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Can an Equitable Interest Held in Trust Be Transferred Wrongfully by the Trustee Free of the Trust?

ELLSWORTH WILTSHIRE

We all know that a bona fide purchaser for value of trust property holds the same free of the trust. But it is usually stated that such a purchaser must obtain the *legal* title to the property to so eliminate the trust beneficiary. However, suppose the trustee holds the equitable (but not the legal) title to property in trust for a beneficiary. Is the interest of such beneficiary in the property cut off in Virginia should the trustee wrongfully convey such equitable title to a bona fide purchaser for value?

The importance of the problem is indicated by three typical cases:

Case A. A mortgages land to X to secure a loan of $10,000. Later A conveys the land to T upon an oral trust from B. Thereafter T wrongfully conveys the land to C for $15,000 cash. C pays the cash and receives conveyance of the land from T without notice of the oral trust. Does C hold the land free of the trust for B? (Whenever the word "mortgage" is used in this article, it will include not only the transfer of land by a mortgagor to a mortgagee as security for the performance of an obligation owing to the latter but also the transfer of land by a grantor to a trustee in trust to secure the performance of an obligation owing to a third party.)

Case B. Through fraud B is induced to convey land to T. Thus T holds the property in constructive trust for B. Later T mortgages the land to X to secure a loan of $10,000, X having no notice of the trust. Thereafter T conveys the land to C for $15,000 cash. C pays the cash and receives the conveyance without notice of the fraud. Does C hold the land free of the constructive trust for B?

Case C. A, the owner of a bond for $10,000, transfers the same to T in trust for X. Thereafter X declares himself trus-

tee for B of his equitable interest in the bond. Later X sells and assigns his interest as beneficiary under the first trust to C. C pays the purchase price and receives the assignment without notice of the trust for B. Is B's interest in the bond thereby cut off?

In Case A and also in Case B, T under the orthodox view has only the equity of redemption in the land in trust for B. The trust is an express trust in Case A and a constructive trust in Case B. The mortgage given to secure the loan transfers the legal title to X, so that T has only the equity of redemption or equitable title as the trust *res*. In each case C, who obtains conveyance from T and pays value without notice, claims he is a bona fide purchaser for value and thus is ahead of B. However, B maintains that C received the *equitable* (but not the *legal*) title to the realty and accordingly takes subject to the trust for B.

In Case C, X has only equitable title to the bond when he declares himself trustee of his interest for B. The declaration of trust is not equivalent to an assignment by X of his interest in the bond to B, for X still remains in the scheme. X is now trustee of the equitable title for B, and T, who as trustee holds the legal title to the bond, cannot ignore X as trustee of the equitable interest therein. Later, when C purchases for value from X, C ostensibly receives by the transfer the equitable interest which X had before X had declared himself trustee for B. C of course claims he is a bona fide purchaser for value and hence is ahead of B. B, however, insists that C at the most only received an equitable title or interest, that B's equity is prior in time to that of C, and that accordingly B should prevail.

Courts and legal writers frequently state that the doctrine of bona fide purchaser for value can be invoked only when the purchaser receives the *legal* title to the property. They maintain that where each of the claimants has only an equity, the one prior in time should prevail. Indeed, as is said in *Briscoe* v. *Ashby*, 24 Gratt. 454 (1874), discussed hereinafter in detail: "Now every equitable title is incomplete on its face. It is in

truth nothing more than a title to go into chancery to have the legal estate conveyed, and therefore every purchaser of a mere equity takes it subject to every clog that may lie on it, whether he had notice or not."

The English cases uphold the proposition that, when an equitable interest is held under an express trust or subject to a constructive trust, the purchaser thereof for value without notice of the trust holds subject to the trust. Bogert, *The Law of Trusts and Trustees,* Section 885. Thus, in *Cave* v. *Cave,* 15 Ch. D. 639 (1880), a trustee wrongfully used trust money to purchase land and the legal title was conveyed to him. Later, he mortgaged the land to A, then mortgaged the same to B, and finally mortgaged it to C, each of whom had no notice of the trust. The court held that A, having obtained the legal title, took free of the trust but that the beneficiaries of the trust were ahead of B and C, as each of them received only an equitable interest.

Some American cases have held the same view adopted by the English authorities. However, several American cases have permitted the bona fide purchaser for value of an equitable interest to prevail. Thus, in *Loring* v. *Goodhue,* 259 Mass. 495, 156 N.E. 704 (1927) a business trust had the beneficial interest therein evidenced by certificates. The owner of one of these certificates transferred it to a dealer to have a new certificate issued therefor. The latter had the new certificate issued in his own name and then wrongfully pledged the new certificate to secure a loan. The lender had no notice that his debtor was not the beneficial owner. It was held that the pledgee was ahead of the original certificate holder.

The Restatement of Trusts, Section 285 (1935) states the rule that, if the trustee conveys trust property in breach of trust to a bona fide purchaser for value, the purchaser holds the same free of the trust and is under no liability to the beneficiary, although the trust property is an *equitable* interest. In *Comment a* to that section it is said: "The policy which protects a bona fide purchaser of land, chattels, and choses in

action is applicable also where the trust property is an equitable interest."

The basis for applying the doctrine to the transfer of an equitable interest is given in Scott on Trusts, p. 2162 (2d ed. 1956) as follows:

> In spite of these decisions and in spite of the numerous dicta to the effect that the doctrine of purchase for value is applicable only where the purchaser acquires a legal interest in the property, there would seem to be good reason for holding that a purchaser of an equitable interest, if he pays value and has no notice that the equitable interest was held in trust, should take free and clear of the trust. It would seem that the same policy which permits the purchaser of land or chattels or choses in action to keep the property so purchased is applicable to equitable interests. The problem in each case is one of weighing the interest in the security of transactions against the interest in the security of property already acquired. The tendency of the law has been more and more to protect persons who in good faith enter into business transactions rather than those who simply seek to retain what they already have. If it is a sound policy, and not a mere matter of technique, which underlies the protection given to purchasers of trust property who pay value and have no notice that the trustee is committing a breach of trust, it would seem that the same protection should be given to purchasers of equitable interests. If the beneficiaries of a trust must bear the risk that the trustee may prove recreant to the trust by transferring the trust property to a bona fide purchaser, why should they not bear the risk whether the trust property happens to be a legal or an equitable interest? The real question is whether equitable interests, like legal interests, are not such usual subjects of commerce that commercial transactions with respect to them deserve protection. If they are, the doctrine of bona fide purchase should apply to such interests. It would seem clear that it should apply to such an interest as that which is held by the owner of land which is subject to a mortgage. Even though under the

> orthodox common-law theory the owner of land subject to a mortgage is held to have only an equitable interest, an equity of redemption, it would seem clear that if the owner held the interest upon a secret trust, a bona fide purchaser should take the land free of the trust although subject to the mortgage. It would seem even more clear that if the owner of land subject to a mortgage is induced by fraud to sell the land, a bona fide purchaser from the fraudulent vendee should take the land free of the constructive trust upon which his vendor held it as a result of the fraud. * * * Of course, in many American states it is held that a mortgage does not give the mortgagee legal title to the land but only a legal lien upon the land, and that the mortgagor is the owner of the land, holding the legal title to it subject to the mortgage, and has not merely an equitable interest. In such states of course where land which is subject to a mortgage is held in trust, a bona fide purchaser of the land acquires the legal title to the land and is protected.

Where does Virginia stand on this question? In considering the attitude of the Virginia Supreme Court of Appeals, it is advisable to discuss the competing rights of the bona fide purchaser and the trust beneficiary in two separate situations: (1) When the trustee wrongfully conveys to the purchaser what would have been the legal title to the trust property but for the possible effect of an outstanding mortgage and (2) When the trustee holds only an equitable interest (not made so by the effect of an outstanding mortgage) in the trust property and wrongfully conveys such interest to the purchaser.

(1) *When the property transferred is subject to an earlier mortgage.*

The property transferred wrongfully by the trustee to a bona fide purchaser may be subject to an earlier mortgage. As in Case A, such mortgage may have been placed upon the property before the trust was created. As in Case B, such

mortgage may have been placed upon the property by the trustee himself.

Whether the purchaser seeking to hold the property free of the trust gets legal or equitable title depends upon whether with respect to mortgages Virginia has adopted the "title" theory or the "lien" theory. Scott on Trusts, p. 2163 (2nd ed. 1956) quoted earlier herein. In a "title" state, the mortgagee has the legal title, the trustee has merely an equitable title (equity of redemption), the trustee conveys only equitable title to the purchaser, and the latter in many jurisdictions takes subject to the trust. However, in a "lien" state, the trustee has legal title, the mortgagee merely has a legal lien, the trustee conveys legal title to the purchaser, and the latter accordingly taks free of the trust. Glenn on Mortgages p. 209 (1943).

Prior to *Gravatt* v. *Lane,* 121 Va. 44, (1917), Virginia adhered to the "title" theory. The mortgagee was deemed "entitled to an estate as tenant in fee or for a term for years, as the case may be, . . . as regards title, subject to an agreement as to the possession and defeasible at law, by the performance of the condition." *Faulkner* v. *Brockenbrough,* 4 Rand. 245 at 248 (1826).

In the *Gravatt* case, one question was whether the owner of the land, upon which there was an unsatisfied mortgage, could maintain the action of ejectment in his own name against a third party. Clearly under the "title" theory of mortgages, the owner could not. Ejectment could only be brought in the name of the holder of the legal title, and the legal title was actually in the mortgagee. However, the court held that the owner could maintain the action in his own name notwithstanding the existence of the unsatisfied mortgage. In so doing, the court has appeared to adopt the "lien" theory of mortgages. This is shown from the following portion of the opinion by Prentis, J.:

> The great weight of authority, however, is that an outstanding unsatisfied mortgage or deed of trust on land to

> secure a debt is regarded as a mere lien, and that the mortgagor or grantor may still maintain ejectment in his own name, and the defendant will not be permitted to set up the outstanding mortgage or deed of trust to defeat the action.
>
> . . . .
>
> We perceive no sufficient reason on principle for a different rule, even though the debt has not been satisfied. While technically the legal title is in the trustee, it is only vested in him for a definite purpose, namely, to secure the debt. Such a deed should be construed in actions of ejectment as a mere lien upon the property. This view is in accord with reason and the greater weight of authority and has the approval of this court.

The court made no reference to *Faulkner* v. *Brockenbrough, supra,* or other Virginia cases espousing the "title" theory. The only Virginia authorities it relied on held that the mortgagor of a *satisfied* mortgage could maintain ejectment in his own name. But these cases were firmly based on a Virginia statute (now Va. Code Ann. §8-817 (1950), which is in no way applicable to unsatisfied mortgages.

It would therefore appear that the *Gravatt* case has unmistakably placed Virginia among the "lien" states. Dean W. M. Lile in 8 Va. Law Rev. 224 (1924) reluctantly states Virginia has by that case adopted the "lien" theory "inadvertently as is believed". See also *The Nature of a Mortgage in Virginia* in 14 Va. Law Rev. 235 (1927).

One year before the *Gravatt* case, a rather similar situation was presented in *Murphy's Hotel* v. *Benet,* 119 Va. 157 (1916). There A mortgaged land to B and later mortgaged it to C. Each mortgage was duly recorded when given. Before the first mortgage was given, X obtained a judgment against A, but the judgment was never docketed and neither B nor C had notice thereof when their respective mortgages arose. X claimed his undocketed judgment was ahead of C's mortgage upon the basis that the legal title to the land was in B and that

accordingly C's mortgage merely gave him an equity. The court held the second mortgage was superior to the undocketed judgment.

If Virginia was then a "lien" state, this holding was obviously correct. B under the mortgage received not the legal title but only a legal lien superior to the undocketed judgment. Likewise, C under the second mortgage obtained a legal lien superior to the same judgment. However, the court failed to discuss either the "lien" theory or the "title" theory. It apparently took the position that C was a "purchaser thereof for valuable consideration without notice" under what is now Section 8-390 of the Code of 1950 and that hence as to it the judgment was not a lien until and except from the time the judgment was duly docketed. The Court failed to mention in its opinion whether such a "purchaser" must have legal title or could prevail only with equitable title. It is interesting to note that the *Murphy's Hotel* case has not been cited in any later case.

Since the *Gravatt* case, only one case has been found that might involve whether Virginia is now a "lien" state or is still a "title" state. In *University of Richmond* v. *Stone,* 148 Va. 686, (1927), the owner of land conveyed it upon a mortgage to secure a note, which note provided for the payment of attorney's fees in event of default. The mortgage, however, was silent as to attorney's fees. Later the owner conveyed the land to a purchaser subject to the mortgage. Thereafter the question arose of whether the payment of such attorney's fees was secured under the lien of the mortgage, so far as the purchaser was concerned. The court held the lien under the mortgage for the attorney's fees was valid as against the purchaser on two grounds: (1) the purchaser took with notice of the provisions of the note and (2) the purchaser acquired only the equity of the grantor and hence received no better title than the grantor had, citing *Briscoe* v. *Ashby,* 24 Gratt 454 (1874), and *Wasserman* v. *Metzger,* 105 Va. 744 (1906), hereinafter discussed. The major portion of the opinion was devoted to a detailed consideration of the ground that the

purchaser took with notice of the provision in the note as to attorney's fees and was hence not bona fide. Neither the *Gravatt* case nor the lien theory was even mentioned in the court's opinion. Since the ground of taking with notice was considered so much more elaborately than the ground of taking only the equity of the seller, it is not believed that the *Stone* case should be deemed to overrule the *Gravatt* case and to toss Virginia back among the "title" states.

We may therefore conclude that, when the property conveyed by a trustee in breach of trust to a purchaser is subject to a mortgage, the doctrine in Virginia is that the purchaser receiving the conveyance and paying value without notice of the rights of the beneficiary takes free of the trust. Hence, in Virginia in Case A and Case B the purchaser would hold the property free of the trust.

(2) *Where the trust property conveyed by the trustee to the purchaser is merely an equitable interest (not so made by a mortgage).*

This leaves for consideration the situation, such as Case C stated above, where no mortgage is involved, the trustee has only an equitable interest in trust, and he wrongfully transfers the equitable interest to a bona fide purchaser for value. There both the beneficiary of the trust and the purchaser have "equities" or "equitable interests". Does the beneficiary, who of course has the prior equity, prevail in Virginia? Or does the purchaser with only equitable title take free of the trust?

The leading case is *Briscoe* v. *Ashby,* 24 Gratt. 454 (1874). There a trustee purchased land at a court sale and paid the cash portion of the purchase price with trust funds. The Court retained the legal title until the balance of the purchase price was paid. While the legal title was so withheld from him, the trustee conveyed the land to a purchaser, who paid cash and received the conveyance without notice of the trust. It was

held that the purchaser took subject to the trust. The court in its opinion stated in part as follows:

> The reason of the distinction between the purchaser of a legal and equitable interest seems to be that the protection accorded to bona fide purchasers is a departure from the general rule of jurisprudence, which holds that no man can transfer a greater right than he possesses, and regards the vendee as standing in the same position as the vendor under whom he claims. This exception was made by equity against the rights and remedies which it had called into being, and in favor of purchasers who bought in good faith, and under the impression that they were acquiring a good legal title. But when the purchase is a mere equity which owes its existence to a court of chancery, and cannot be enforced without its assistance, the reasons from departing from the general maxim . . . is at an end, and the right acquired by the vendee is necessarily limited to that of the vendor. When, therefore, a purchaser buys an equitable estate or interest with a knowledge of its real character and without obtaining a legal title, he can found no claim on the mere fact of the purchase, and must stand or fall by the title of the vendor.

Thus, the *Briscoe* case clearly holds that the purchaser of an equitable estate from a trustee takes subject to a trust of which he has no notice.

This case was followed by three cases, all of which involved mortgages. In the first, *Throckmorton* v. *Throckmorton,* 91 Va. 42 (1895), a wife claimed her husband had unbeknown to her purchased land in his own name but with her money. He thereafter conveyed the land successively in three separate mortgages. The wife claimed her husband held the land in constructive trust for her and that her interest was superior to all three mortgages. The court held that, even if it be true that neither the trustee nor the beneficiaries of the mortgages had notice of the wife's claim and therefore were bona fide purchasers for value, the evidence on behalf of the wife failed to establish a resulting trust in her favor when her husband

purchased the property. The indication that the second and third mortgages would be superior to the beneficiary of a resulting trust is at best a weak dictum. The *Briscoe* case was not even mentioned, and it is clear that the court rested its holding primarily upon the fact that the wife had not proved a resulting trust in the first instance.

The doctrine of the *Briscoe* case was followed in *Evans Bros.* v. *Roanoke Savings Bank,* 95 Va. 294 (1879), and again in *Wasserman* v. *Metzger,* 105 Va. 744 (1906). However, in both of these cases the trustee was held to have conveyed merely an equitable estate because of an earlier mortgage. Since Virginia is now committed to the "lien" theory of mortgages through the *Gravatt* case, it would appear that the purchaser would, if each case were before the court today, take free of the trust. However, these two cases do show clearly the adherence of the court to the position that, if a trustee has only the equitable title, he cannot convey such interest to a bona fide purchaser so as to cut off the trust.

We have found no later Virginia cases bearing upon the question.

Summary

The situation in Virginia may be summarized as follows:

1. As Virginia is now a "lien" state, when the trustee has the legal title to property in trust subject to the lien of a mortgage, a bona fide purchaser for value from him subject to or assuming the mortgage will hold the property free of the trust. This of course eliminates a vital danger which would otherwise exist when land is sold and the purchaser takes subject to or assumes an existing mortgage. The purchaser, or the title insurance company if it insures the title of the purchaser, need have no fear that perhaps the seller holds the property upon an express or constructive or resulting trust of which the purchaser has no notice.

2. But, if the trustee has only equitable title to property and holds the same upon an express trust or has obtained

such title through fraud, duress, undue influence, or breach of confidential relationship or has purchased such title with the money of another or holds it subject to some other equity, a bona fide purchaser of such equitable title from him would, it appears, take subject to the trust. However, the leading case was decided eighty-five years ago, and the later cases have been mortgage cases handed down before Virginia adopted the "lien" theory of mortgages. In recent years the Restatement of Trusts, authorities such as Professor Scott, and some courts of last resort in this country have taken the view that in such a situation the purchaser should take free of the trust. Our Supreme Court of Appeals, which has heretofore discarded the "title" theory of mortgages for the more modern "lien" theory, may well, when presented squarely with the problem, favor the interest in the security of transactions over the interest in the security of acquisitions in this situation to the extent of allowing the bona fide purchaser for value of an equitable title from a trustee to hold the same free of the trust.