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ADVICE FOR ADVISORS — TRUST INVESTMENTS

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I. THE PROBLEM

Too often the corporate trustee is compelled to make an investment decision which his common sense opposes. Trust officers, mindful of their liabilities should even the slightest risk materialize, sometimes must take the sure-safe course against their inner judgment. The "prudent man" rule, as it is stringently applied to trustees, threatens to make timid souls of good red-blooded American fiduciaries.

Two examples will illustrate the problem. In the first, a trust estate includes common stock in a young growth company. Dividends have produced a consistent 7% return. A good profit potential is enhanced by the prospect of a stock-split, likely in the offing. Chances of a drop in the market appear remote; the trust officer's personal hunch is that the odds are 50 to 1 that the stock will seek a higher level. But he sells the attractive stock and re-invests the proceeds at half the former return — to the distress of the beneficiary.

A second example is offered by a trust estate which includes a controlling block of shares in a close family corporation. Death of the settlor has cast a tiny cloud over the future of the venture; a cloud which would probably be dispelled were control to remain in the trust estate. The widow beneficiary and her good friends in the company importune the trustee to retain the shares — but he disposes of them and buys ultra-conservative securities.[1]

Does the law require trustees to be so timorous? A first glance at Colorado's statute[2] dealing with the investment responsibilities of trustees would appear to offer encouragement to the trustee who would deal squarely with the risks involved in special situations. Fiduciaries are expressly authorized:

> to acquire and retain every kind of property — real, personal and mixed — and every kind of investment, specifically including, but not by way of limitation, . . . stocks, preferred or common . . . which men of prudence, discretion and intelligence would acquire or retain on their own account.[3]

Commenting soon after the passage of this statute in 1951, Dean Edward C. King said, "Properly understood, it will facilitate the investment of trust funds, will tend to produce a better income for beneficiaries, and will permit wider diversification of investments.[4]

Are trustees, then, to be blamed for pusillanimity which trou-

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1 Colo. Rev. Stat. § 83-1-1 (1953) gives statutory approval to certain archconservative securities bringing low returns. It is mandatory for certain public funds, and sometimes has been used by private trustees as an investment guide.

2 Colo. Rev. Stat. § 57-3-1 to 6 (1953).

3 Colo. Rev. Stat. § 57-3-1 (1953).

4 King, *The Meaning of the "Prudent Man Rule,"* 24 Rocky Mt. L. Rev. 44 (1951).

bles their beneficiaries? Not if one reads the rules of prudence which preface the statutory language quoted above. Trustees must:

> . . . have in mind the size, nature and needs of the estates entrusted to their care, and shall exercise the judgment and care under the circumstances then prevailing which men of prudence, discretion and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds. . . .[5]

A trustee must be doubly prudent. Not only must he adhere to the standards prescribed; he must also consider the hindsight which might occur some day in court. True, some court decisions disclaim

[5] Fed. Reserve Reg. F, 12 C.F.R. § 206 (1959).

any tendency to use hindsight, and the statute speaks of "circumstances then prevailing"[6] — but a judge has wide fields of speculation to range when he is deciding what a prudent, discreet, intelligent man should have done months before. An investment which looked good to the trustee last year may not look prudent to the court today, or to the supreme court tomorrow. Poor widow plaintiffs have winning ways against banker-trustee defendants.

The trust officer of a national bank is mindful, too, of federal regulations[7] making his board of directors responsible for investment decisions, as steered by the trust investment committee.

A corporate trustee which fails to sell stocks is likely to be held to its "duty to exercise a proper degree of care and skill"[8] — leading in turn to questions of proper internal organization of the trust company, or the proper functioning of its officers.[9] A trust officer, confronted with the prospect of judicial scrutiny of the inner workings of his department, may well conclude that the "discretion" vested in him is, as a practical matter, very narrow indeed.

Nor can he turn elsewhere for guidance. It is only the extraordinary situation which will lead a court to make a trustee's decisions for him.[10] He might consult with experts, but must not allow their advice to govern him — as Mayor Curley discovered in Boston.[11] Mayor Curley's problem arose from a trust created by Benjamin Franklin, manifestly for the purpose of demonstrating the validity of his maxim, "A penny saved is a penny earned." Franklin settled on the people of Boston a thousand pounds sterling to be placed at interest for a hundred years, forseeing a corpus of 139,000 pounds at the end of the century. At that point the trustees were to spend 100,000 pounds and place the rest at interest for another century — ad infinitum. It was this re-investment which the mayor -trustee sought to delegate to the city treasurer. The court forbade it: "The trustee cannot properly employ an agent to select investments."

Short of such reliance, and proper, is for the trustee to listen to advice and reserve to himself the final decision.[12] However, he has little freedom to *buy* advice.[13] Authority differs whether such an expense is proper when not expressly authorized by the trust instrument. A trustee may encounter a variety of answers to the question, "Is investment counsel expense proper?"[14]

Summarizing the problem at hand, it seems accurate to say that any departure by the trustee from the norms of orthodoxy in the investment field may produce litigation which he has a strong chance of losing — unless the terms of the instrument afford a way out.

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6 Colo. Rev. Stat. § 57-3-1 (1953).
7 *Ibid.*
8 77 A.L.R. 505 (1931).
9 2 Scott, Trusts § 174.1 (2nd ed. 1956).
10 *Id.* § 259.
11 City of Boston v. Curley, 276 Mass. 549, 177 N.E. 557 (1931).
12 *In re* Dodge, 39 N.Y.S.2d 186 (1943).
13 2 Scott, Trusts § 188.3 (2d ed. 1956).
14 The variety of answers encountered: *In re* Gutman, 14 N.Y.S. 2d 473 (1937) (no); *In re* Greata, 17 N.Y.S. 2d 776 (1939) (yes); *In re* Sellers' Estate, 31 Del. Ch. 158, 67 A.2d 860 (1949) (maybe).

II. SOME SOLUTIONS

Trust draftsmen have contrived at least four escape-mechanisms from some of the consequences described above. Three of them are of limited efficiency: the co-trustee, the discretionary clause, and the exculpatory clause.

The first of these, the co-trustee, is often one who has been brought in because he is peculiarly equipped to make the investment decisions arising out of trusts. This does not solve the whole problem, however, because his special qualifications do not free his co-trustees from liability for improvident investments. One trustee may not delegate any discretionary duties to another trustee. "It is improper for one of the trustees to leave to the others the control over the administration of a trust," says Scott.[15] Hence the corporate trustee gets little surcease from the presence of a co-trustee advisor; he still must exercise his independent judgment in investment matters and may be liable for unintelligent decisions.

Nor does the advisor welcome a full co-trusteeship. The reason for bringing him in may be solely for the purpose of reviewing investment decisions. To clothe him with the garb of trustee is to burden him with duties and liabilities not commensurate with the specific job intended for him.

The objections just stated are voiced on behalf of the corporate trustee and the advisor individually. Further objection may be raised by them together; that the placement of all discretionary

15 2 Scott, Trusts § 184 (2d ed. 1956).

duties with them jointly produces duplication of effort, and that before either can move he must await the other. A deadlock takes them both to court.

The harness of co-trusteeship, although desirable in many instances, may prove too cumbersome for the team whose work we are discussing here.

A second device, the discretionary clause, may do little more than duplicate the effects of the prudent man rule established by the decisions[16] and re-affirmed by statutes like Colorado's. "The courts are likely to interpret such provisions rather strictly," cautions Scott.[17] Even if the instrument contains an express direction to retain certain stocks, the trustee may be held liable for imprudent compliance with the directions.[18] A clause may provide that the trustee can recruit investment counsel, and pay for it, but it does not relieve him of the ultimate decision and the liability which follows.

The third mechanism, the exculpatory clause, is of questionable value in dealing with the problem under study here. It is proper to relieve a trustee of the consequences of ordinary negligence; but if such a clause goes too far in exempting the trustee from any liability whatever for the consequences of his mistakes, it may have defeated the very purpose of having a trust at all. A trust is designed to lodge somewhere the responsibility of managing the estate. Responsibility without some liability is an anamoly. Public policy cannot support carte blanche waivers of trustees' liabilities.[19] On the other hand, too faint an exculpation may afford the trustee no reassurance that he is protected, and he finds himself at the door wherein we entered at the beginning of this article.

Some of the cures mentioned up to this point may be compared with the old mustard-plaster treatment of the common cold: the cure was worse than the ailment. But a specific remedy remains to be examined.

The fourth contrivance appears to be the most versatile and effective solution for special investment problems. It is suggested in 2 Scott § 185: "By the terms of the Trust it may be provided that the action of the Trustee in certain respects shall be subject to the control of . . . a third person in no way connected with the trust."

By this means a settlor and his lawyer may recruit the talents of an advisor without subjecting him to all the responsibilities of a trustee. Such an advisor is a fiduciary — but only with respect to the specific assignment given him. He need not hover over the shoulder of the corporate trustee in other matters; yet his attention to the special topic assigned is reassurance that the settlor may safely relinquish control.

That the trustee is well-insulated by this device is made clear in *Reeve v. Chase National Bank*.[20] There, a power of investment was retained in the settlor himself. He later yielded to the corporate trustee's persuasion to buy second mortgages. When a loss en-

16 The leading case is Harvard College v. Amory, 9 Pick. 446 (Mass. 1830). Its language appears in the Colorado "prudent man" law quoted herein, p. 306.
17 3 Scott, Trusts § 227.14 at 1704.
18 *Id.* § 230.1 at 1721.
19 2 Scott, Trusts § 222 (2d ed. 1956).
20 287 N.Y. Supp. 937 (1946).

sued, the court held that the settlor could not escape the consequences of the power he had reserved and exercised. The case is notably strong in view of the fact that the mortgages urged by the bank-trustee were those offered by its own affiliate. Ignoring the trustee's self-dealing, and viewing the trust instrument, the court said, "The directions of the settlor were a protection to the trustee."

Reinforcing this position is *Hartman's Estate*,[21] which acknowledged that the settlor might lodge *all* management powers in a holder designated for that purpose. The trustee was absolved of any consequences of the holder's misbehavior not known to him nor reasonably discoverable by him. From this rule it must follow that the lodging of *some* powers in their holder effects corresponding protection to the trustee.

One authority suggests that a limited power may be specially restricted, as desired by the settlor, to guard against forseeable contingencies. Thus the holder might be directed to hold common stock only so long as dividends are maintained in the manner specified.[22]

It is often best to leave the initiative for guiding affairs of the estate with the bank-trustee, only establishing the power-holder as monitor in a narrow field of action. The words of the instrument may give the holder a power to veto some actions, or compel others.

It has already been stated that the power-holder is a fiduciary in his small arena, though he is not a trustee because he lacks title. A clear abuse of his discretion invokes the authority of the courts;

21 331 Pa. 422, 200 Atl.49 (1938).
22 Knecht, *Trust Advisor*, 94 Trusts and Estates 815 (1955).

but to have such an effect, the abuse must be clear. This was illustrated in a case involving a trust established by John D. Rockefeller for his daughter and generations to follow. The instrument gave a committee power to allocate receipts to income or principal of the trust estate. When the committee assigned all stock dividends to principal (contrary to the practice approved by New York statute at the time) the court held that this was not an improper exercise of the discretion Mr. Rockefeller intended.[23] (The reports of this case do not disclose the amount involved, but a clue is provided by the number of attorneys who participated. Nineteen lawyers appeared for the parties below, and sixteen appeared at the court of appeals to hear the judgment affirmed. None of the ten judges who dealt with the case ventured to second-guess the financial acumen of John D. Rockefeller.)

Consistent with the Rockefeller decision, cases reported by Scott require extreme conduct on the part of a holder to charge him with abuse of discretion.[24] Abuse is equated with "dishonesty," "improper motive," or "action beyond the bounds of reasonable judgment."

Settlors should be comforted by the law's insistence that trustees must comply with the directions given by a holder pursuant to the instrument. The trustee who refuses compliance, or fails to secure the holder's consent when required, has breached his trust.[25]

What, then, if the trustee complies and losses follow? Any loss resulting from good faith compliance with the directions of the holder will not be surcharged to the trustee.[26] Further, should it be discovered that a trustee has inadvertently acted without the holder's approval, the defect may be cured by later ratification from the holder.

Thus the trustee's liability for investment losses occasioned by the holder's misguidance can spring only from the trustee's failure to take corrective action in two situations: (1) If he knows, or ought to know, that the holder is violating his fiduciary duties; (2) If changes unanticipated by the settlor, but discovered by the trustee, make compliance with the terms likely to impair the trust.

23 Chase Nat'l. Bank v. Chicago Title & Trust Co. 271 N.Y. 602, 3 N.E. 2d 205 (1936).
24 2 Scott, Trusts § 185 (2d ed. 1956).
25 *Ibid.*
26 *Id.* at 1363.

Even these sources of liability to the trustee may be averted by terms in the instrument relieving him of a duty to inquire, and expressly giving sole control to the holder. If the instrument does not intend such blanket authority in the holder, the trustee's duty is satisfied by a reasonable amount of inquiry into the propriety of the investment.

Advisors may, of course, be appointed by the instrument to decide discretionary matters other than selection of investments. Ingenious draftsmen will foresee questions of invasion of corpus, allocation of receipts to income or principal, and similar matters.[27]

An advisor, rather than a co-trustee, may be advantageous where the advisor lives at a distance from the trustee and could not participate in all trustee actions without undue delays.

The power device prescribed here seems to have gained popularity since 1930. The paucity of appellate decisions on the topic indicates that power-holders stay out of court. They travel under several names: "quasi-trustee,"[28] "advisory trustee"[29] and "trust advisor."[30]

A search of Colorado Supreme Court reports disclosed no cases hinging on the validity of the powers of a trust advisor. One may surmise that the strategy has not been employed widely in this jurisdiction — or that lawyers who employed it have succeeded in keeping their clients out of litigation. Trust advisors' powers, carefully drafted and prudently employed, may gather favor as valuable tools for the task of preserving assets peculiarly fitted to the needs of trust estates.

27 Comment by Austin W. Scott, 72 Harv. L. Rev. 695 (1959).
28 120 A.L.R. 1407 (1939).
29 Gathright's Trustee v. Gant, 276 Ky. 562, 124 S.W. 2d 782 (1939).
30 Knecht, *Trust Advisor*, 94 Trusts and Estates 815 (1955).