a dividend among its stockholders, such dividend is capital and not income; the excess received by the trustee on the stock mentioned above its appraised value is part of the corpus of the trust. Note: This case also applies to ordinary and non-contractual increase of securities; not to the point now at issue.

Stewart v. Phelps (1902), 75 N. Y. S. 526: Testator bequeathed an estate valued at \$4,714,833 in trust for his daughter; he directed certain payments out of capital to be made to her at various times and such payments were made; balance of assets remained in trust; by sale

of securities for more than appraised value, trustee realized excess of \$399,067; trustee also made purchases and sales and realized additional profits of \$129,969; rights to subscribe to additional stock of corporation was sold for \$6,243; trustee also received a stock dividend from a corporation, which trustee sold for \$1,987; referee allowed life tenant proceeds of sale of stock dividend and item of \$416 interest realized on a security sold; referee held the remaining increases in the estate were accretion to the principal of the trust fund, to which the life tenant was not entitled. Decision: Court sustained holdings of referee. Note: This case applies also to ordinary and non-contractual increase of securities; not to the point now at issue.

In the present appeal the court also refers to Perry on Trusts, 6th ed., Sec. 546. We find the following language: "Any accretion to the fund itself, * * * as by the rise in value of securities, goes to the remainderman; the life-tenant also derives advantage from this increased value, through the larger income resulting; but, if the securities mature or are sold, the increased value belongs to the remainderman." Note: The text applies to ordinary and non-contractual increases in value of trust assets; not to the point now at issue.

IX.

The court in its decision in the present appeal expresses itself thus: We think it may be taken to be settled that increase of a trust fund, resulting from the increase in the value of bonds or other securities, due to whatever cause, ought to be regarded as part of the corpus of the trust and not as income to which the life-tenant is entitled. Since the cases quoted bear only on ordinary increases, and not on accumulating discounts, the court should differentiate between ordinary increases and the court's so-called increases by way of accumulating discount, since they are unlike and both have different characteristics; ordinary increases are increases not contracted for and accumulating discounts are increases contracted for at the time of purchase of bonds below par.

X.

The court continues: This conclusion (of the court) gains added force from the consideration, whenever bonds are purchased by the trustee at a discount, that the amount of such discount remains in the hands of the trustee as uninvested part of the corpus of the trust fund; it is the duty of the trustee to make a timely investment of the same in other securities, to the interest upon which as it accrues the

life-tenant would be entitled; thus there would be made up to her approximately the amount of income which she would have received had the original investment been in bonds at par; this is all to which she would have been entitled. Again the court has fallen into error. Of course uninvested corpus remains in the hands of the trustee and the life-tenant is not entitled thereto. The life-tenant is entitled only to income on the fund when invested. See comment already made on this point above. Reference to a bond table will show that there are different rates of return on an investment of \$900 at par in a 5 per cent semi-annual bond having 10 years to run and an investment of \$900 in a 4 per cent semi-annual bond at 90, the latter also having 10 years to run. In the first case the investment will show a return of 5 per cent, or \$45 per year; in the second case a return of 5.3 per cent, or \$47.70 per year, a difference in return of approximately \$2.70 on each \$900 invested. An estate of \$476,000 is equal to 528 times \$900. 528 times the difference of \$2.70 equals an annual loss of \$1425. Such annual loss is too great to be dismissed in the offhand way indicated by the remarks of the court that "there would be made up to the life-tenant approximately the amount of income she would have received had the original investment been in bonds at par." During a long life tenancy the loss would be enormous.

XI.

The will provides for the payment to the life-tenant of a minimum amount of income per month and if the amount of income at any time falls short the trustee is directed to make up the amount out of corpus. The court in this connection remarks as follows: The only contingency upon the happening of which the trustee would be justified in paying over to the life-tenant any portion of the corpus would be as provided in the will; yet, if the argument on behalf of the life-tenant is to be given effect, the trustee would be required to withdraw from the corpus of the estate the uninvested portion thereof, represented in the amount of discount retained in making purchases of bonds at less than par, and pay the same over to the life-tenant. We do not see why the court refers to the specific provisions mentioned and associates them with the question of accumulation of discounts; we do not consider the two matters related.

We believe we are conservative when we state that experienced corporate fiduciaries, in the investment of trust funds in legal investments, seldom make investments that develop losses. Suppose loss does occur once in ten thousand investments. Surely it cannot fairly

be urged, because of one such remote possibility, that trustees must be unfair to nine thousand nine hundred ninety-nine life-tenants, and refuse to accumulate discounts on bonds held in their trusts, after purchase of such bonds on the principle that proper adjustments would be made from year to year; to take such a stand, and to be logical, would require trustees also to refuse to pay over the full net income on par or premium bonds, for fear that one in ten thousand might default and foreclose or other proceedings become necessary to realize upon the investment. Mere fluctuations in market value of bonds held by trustees does not constitute loss; such fluctuations are caused by changes in general financial conditions, that affect market rates for money, but are not to be written into the accounts of trustees.

Even if the excuse, that a possible default might occur before maturity of one discount bond is considered basis enough to justify refusal to adjust discounts on all other discount bonds held by a trustee, why not make belated adjustment on the one bond as it matures and is collected, or, if sold before maturity, at the time the proceeds of sale be realized? While we claim such belated adjustment is unfair, it is more equitable than no adjustment whatever. To deliberately refuse to make the adjustment cannot be justified, in view of the basis of discount investments.

XII.

The court suggests: If it be contended by the life-tenant that she is not asking the present payment over to her of such discount, but only the accumulation for her benefit, the answer is twofold. First, that the right to have the discount accumulated must rest upon her right to receive the same now or later as income, which right does not exist. Second, there is no provision in the will which would empower the trustee to accumulate any portion of the trust property in any other form than as part of the corpus. The declaration of the court "which right does not exist" is dogmatic and without reason (referring to the claim of the life tenant to accumulating discount). The further declaration, that there is no provision in the will to accumulate in any other form than as part of the corpus, is beside the point at issue. Since accumulation of discount on bonds are herein shown to be part of the earnings of the investment, why should they not be paid to the life-tenant as they accrue? That question is answered above.

XIII.

The court offers the following suggestion: It is easy to conceive

of instances during a trust wherein trustees who have justifiably purchased securities at a discount might later find it advisable to dispose of such securities at the same price below par at which they had been purchased; what if in the meantime some court had directed the (accumulated) discount paid over to the life-tenant; what if the securities become valueless; in such case would the corpus of the estate be held to suffer not only the loss incident to the unfortunate investment but also the amount of the (accumulated) discount which the trustee had in the meantime been required to pay over to the life-tenant? We say, certainly, so long as the investment is deemed safe; that such was the fundamental principle and exact basis upon which the bond was purchased. Trustees do not stop paying over income on bonds purchased at par or at a premium, while they are deemed safe. The same rule ought to apply to bonds purchased at a discount. If it later develops that an investment in a premium bond, a discount bond or a par bond has been unfortunate, then the trustee must stop paying over income thereon. Finally, on the enforcement of the lien securing any such bond, the proceeds arising from foreclosure should be applied as directed for proceeds of foreclosure sales received by trustees. If the proceeds thus applicable to corpus are greater than the value of the bond as carried in the accounts of the trustee, there is a profit by appreciation; if the proceeds thus applicable to corpus are less, there is loss by depreciation. Such matters are easily adjusted as they arise.

Unless a particular bond received by a trustee is a legal or authorized investment and is considered safe, whether it be quoted at par or at a premium or at a discount, the trustee should not retain the bond as a trust investment. Unless a particular bond offered to a trustee is a legal or authorized investment and is considered safe, whether it be quoted at par or at a premium or at a discount, the trustee should not consider its purchase. Any holding by a trustee of a particular bond, is on the basis that it may be held until maturity and will then be paid at par. Often a bond is sold before maturity, whether it be held at par, at a premium or at a discount, depending on the needs of the estate or the judgment of the trustee at the time. Any profit or loss to corpus on any sale is readily adjusted at the time of sale, no matter at what value the bond stands in the accounts of the trustee at the time. The fact that a bond may stand in the accounts of the trustee at a discount, causes no confusion or trouble whatever. In every case of sale any such profit or loss represents the difference between the proceeds of sale and the value of the bond as carried in the accounts of the trustee; the difference on a premium bond or a dis-

count bond or a par bond would affect corpus of the estate and not income. In the case of a premium bond, no such loss would be made up out of income; nor in the case of a discount bond should any such loss be made up out of income; such loss would be a loss to corpus only. It is a mistake to assume in case of a premium, a discount bond, or a par bond, that it would be necessary to have the life-tenant refund any such loss.

Those who without reason wish to controvert the right of the life-tenant to accumulating discount, suggest the question: What if a discount bond should default before maturity and be foreclosed, and if in the meantime the discount be written up as proposed, will not the loss to corpus be greater than if the carrying value of the bond in the accounts of the trustee had been unchanged from the original amount paid? Naturally, if the investment of corpus in a particular bond is greater, any loss subsequently sustained will be greater. As income is credited with the accumulating discount, the investment of corpus in the bond increased in like amount; that is as it should be and as was contemplated under the fundamental principles controlling purchases of discount bonds; it is not an accident; it is the writing into the accounts of the trustee of the fact, considered on the basis of purchase, that the discount is less than it was originally and thus the bond is worth more; it will from interest period to interest period continue to be less, until the bond matures, when the principal of the bond as a legal obligation will call for payment of par and will stand in the accounts of the trustee at par. So long as there is no default in a bond, whether purchased at par or at a premium or at a discount, the trustee should pay the exact earnings thereon to the life-tenant. If default occurs in a premium bond, the loss to corpus may be more than if default occurs in a discount bond, as a premium bond stands in the accounts of the trustee at an amount greater than a discount bond. Since we know from experience that discount bonds are no more liable to default than a premium bond, equally well secured, there is no more reason not to pay out the exact earnings of a discount bond than the exact earnings of a premium bond. The real question is: What are the actual earnings of the respective bonds? When ascertained, the duty of the trustee to pay the actual earnings to the life-tenant should be as positive in the case of a discount bond as in the case of a premium bond. In the purchase of a premium bond the amount of the premium over par is all paid out at the time of purchase; in the purchase of a discount bond the amount of discount is spread evenly over the period of time the bond has to run. Trustees should be required to meet their

responsibility in both cases and use no more hesitancy in the one than in the other.

XIV.

The court offers the following suggestions: In the performance of their duties to invest, preserve and increase the corpus of trusts, trustees are empowered to purchase and sell securities and reinvest, depending on the state of a variable bond and money market and upon variations in the value of securities caused thereby; this being so, to bind trustees by the obligation to pay over accumulating discounts for the benefit of life-tenants would involve the integrity of the corpus of the estate, which it is their duty at all times to preserve intact. We except to the language of the court in saying that it is the duty of a trustee to increase the corpus of the estate. Trustees are never allowed to speculate. We do not believe the court meant what it said, in using the words "increase the corpus"; it is the duty of the trustee to invest and preserve the estate and if by reason of ordinary increase in value of trust assets the amount of the estate is increased, such increase belongs to capital; likewise if there be decrease by reason of ordinary decrease in value of trust assets, the decrease falls on the capital. We do not confuse decrease caused by amortization of premiums on bonds purchased by trustee at a premium, nor increase caused by accumulation of discount on bonds purchased by trustee at a discount, as ordinary increase or decrease of trust property. We have already above taken issue with that proposition. Accumulations of discounts do not concern the corpus of a trust.

XV.

The court attempts to comfort the life-tenant by saying (in effect) that the net income on a bond for \$1,000, bearing 4 per cent contract interest, is the same as the net income on a 5 per cent bond for \$900 purchased at par. Let us examine the question and determine it for ourselves. The interest on \$100,000 safe bonds, bearing 4 per cent contract interest, would amount to \$4,000 per annum; interest on \$90,000 par value of safe bonds, bearing 5 per cent contract interest, would amount to \$4,500 per annum; the life-tenant would thus lose income at the rate of \$500 per year; during the life of a bond running for ten years the life-tenant would lose \$5,000; at maturity both lots of bonds would be paid at par; on the investment at par the trustee would receive return of the \$90,000 invested, and there would be no loss or gain to corpus; on the investment at a discount the trustee would receive return of the \$90,000 invested and in addition the difference be-

tween \$90,000, original cost of the discount bonds, and \$100,000, the proceeds of the bonds paid at maturity at par. Under the decision the \$10,000 excess, over original cost of the discount bonds, would be added to the corpus of the estate and corpus would be unduly increased, to the loss of the life-tenant; the total loss to the life-tenant would be \$15,000—\$500 per year for ten years and \$10,000 accumulated discount added to the corpus. Notice the undue power that would thus be lodged in the trustee to favor the remainderman, entitled to corpus, as against the life-tenant, entitled to income. Should the life-tenant be satisfied with such partiality and injury? No. It is not equitable to vest such uncontrolled powers in any trustee.

XVI.

The court offers the following suggestions: It is the duty of the courts to establish a rule of action which will tend to relieve the administration of trusts from confusion and avoid possible involvements of the corpus of an estate, as would arise out of the adoption of the proposition for which the life-tenant contends. Certainly courts should relieve the administration of trusts from confusion; certainly courts and trustees should avoid possible involvements of the corpus of estates. It is borrowing trouble to say such confusion and involvements would arise out of the adoption of the principle contended for. We know from personal experience there is no confusion; also we know from personal experience no involvements arise out of the adoption of the principle. Accounting officers of banks, trust companies and financial institutions everywhere, accounting officers of life insurance companies and other corporations everywhere; accounting officers of investment corporations everywhere; accountants of large individual investors and investment firms everywhere, including many such in the State of California, are familiar with such practice and are not confused or involved thereby. No, the court has missed the issue; also the court is forgetting that there is a rule of equity underlying all trusts: Trustees must be impartial between beneficiaries and must render unto each his due—no more and no less.

XVII.

Formerly courts were not correct in decisions affecting the duty of trustees to amortize premiums on bonds purchased above par, as courts had not studied the fundamental principles involved; about twenty years ago the courts realized that the matter was too important to receive indifferent consideration, and the courts changed their atti-

tude, so that now, by great weight of authority, courts require the adjustment of premiums. The question of adjusting discounts has now been decided for the first time by an appellate court; of course the decision is final in the particular estate. As we have shown the decision is immature, it will hardly be followed when the question comes up for review in other states; the decision has little value as a precedent outside of California and should have little influence in courts of other states; unless a decision is mature, just and equitable, it cannot be said the decision establishes a principle, for the guidance of courts in other similar matters; we therefore look for a reversal of the recent decision, when a similar question is again presented to an appellate court.