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Legal and Investment Standards of Trustees

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"Social necessities and social opinion are always more or less in advance of law. We may come indefinitely near to the closing of the gap between them, but it has a perpetual tendency to reopen. Law is stable; . . . societies . . . are progressive. The greater or less happiness of a people depends on the degree of promptitude with which the gulf is narrowed."1

I. THE PROBLEM

Major economic crises are productive of searching inquiry into the investment management of trustees. One unfamiliar with American financial history of the past half century might, in fact, obtain a fair outline of the panics and depressions of that period by a review of the cases in which the judgement of trustees has been called into account. The outline would be deficient as to causes and sequences but it would reveal main incidents of the severe financial storms and indicate that the test of the trustee's investment-managerial ability, like that of the mariner, is not to be sought in fair-weather sailing, but in the ability to act intelligently and adequately in the face of conditions which are out of the ordinary. More important and more fundamental than the question of how an individual trustee meets his responsibility is the adequacy of the standards by which he is judged. The former is a question of the moment. The latter bears directly upon the entire legal obligations of the trustee as an investor and conservator of the trust estate.

In the years since 1929 the courts have adjudicated an interesting array of cases in which the economic background of the actions is to be found in the hey-day of the prosperity preceding that fateful year or in the catastrophic collapse which followed. In so doing, the body of the law has been enriched by more than one lucid exposition. These expositions tell us whether the trustee has navigated his investment ship well or ill. But there is naturally left untouched a more fundamental question. For the ship which the trustee has navigated is one fashioned by the law—fabricated of statutory enactment and precedent. How the individual has acquitted himself is a matter which dwindles beside the broad question whether the standards by which he is judged are adequate for measuring trustee-responsibility in the light of present investment knowledge, and, of first importance, whether those legal standards are practical—the accepted standards of the financial market place. The ques-

1. Investment Analyst, Alexander Hamilton Institute.
1. MAINE, ANCIENT LAW (5th ed. 1873) 23.
tions, raised by the experiences of recent years, go to the root of the whole matter of statutory regulation. The facts are that standards for trustee investments have been prescribed by law—and that the working of the standards has been less than satisfactory. True it is that legal standards have contributed to safety and soundness in investment policies and that an inexperienced trustee compelled to adhere to legal investments, offers greater protection to his beneficiaries than if his hands were free. But the problem is not whether existing legal standards are better than no standards at all; it is whether juristic norms of fiduciary law have not been demonstrated to be susceptible of improvement.

A—Questions to be Considered

To summarize the questions brought to the fore by the depression experience, these lines of thought are suggested.

1. A trustee is an investor of the funds of others. The success with which he administers the funds will be determined fundamentally by his skill as an investor. There are standards of investment-managerial ability and standards of investment policy. Are investment standards and legal standards in harmony at all points or are there conflicts?

2. If there are conflicts between legal standards and practical investment standards and policies, do the former tend to generate or promote unsound policies of investment in any respect?

3. If there is a conflict between sound investment policy and legal standards, is that conflict to be removed by making legal standards more rigid or more flexible?

4. In the selection of a trustee the tendency is more and more to choose an institution specializing in the management of estates and qualified presumably to exercise the highest degree of attention to the problem and skill in the management. Is there in the process of growth, or should there be, a differentiation in the standards applied to the institutional and to the individual trustee? Should a better standard of performance be set up for the former than for the latter?

5. The primary legal duty of the trustee is to conserve his estate. Should that basic concept of the trustee's duty be altered or enlarged?

Questions such as these are not merely a product of the experience of very recent years nor is the problem one which is peculiar to any one state or one country. Nearly five years ago a comment appeared in one of the leading English economic journals, which mirrors the fact that the relationship between legal standards and investment standards was receiving attention in that financial center before the depression was more than beginning its disastrous course.
"The Pauline caveat against unequal yoking together is aptly illustrated by the marriage between investment and the law. Investment, like Nature, is ‘constantly changing.’ The law, by contrast, is the most conservative institution in the world."

"The problems ceaselessly arising in the domain where the two impinge upon one another resemble those of the possessor of a motor car of uncertain age. The model always tends to be somewhat out of date because manufacturers’ ideas change so quickly. At any given moment, is it better to give the old vehicle a new coat of paint and tinker slightly with its carburetor, or to start afresh with a modern machine?"

"To many observers with practical investment experience, trustee law appears to contain many anomalies. It prohibits investment in numerous sound stocks, while authorizing the purchase of others whose status is by no means unquestioned. It would seem, in some respects, to have lost sight of the all-important consideration that its purpose is to further the interests of the investor, and not the borrower of capital. Its restrictive influence has given a tinge of artificiality to prices in the trustee list. Its criteria have no direct relation to modern ideas of the essential characteristics of sound investment."

A year and a half later The Economist commented on the extent to which the decline in national earning power had affected all securities and observed that present difficulties in trust investments were due less to the inclusion of any one group of securities in the legal list than to the inability of past concepts of the law to stand the strain of present-day conditions.

The questions outlined above are the ones to which some answer, at least tentative, will be sought. The connecting thread which joins them is the practical working of legal standards. And to approach a solution it seems desirable first to sketch in a background. That background is an outline of the financial difficulties of recent years and the way in which those difficulties have made the trustee’s office a difficult one. It is an outline, too, of the view which the law entertains of the trustee’s duties and responsibilities; the inquiries which are made as to his conduct; the courts’ conceptions of what constitutes a proper and what an improper discharge of his duties; a delineation of the sometimes shadowy, sometimes boldly marked line, which separates prescribed conduct from discretionary conduct.

B—The Depression Era

The background upon which the current interpretation of trustee responsibility is being written is to be found in the financial pages not
only of 1929 but also of 1931-1932. The bubble pricked in 1929, which will long be remembered as the year of the great crash, was one of inflated stock prices which should have given trustees no concern. Nor need they have been unduly alarmed if their funds were in bonds, for while, from the middle of 1929 to the middle of 1930, the average value of stocks on the New York Stock Exchange declined 17.34 per cent and prices, as shown by representative averages, dropped 29 per cent, bond values increased 3½ per cent as lower money rates followed close upon the passing of the first phase of credit strain. The next two years, however, brought difficulties of the most serious nature, and brought them to the most conservative of trustees. From 1930 to 1931 there was only a 6 per cent decline in railroad bond prices while stock values were receding by 26 per cent, but from July 1, 1931 to July 1, 1932 as stock values dropped 67 per cent, bond values also melted away. In this twelvemonth the value of listed bonds on the New York Stock Exchange declined 24 per cent. Proportionately the collapse of bonds was greater than the stock collapse of 1929. More to the point, the prices of railroad bonds declined by as much as 48 per cent. "Convention values" were adopted as a basis for valuing institutional investments.

In the light of after-the-event knowledge there is patently but one policy which a trustee could have followed after the middle of 1931 which would have insured against a shrinkage of values. This would have been a cleaning out of all corporate issues other than short term obligations of the highest grade and their replacement by government bonds. By concentrating on this class of values the portfolio could have been maintained—although at a considerable loss of income, particularly if the issues purchased were short term. It is natural that after such a debacle the judgment of trustees should be called into question.

4. These figures are taken from the monthly reports, New York Stock Exchange, on values of listed securities.

5. The National Convention of Insurance Commissioners adopted a resolution, in December, 1931, altering the methods of valuing security holdings. Whereas it had been the usual practice to value securities at year-end market values, the resolution recited that "under present conditions the market quotations on stocks and bonds for a particular day are not a fair standard for the ascertainment of fair market value." The recommendation proceeded to advise the adoption of the average of prices for five quarterly periods ending September 30, 1931, and since these averages were approximately equivalent to market prices of June 30, this date was selected as the period on which to base values. Securities acquired after this date were not to be valued at more than their market prices nor was the rule applicable to securities defaulting after that date. The basis of valuation thus fixed, differing from actual market value, is known as a "Convention value."

This basis for convention values has been extended and modified by action in subsequent years, and supplementary regulations have been made by some State Insurance departments.

6. The objector may not be without fault himself. "The objections so conveniently
it is inevitable that there should be a searching examination of the investment standards to which a trustee should conform. The problem is not one alone of legal regulation nor is it one alone of the evolution of investment management. The question is whether out of the practical investment experience the law may be able to absorb new ideas which will ward off or minimize the collapse of trust securities.

II. LEGAL STANDARDS

To approach the legal aspects of the problem the investment-management phase must first be noted. A conscientious trustee has invested his funds with what he regards as prudence. He watches them with what he regards as diligence. Then the whole structure of bond prices appears to collapse. He can find no reason for the depreciated figures at which some securities are selling, so far as the obligor's condition is concerned. Prices of other securities collapse swiftly and he realizes that here there is actual difficulty. There is forced upon him a choice which is unenviable. He may choose to rid the trust of all depreciated securities, seek safety of principal first and turn all investments, about which he is in doubt, into "governments." This choice will conserve the present worth of the principal but it is a fairly definite sacrifice of much of the depreciated principal. The government bonds will not make up losses—and to this objection must be added the drop in the income to the beneficiaries. On the other hand, he may stick to his guns, having satisfied himself that this course is safest, and run the risk, if his judgment proves faulty, of the accusation of want of diligence. He may bear in mind the need of the beneficiaries for income and the definite sacrifice involved in taking shelter in government bonds and endeavor to improve the status of his fund by judicious switching. But if a switch proves to be from the frying pan into the fire, will his prudence come into question?

A—General Principles

In charting his course the trustee has the guidance of the law in states which prescribe within general or specific lines the types of investment he may make. He has the specific guidance in many cases of

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the instrument which created the trust and he has the further guidance or authority, in appropriate cases, of orders of the court. In the case of specific guidance, by statutory mandate, the trustee departs from the indicated course at his peril. But whether he has a full or a limited discretion, his duties to observe good faith and to act with prudence and diligence and without negligence remain. Though the trustee may be permitted a discretion by the instrument and is not limited to the legal list in making his investments, he is not absolved from the duty to exercise prudence, observe good faith and to be diligent in the administration of his trust.


The existence of a legal list has a double aspect. It offers a comparatively safe harbor and it must make for a greater degree of safety in the investment of inexperienced individual or corporate trustees. By the same token, it may work toward tying the hands or inhibiting the actions of an experienced and alert one. At least it may lull him into greater inaction than he would or might be likely to repose in were his investment policy to be judged apart from the law's sanction.

11. Mattocks v. Moulton, 84 Me. 545, 24 Atl. 1004 (1892); Tuttle v. Gilmore, 36 N. J. Eq. 617 (1883); Matter of Hall, 164 N. Y. 196, 58 N. E. 11 (1900); Carrier v. Carrier, 226 N. Y. 114, 123 N. E. 135 (1919); In re Hurlbut's Ex'r, 210 App. Div. 456, 206 N. Y. Supp. 448 (2d Dep't 1924); In re Cady's Estate, 211 App. Div. 373, 207 N. Y. Supp. 385 (4th Dep't 1925); In re Knowler's Estate, 121 Misc. 208, 200 N. Y. Supp. 777 (Surr. Ct. 1923); Pray's Appeals, 34 Pa. 100 (1859); Hart's Estate, 203 Pa. 480, 53 Atl. 364 (1902); Kline's Estate, 280 Pa. 41, 124 Atl. 280 (1924).

In Equitable Trust Co. v. Snader, 174 Atl. 132 (Del. Ch. 1934), it was held that an authority to invest in non-legal securities must be clearly proved. The phrase "in their discretion" was interpreted to give a choice to the trustees to reinvest within the legal list but not to go outside.


14. In re Flint's Will, 240 App. Div. 217, 269 N. Y. Supp. 470 (2d Dep't 1934). "Trustees are bound in the management in all the matter of the trust to act in good faith and
The long established standard of diligence and prudence has been the care which intelligent men use in the administration of their own affairs, but with qualifications. "The trustee is bound to employ such diligence and such prudence in the care and management of investments as, in general, prudent men of discretion and intelligence in such matters employ in their own like affairs," but speculation is excluded and the standard is "the common skill and prudence of an investor of money to be safely kept, with such reasonable income as is commensurate with safety of the principal." An apt characterization of the standard is that of a prudent man who takes into account his trust. There is here no super-man standard established.

"An executor or trustee is not a guarantor for the safety of the securities which are committed to his charge, and does not warrant such safety under employ such vigilance, sagacity, diligence and prudence as in general prudent men of discretion and intelligence in like matters employ in their own affairs." Costello v. Costello, 209 N. Y. 252, 261, 103 N. E. 148, 152 (1913). Even in the face of authority to continue to hold, vigilance and alert judgment will be required. In re Channing's Estate, 129 Misc. 393, 222 N. Y. Supp. 351 (Surr. Ct. 1927). But the duty to show negligence in failing to sell is upon the party seeking to surcharge. In re Wagner, 40 Misc. 490, 82 N. Y. Supp. 797 (Surr. Ct. 1903).


17. Hart's Estate, 203 Pa. 480, 486, 53 Atl. 364, 366 (1902). The trustee should assume no risks which would not be taken by an ordinarily prudent man who is trustee of another's property. Mattocks v. Moulton, 84 Me. 545, 24 Atl. 1004 (1892); In re Buhl, 211 Mich. 124, 78 N. W. 651 (1920); Cornet v. Cornet, 269 Mo. 298, 190 S. W. 333 (1916); In re Carmody's Estate, 134 Misc. 11, 235 N. Y. Supp. 78 (Surr. Ct. 1929); Estate of Allis, 191 Wis. 23, 209 N. W. 945 (1926). The advice of counsel or of men versed in the stock market may be considered as a circumstance indicating at least diligence. But the advice of counsel or of men versed in stock market affairs is not conclusive of the exercise of prudent or intelligent discretion. In re Belcher's Estate, 129 Misc. 218, 221 N. Y. Supp. 711 (Surr. Ct. 1927). Apparently the action may indicate diligence, but acting upon advice is not necessarily prudent. This is a principle on which the law and Wall Street are in agreement.

18. "All that can be required of a trustee to invest is, that he shall conduct himself faithfully and exercise a sound discretion." Harvard College v. Amory, 26 Mass. 446, 461 (1830).

any and all circumstances, and against all contingencies, accidents or misfortunes. The true rule which should govern his conduct is, that he is bound to employ such prudence and such diligence in the care and management of the estate or property as in general prudent men of discretion and intelligence employ in their own like affairs.\textsuperscript{20}

The balance of the trustee's responsibility comes up for adjudication when his investment policy is questioned. The one side of the scale is weighted by his positive duties and the limitations upon his conduct, however imposed. But on the other side the negative rules maintain the balance. If diligence, prudence and good faith are of the essence of the trustee's office, it is equally true that his policy is not to be judged by results, but by the judgment reasonably to be expected of one administering a trust at the time his decisions are made.\textsuperscript{21} The illuminating light of experience may show his judgment to have been erroneous.\textsuperscript{22} As a matter of fact that which passes for good judgment may be no more than good fortune and that which appears to be poor judgment may be misfortune.

\textbf{B—The Recent Trends in the Law}

After every period of financial stress the responsibility of fiduciaries engages the attention of the courts; it is a legal accompaniment of the depression phases of the business cycle. The depression of 1870 and the following years brought its quota of cases. In 1890 it was held that a trustee was not liable for loss arising from the depreciation of property on which funds were loaned, the loss being attributable to a financial panic.\textsuperscript{23} Six years later an English court found no mandate which compelled it to hold an honest trustee responsible for loss arising from the retention of securities in a falling market.\textsuperscript{24} Running through

\textsuperscript{20} McCabe v. Fowler, 84 N. Y. 314, 318 (1881); Crabb v. Young, 92 N. Y. 56 (1883); Matter of Clark, 257 N. Y. 132, 177 N. E. 397 (1931). However, even where the investment is one authorized by law, the fiduciary must be prepared to meet the charge that the investment was improper and imprudent. Durant v. Crowley, 197 App. Div. 540, 189 N. Y. Supp. 385 (1st Dep't 1931), aff'd, 234 N. Y. 581, 138 N. E. 455 (1922); In re Frazer's Estate, 150 Misc. 43, 268 N. Y. Supp. 477 (Surr. Ct. 1933).

\textsuperscript{21} Taft v. Smith, 186 Mass. 31, 70 N. E. 1031 (1904).


\textsuperscript{24} In re Chapman, [1896] 2 Ch. 763.
the decisions of the past sixty years, a period which has witnessed four business and financial depressions of major magnitude, expressions are to be found to the effect that a trustee is not to be held responsible for not knowing more than others; that judicial note may be taken of the condition of the financial markets; that a trustee cannot be held responsible for the results of a world calamity; that in determining the degree of the trustee's skill exceptional conditions are to be considered; that, if the value of an investment declines for causes which do not connote negligence on the part of the trustee, he is not responsible;


26. "Cases are found wherein the depreciation of values of seasoned securities are accounted for by a general business depression and, in such instances, the courts have refused to surcharge representatives of the estate. ... When the executors took over the estate herein a financial storm had set in—not country-wide but world-wide." In re Winburn's Will, 140 Misc. 18, 249 N. Y. Supp. 758, 763 (Surf. Ct. 1931).

As a matter of fact it is probable that financial crashes were narrowly averted on at least two occasions before the final one. The inflation was not in respect to the then current earnings. United States Steel sold well above 200—but it was earning over $20 per share. The inflation was with respect to average or normal earning power. On the earnings of the one year United States Steel was worth its price—if those earnings were to continue indefinitely. The speculative psychology errs not so much in overcapitalizing present earning power as in the losses of perspective and the assumption that exceptionally high earnings are to last without fail. See also In re Balle's Will, 152 Misc. 739, 274 N. Y. Supp. 284 (Surf. Ct. 1934).

27. "The case must be judged as it appeared at the time of the investment and before the great war (the most shocking calamity of modern times) had upset values. ... It would be a harsh rule to hold accountants responsible for the depreciation in value of securities resulting from such unparalleled conditions. Happily the law does not oblige us to do so." In re Detre, 273 Pa. 341, 349, 117 Atl. 54, 57 (1922). In re Pettigrew's Estate, 115 N. J. Eq. 401, 171 Atl. 152 (Prerog. Ct. 1934), aff'd, 116 N. J. Eq. 565, 174 Atl. 478 (1934); Ormiston v. Olcott, 84 N. Y. 339 (1881); Matter of Gray, 91 N. Y. 502 (1883); Matter of Feltner, 224 N. Y. 573, 120 N. E. 562 (1918); Matter of Clark, 257 N. Y. 132, 177 N. E. 397 (1931); In re Varet's Estate, 181 App. Div. 75, 178 N. Y. Supp. 125 (2d Dep't 1919); In re Thompson, 41 Misc. 420, 84 N. Y. Supp. 1111 (Surf. Ct. 1904); In re Winburn's Will, 140 Misc. 18, 249 N. Y. Supp. 758 (Surf. Ct. 1931).


that the question is not so much what the trustee has done but how and why he has done it; that so long as a trustee is not negligent and invests in accordance with the requirements of the trust instrument or of the statute he is not to be held an insurer or guarantor or responsible for failure to anticipate events.\textsuperscript{80}

These statements of the general rules are reiterated in cases having their roots in the financial debacle of recent years. Thus in \textit{People's Nat. Bank & Trust Co. of Pemberton v. Bichler}, the court observes:

"In the light of history, it would of course have been wiser to have sold the securities within a short time after the appointment of the administrator, but wisdom after the event is not the test of responsibility, and the law holds trustees, whether administrator, executor, guardian or others standing in fiduciary relation, only to the exercise of reasonable diligence and ordinary prudence and caution."\textsuperscript{31}

It is obviously easier to set forth generally the contrasted zones of freedom from liability and responsibility for negligence, than it is to draw the precise dividing line between them. While a reasonable allowance for mistakes is made and the trustee is not to be held accountable for such errors, the trustee "must take no risks which would not be taken by the ordinarily prudent man who is trustee of another person's property."\textsuperscript{32} When a security held by a trustee comes within the region of doubt, his duty is to eliminate it at the earliest possible time. But what seems to be the region of doubt to one well informed investor may not so appear to another. In these times of rapid change almost every security seems to come within the region of doubt. A general, but eminently practical rule was suggested nearly fifty years ago, that it is incumbent upon the trustee to watch constantly the investment and to be on the alert to protect it.\textsuperscript{33} This test was applied in \textit{Matter of Jarvis}.\textsuperscript{34} In another case, taking into consideration the state of the corporation, the attitude of the municipal administration and the adjournment of the

\begin{itemize}
\item 31. 115 N. J. Eq. 602, 606, 172 Atl. 209, 211 (1934).
\item 32. \textit{Cook's Trust Estate}, 171 Atl. 730, 731 (Del. Ch. 1934).
\item 33. McCullough's Ex'rs v. McCullough, 44 N. J. Eq. 313, 14 Atl. 123 (1888).
\item 34. 110 Misc. 5, 180 N. Y. Supp. 324 (Surr. Ct. 1920).
\end{itemize}
legislature without affording relief, the failure to dispose of Interborough Rapid Transit bonds was held to disclose a lack of diligence.

"That the times were abnormal and others were taking the same risks is not an answer for a trustee, as it may be an excuse for one speculating with his own money. A trustee's duty of care, ever increasing to meet rising dangers, is not to be measured by that standard." 35

It may be taken as settled that no act of a settlor or cestui can relieve a trustee of duties and obligations which are inherent in his office. The basic requirements of prudence and diligence attach. However, the trustee's discretion may be enlarged. Perhaps the rule may be stated accurately and precisely in this form: the directions of the settlor or of the beneficiary widen the area for the exercise of diligence and prudence without affecting the essential nature of these duties.

The estates which come into a trustee's hands are various in their composition. In some, the groundwork of stable policy is already laid, in others the trustee must build a sound estate out of a strange collection of material. Certainly where the corpus of the trust handed to the trustee consists of securities not legally authorized, the duty of the trustee is to sell such securities and to reinvest in appropriate securities.36 With the understanding that he departs from the approved list at his peril (in the absence of permission or court order) probably one of the first acts of the average trustee is to steer his course to that haven of refuge from responsibility. Prudence dictates such action.37 While expressions may be found in the cases permitting the trustee to continue the non-legal investments originally delivered to the trustee,38 the mere fact that investments had been made by a testator and were approved of by him has been held not to absolve the trustee from responsibility for

37. Gray v. Fox, 1 N. J. Eq. 259 (Ch. 1831); Halstead v. Meeker's Ex'rs, 18 N. J. Eq. 136 (Ch. 1856); Lathrop v. Smalley's Ex'rs, 23 N. J. Eq. 192 (Ch. 1872); Wielers v. Hart, 68 N. J. Eq. 796, 64 Atl. 1135 (1905); Smith v. Robinson, 83 N. J. Eq. 384, 90 Atl. 1653 (Ch. 1914); In re Hirsch's Estate, 188 N. Y. 584, 81 N. E. 1165 (1907); Steele v. Lepold, 135 App. Div. 247, 120 N. Y. Supp. 569 (1st Dep't 1909); Matter of Randolph, 134 N. Y. Supp. 1117 (Surr. Ct. 1911); In re Vom Saal's Estate, 82 Misc. 531, 145 N. Y. Supp. 307 (Surr. Ct. 1913); In re Bernheimer's Estate, 106 Misc. 719, 175 N. Y. Supp. 594 (Surr. Ct. 1919); In re Darlington's Estate, 245 Pa. 212, 91 Atl. 486 (1914).
retaining them unless this course can be justified. A somewhat different test is to be applied when there is affirmative sanction in the trust instrument for the retention of securities not legal in their scope. Thus where a trustee was authorized to invest in good railroad stocks and the selection in question had maintained its value well until the financial strain of an expensive extension and the war-time rise in costs conspired to wreck values, the trustee was held blameless for the loss. And in accord with this is the later decision in the Clark Case. Here the testator owned sugar stocks which the trustee was authorized to continue as investments without liability. They were held through a steady and severe decline, but the condition of the companies not having been impaired, negligence was not attributable to the trustee. Here again the matter comes down to the putting of full responsibility on the trustee. He cannot abdicate his responsibilities and substitute the judgment of the settlor's for his own. The duty of reasonable prudence persists.

III. INVESTMENT STANDARDS

This brief summary of the legal standards applied to trustee investment management will supply sufficient raw material for a consideration of the questions raised at the beginning of this paper. The first of those questions is whether there is a conflict between the standards of professional management and the law. The second is whether the standards of the law are in all respects sound. They may be considered together. In the consideration of these queries, it is in order to outline some of the objectives of sound investment management. Our purpose is to deal not with the details of security analysis and the selection of investments but with broad policies.

A—The Insurance Principle of Diversification

One principle of investment management is the application of the insurance principle to the handling of funds. Where there is a risk the need for application of the insurance principle exists. Companies underwrite risks which can be calculated on an actuarial basis. Business houses which are exposed to the risk of loss through fluctuations of commodity prices seek to insure against damage by "hedging" their pur-
chases through the sales of futures on the organized exchanges, or their contracts for forward delivery of finished goods by the purchase of futures. Flour millers are an example. Middle-men in the same line hedge. By taking a position on both sides of the market the "hedger" is largely protected against what might be ruinous losses if prices moved against him.42

There are two risks in the investment of funds. One is the risk of depreciation of principal and income through changes in the profit-making ability of industry. The other is the risk of diminution in the purchasing power of money during periods of rising commodity prices. To the first risk common stocks are entirely exposed. And this is likewise true of preferred stocks and bonds of a grade which are likely to have their margins of safety seriously impaired or obliterated by fluctuations in earnings. On the other hand, bonds and preferred stocks, paying fixed returns, if issued by governments, municipalities or corporations sufficiently strong to withstand severe business depressions, are the least subject to this risk. But these same bonds and preferred stocks which are comparatively immune from the first risk are fully exposed to the second. If the price level undergoes a material advance, the pinch is felt most acutely by those who are dependent upon the stated interest from bonds and mortgages and the fixed dividends of preferred stocks. The dollar income remains unchanged. But the dollars buy fewer goods.

To insure against these risks, the skilled investor endeavors to maintain a balanced position.43 When prices are rising he has a preponderance of his funds in stocks so that increased dividends and the gain of principal may offset the higher cost of living. When prices are falling he aims to have the major part of his funds in fixed-income securities of the highest grade to insure against a curtailed income and loss of principal values through the shrinkage in corporate profits.44 This very process of insurance means that investment policy must be flexible—

42. BAER AND WOODRUFF, COMMODITY EXCHANGES (3d ed. 1934) 83 et seq.
43. "There is one presumption to which this theory of investment practice, or in fact any intelligently constructive theory of investment, runs counter, in spite of its prevalence. It is the presumption that 'good' investment securities, once acquired, should be kept. ... An investment which is good today is not good tomorrow; high grade, low interest bearing bonds should be purchased today but sold tomorrow. This is not speculation, as the rapid turning over of securities will appear to be to some people but merely 'hedging' in accordance with an incessantly and actively changing economic environment. This matter should be emphasized." DEWING, FINANCIAL POLICY OF CORPORATION (1926) 1222-1223.
44. "... during the past 32 years, when we have had inflation as well as deflation, neither bonds nor stocks alone could have afforded adequate protection to investors primarily concerned with maintenance and improvement in their standard of living." ROSE, INVESTMENT MANAGEMENT (1933) 39.
adaptable to changing conditions. Because the investor knows that his judgment is fallible, he will maintain a degree of diversity consistent with the size of the fund. This is the insurance principle again—spreading the risk over many securities instead of assuming the relatively great risk of investment in a few securities. One or two cases of erroneous judgment out of twenty-five diversified investments will be less damaging than if their weight fell upon ten separate investments. Finally the investor judges results by the changes in value of the fund as a whole. And this, again, is the insurance principle. Nine securities appreciate $1,000 each and one security entails a loss of $1,000. The fund has been successfully managed according to the ratio the $8,000 profit bears to the whole fund. It may be a large gain or a small one, depending upon the size of the fund; the performance may be excellent or indifferent, in accordance with whether the results are better or worse than average expectation in the market of the time. But whether a small gain or a large one, whether a good or a mediocre performance, the fund has been successfully managed to the extent of an $8,000 profit. The investment manager might reproach himself for not doing better. But he would not esteem his performance a failure because of the loss on the one security.46

B—Diversification in the Law

To repeat the first question: does a conflict exist between the standards prescribed by the law and the standards of sound investment management? Investment is an art and not a science. But it is an art in which the observance of certain principles is recognized as conducive to success. In his selection of securities the investor gives great weight to earning power, past, present and potential. He appraises the financial

45. "... the investor should have no sentimental interest in holding one security or another, and no reluctance about changing rapidly from one type of investment to another—any more than a merchant has a reluctance about the rapid turnover of his merchandise or the banker of his bills. His concern should be in the total fund rather than in the individual investments—the latter being merely the means to the end." Dewing, op. cit. supra note 43, at 1208.

"Though a very well selected security seldom succumbs to failure, risks which can never be entirely eliminated should be reduced to a minimum... The risk can be partially offset by a diversification of investments, so that the investor's total holdings would not be lost in the failure of one issue. It is highly improbable, with a distribution in a widely scattered group of securities, that the failure of one issue would involve the integrity of the other securities held by the investor. In order to insure against such a contingency, a diversification of holdings should be made in more than one type of industry." Laderquist, Investment Analysis (1921) 23.
condition of the company but he places less emphasis upon asset values. He invests for income, and, he hopes, at least, for appreciation. Both of these objectives are indissolubly linked with earning power. Asset value becomes of primary consequence in the event of liquidation and the investor does not wittingly buy into a liquidation. He gives attention to the capital structure of the company. Finally, whether investor for income solely or investor with an eye upon possible appreciation, he endeavors to adhere to the Rothschild maxim of buying cheap and selling dear, to the principle of taking small losses in order to guard against greater ones.

One legal standard which is lacking is that of diversification. There are minor limitations such as New York's imposition of a limit of the percentages to which savings bank assets may be placed in railroad bonds and the limit of $10,000 on the amount of trust funds which may be placed in savings and loan association shares. But let a trustee stay within the confines of the statute and he may place the entire corpus of the estate in mortgages to the exclusion of corporation bonds, thereby concentrating both as to type of security and locality. His motive may be laudable. He may be seeking to improve the income of the estate, and as long as conditions are favorable, he may succeed in so doing. But in a depression of the extent and severity of the one following 1929 or of any major depression of the past, the mortality rate on mortgage interest payments rises, while the shifting of frozen investments is a more difficult matter than disposing of a listed bond. There is here a negative defect in the legal standards for trustee investments. A trustee may, but is not obliged to, diversify. He is assuredly not compelled to concentrate. But there is no safeguard for the beneficiary against over-concentration. A hint of appreciation of the principles of diversification appears occasionally in judicial rulings. In a New York case, among the problems of the trustee considered was the lack of diversification in the investment.

The germs of a legal standard of diversification are beginning to appear in statutory form. Wisconsin prescribes a rule that a fund between $5,000 and $20,000 shall not have more than 40 per cent concentrated

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46. "Safety must not be confused with the selling value of property. The investor is interested in earning power. Many purchasers of bonds have drawn the conclusion that because a bond is a specific lien it is secure. The value of the property, as security for the bondholder, depends upon the property as a going concern." LAGERQUIST, op. cit. supra note 45, at 13.
47. N. Y. BANKING LAW (1933) § 239 (7), (15).
49. Wis. STAT. (1931) § 231.32.
in one issue. Funds from $20,000 to $50,000 cannot have more than 30 per cent in one issue and funds of more than $50,000 cannot have more than 20 per cent placed in one issue. As a scientific investment code these requirements are rudimentary and inadequate; in fact they enunciate the reverse of what should be required if diversification as to issues alone is sought. It is the small fund which should have the greatest diversity. Since diversification is merely an insurance against investment risks the insurance should be highest on the fund least able to withstand losses. Assuming that there were two funds, one of $20,000 and one of $100,000, (invested in accordance with the Wisconsin requirements) and that each fund had the misfortune to include an issue which depreciated, under the percentage-maximum of the Wisconsin statute, shrinkage might affect as much as $8,000 of the $20,000 fund, which would be a serious impairment. But it could not affect more than $20,000 of the $100,000 fund. The larger fund, which can withstand the loss better, enjoys a greater degree of protection than the smaller fund.

But this is not the main point. We have here a definite statutory recognition of diversification, assimilating an investment principle to the law. An ideal code would require diversification as to types of security and as to industry. Thus, instead of emphasis upon a limitation of the amount of investment in a single issue, a plenary code should limit the proportion of trust funds which can be placed in different business risks. It is not suggested that such standards should be minute. But a general limit as to the proportion which could be placed in mortgages, in railroad obligations and in public utility obligations would give a trustee reasonable flexibility in the handling of funds, while setting up a barrier against geographical or industrial concentration. Why invest the major part of a trust fund in mortgages, thus exposing it to the risks incident to the economic welfare of one locality, or localize the monies of the estate in the securities of a single railroad or public utility? Nor is precedent for compulsory diversification lacking. Tennessee's trustee requirements in this respect are those of New York's savings banks—not over 25 per cent in rails and utilities nor over 10 per cent in one issue.

C—Eligibility Tests

A complex question is that of the eligibility tests to be applied to investments. It is here that some curious confusions between law and finance appear. An experienced investor would not think of considering

50. TENN. CODE (Will, Shan & Harlow, 1932) § 8497.
the dividend record as a primary test of quality. It means something, but much more to the point is the earning power from which dividends must be paid. No cursory survey of corporate reorganizations will fail to bring to light numerous cases where creditors and owners would have been better off if dividends had not been paid. It is true that sufficient importance should be attached to a common stock dividend to regard its omission as a danger signal for holders of senior securities. The anomaly in legal trustee standards is the inclusion of the dividend record as a major or principal test of quality. Here again, the conflict between legal and investment policy is not merely local.51

D—Mortgage Investments

In prescribing standards for mortgage investments the criterion is solely asset value—the limitation of the loan to a percentage of the property’s value. This is a standard which must be imposed and which stands as the last line of defense for the protection of the principal. There is another line of defense, however, which is neglected. Earning power as much as equity above the lien should be regarded by the investor. It is considered carefully in appraising the desirability of bonds as investments and is recognized by the New York statute.52 But the earning power of property which forms the security for a mortgage loan has received, on the whole, scant attention. The nearest approach is the differentiation between the percentages of value to be loaned on improved and unimproved property.53 A property’s earning power forms an element in any thorough appraisal. It is admittedly an estimate, but so is the value figure. Out of the unscrambling of the mortgage situation a question arises for future solution. Should legal standards be extended

51. “The quality of a corporation issue does not vary directly with the rate-paying population, nor is the 5 per cent consolidated preference stock of the Great Western Railway whose dividend had been short-earned for the last two years, necessarily sounder than the 4 per cent debenture of the London, Midland and Scottish Railway, whose interest in the company’s worst year has been twice covered by earnings. The former, however, remains a full trustee security, because the Great Western board has chosen to deplete its resources by paying recent 3 per cent ordinary dividends mainly out of reserves, while the latter is no longer a trustee security because the L. M. S. has ceased to pay ordinary dividends.” 119 ECONOMIST (1934) 687.

52. N. Y. BANKING LAW (Supp. 1933) § 239 (6).

53. In Massachusetts not over 60 per cent of the value of property, but not over 40 per cent of the value of unimproved property. Mass. Ann. Laws (Lawyer’s Co-op., 1933) c. 165, § 54 (1). In New Jersey 60 per cent on improved, 30 per cent on unimproved property. N. J. Comp. Stat. (Supp. 1930) tit. 184, § 33, as amended by N. J. Laws 1931, c. 167 (7). In New York 60 per cent on improved, 40 per cent on unimproved property. N. Y. BANKING LAW (Supp. 1933) § 239 (6).
from the last-line defense of asset value to the front-line defenses of earning power of the property and of the financial condition of the obligor? Were such standards to be erected there would be no necessary narrowing of the mortgage field. There would be created two classes of mortgages: (1) those on properties secured by the bonds of borrowers where the estimated rental value and the borrower's general credit meet the requirements for trustee investments; (2) those which fall outside this group. There are occasional recognitions of this principle in the law, namely, the stressing of earning power rather than asset value.44

Existing standards for appraisal have been criticized at times on various grounds.55 One serious fault to be found is the failure to differentiate between causes of changes in value. We may suppose two parcels to have a reasonable value of $10,000. Then a period of rising prices follows. Land values rise, say 50 per cent. During this same period the street on which one parcel is located changes in character from a second grade residential to a first grade business district. A conservative appraisal now places the value of one parcel at $15,000 and of the other at $30,000. There is clearly a difference in the stability of the noted increases in property values. Let us suppose that a depression occurs during which land values shrink 33 1/3 per cent. One parcel will be worth about what it was at the time of the original appraisal. But the parcel whose use-value has changed may be reasonably expected to maintain that part of its increase due to the change in the character of the locality. A standard which emphasizes alone the percentage of value, at the time the appraisal is made, neglects the very important matter of the underlying causes which contribute to the value. If the value is a mere product of the general price level, an average of estimated values over a term of years would be a safer criterion than the estimated worth at any one time. If the use value of the property is given due consideration, the loan based on the appraisal of a given period is more likely to stand the test of time.

E—Capital Structure

If earnings are of importance, the claim of a security on earnings is likewise a factor in determining what is a safe investment. Our legal standards recognize this tacitly in limiting mortgages to first liens and in emphasizing the lien priorities of bonds. But the words, "capital structure," do not appear in the statutes. And the importance of capital structure as affecting safety may be told very simply.

The St. Louis-San Francisco Railroad had $372,795,000 of securities outstanding as shown by its report for 1933. Of this amount the greater

LEGAL AND INVESTMENT STANDARDS

part represented borrowed capital. Owned capital, represented by preferred and common stocks, amounted to but $114,700,000 of the total outstanding securities. In 1929 no less than $258,000,000 of the railroad's securities—roughly 69.1 per cent—were legal securities for trustees.\(^{56}\) By a curious inconsistency these securities of a railroad which had been through two reorganizations, one as late as 1916, were legal to a much greater percentage of property value than that permitted for first mortgages on improved real estate.

This gap between legal and investment standards may be illustrated by a recent case\(^ {57} \) wherein a trustee was absolved from liability for continuing an investment in the preferred stock of a company which had, as of December 31, 1930, a funded debt of $208,877,422, notes and purchase money of over $20,000,000, and subsidiary preferred stock of $23,672,158—all these securities having priority over $23,000,000 of parent-company preferred stock in which the trust funds in question were invested.\(^ {58} \) Instead of a small funded debt and a large ownership in-

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56. The full capital structure is as follows:

<table>
<thead>
<tr>
<th>Bonds</th>
<th>Amount</th>
<th>Int. Req.</th>
<th>Prior Ind.</th>
<th>Prior Int. Ch.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kansas City, Memphis &amp; Birmingham gen. 4s, 1934*</td>
<td>$3,323</td>
<td>$133</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kansas City, Memphis &amp; Birmingham inc. 5s, 1934*</td>
<td>3,183</td>
<td>158</td>
<td>$3,323</td>
<td>$133</td>
</tr>
<tr>
<td>Kansas City, Ft. Scott &amp; Memphis rf 4s, 1936*</td>
<td>25,835</td>
<td>1,033</td>
<td>6,506</td>
<td>292</td>
</tr>
<tr>
<td>St. Louis-San Francisco prior lien 4s, 1930*</td>
<td>91,887</td>
<td>3,675</td>
<td>32,341</td>
<td>1,325</td>
</tr>
<tr>
<td>St. Louis-San Francisco prior lien 5s, 1930*</td>
<td>25,561</td>
<td>1,278</td>
<td>32,341</td>
<td>1,325</td>
</tr>
<tr>
<td>St. Louis-San Francisco cons. 4½s, 1978*</td>
<td>103,305</td>
<td>4,874</td>
<td>149,790</td>
<td>6,279</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Preferred Stock</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>St. Louis-San Francisco preferred stock</td>
<td>49,157</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Common Stock</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>St. Louis-San Francisco common stock</td>
<td>65,543</td>
</tr>
</tbody>
</table>

*These starred (*) securities were legal investments in 1929.


Here the securities total $372,795,000 and in 1929 $258,095,000 or 69.1 per cent were legals.


58. Central Public Service

Funded debt .......................... $208,877,422
Property purchase obligations due in 1931 .................. 5,516,914
Notes payable, funded .......................... 10,500,000
Notes payable .................................. 4,737,055
Minority Stock interest in capital and surplus of subsidiaries .... 168,301
Subsidiary preferred stocks .......................... 12,913,602
Preferred stock ................................ 23,672,158
Class A stock .................................. 57,581,640
Common stock .................................. 4,078,485

Poore's Manual of Public Utilities (1931) 990

This is a striking example of an inverted pyramid type of capital structure.
vestment, there was a very large funded and floating debt and a very small amount of owned capital. Since the claims of the bond and note-holders had priority of payment over dividends, the claim for earnings of the parent-company's preferred stock (held by the trustee) was so far deferred that a decline of 10 per cent in the gross earnings and other income reported for the year 1930 would result in a drop in the balance, after the payment of the parent-company's own interest requirements, from $5,535,000 to $1,211,000. It is noted in the decision that the company continued to pay dividends to and including January, 1932, and that the collapse was sudden and unforeseeable. But to an investment analyst the collapse of a company where a 10 per cent variation in gross earnings would make a 78 per cent variation in net earnings might be sudden, but it would be foreseeable. In fact it would be certain whenever a declining trend set in.

There is a discernible difference between the test of the law and the standards of scientific investing. The stated rule of law applied in this case is the one of which illustrations have been given: that the trustee is not an insurer and that if he acts with diligence and prudence he will not be held responsible for losses due to causes he did not foresee, nor will he be judged in the light of present knowledge for action taken in the face of the then available knowledge. The questions here is simply whether this legal concept does not need a closer linking with the concept of sound investment policy. For it may be said that probably no competent investment counselor would regard the preferred stock of such a company as suitable for the investment of trust funds where safety of the principal and regularity of the income are of prime consideration. So much then for the first two questions, namely: (1) is there a conflict between professional standards of investment and the law; (2) are the legal requirements in all respects sound? Sufficient appears to warrant the conclusion that there is a difference in approach and in evaluation between scientific and legal investment-technique.

IV. CONCLUSIONS

Assuming these discrepancies between law and finance, the remaining questions, before proposed, come forth for consideration. Should legal standards of investment be made more rigid or more flexible? Should the standards applied to the institutional and to the individual trustee vary? The primary legal duty of the trustee is to conserve his estate. Should this basic concept of the trustee's duty be altered or enlarged?

60. See p. 392, supra.
A—An Argument for Flexibility

Is it better, as a principle, to seek greater protection for the beneficiary in strictly circumscribing the character of permissible investments or in enlarging the trustee's discretion—and holding him to a high standard of judgment in the exercise of that discretion? It is true in New York, as in London, that the restriction of trustee investments to a prescribed list tends to result in the concentration of a great mass of trust funds in the "legals" with a resultant forcing up of the price. Thus the natural working of the law is toward an enhancement of the prices of securities in which trust funds are placed and a consequent artificially low income for the beneficiary.61

This situation has another phase. There is a growth in the understanding of investment problems and estate administration from generation to generation. Institutional trustees are active in educating the owners of estates to the advantages of their administration. There is the reasonable probability that the quantity of trust funds will increase rather than diminish. If there is such a growth obviously there must be attention given to the matter of enlarging the range of eligible investments substantially in pace with the funds seeking investment. Otherwise, with an increased pressure from funds for investment exerted upon a stationary investment list, the result must be to accentuate the conditions just mentioned.62

A broader question is that of the whole theory of a legal investment standard. The comment of J. M. Keynes63 on the trust situation in England may be taken as a starting point for the inquiry. His paradoxical comment was that the established standards were both too broad and too narrow. Applied to the ordinary legal standards in this country, the defect of too much breadth is apparent in the lack of attention to earning power for some classes of investment, the lack of any standard of diversification, and the consequent open road to concentration in securities of one class and of the one locality. That our legal investment standard is too narrow is an opinion expressed more than once by competent authority:

"Studies have been made, from time to time, for the purpose of comparing statistically savings bank 'legals' with other classes of securities. . . . One investigation showed that during a period of years speculative bonds gave a higher total yield than savings bank bonds by 26 per cent and medium grade bonds by 10 per cent. Another investigation of the same general type showed

63. 114 ECONOMIST (1932) 581.
83 per cent advantage for the highly speculative, and 35 per cent [advantage] for the medium-grade bonds over the bonds legal for Massachusetts savings banks. Still a third study, limited to railroad bonds, showed, in this clearly defined group, the non-legal bonds to have an advantage of 36 per cent over the railroad bonds legal for savings.\textsuperscript{64}

Perhaps a more serious question, however, is whether there is not an actual incentive or, at least, an encouragement to passive and unsound management. In the past, and today, a trustee may place the estate's funds in legal investments and keep them there unchanged, for the life of the trust. Let us suppose that a trustee in 1921 invested the corpus of a new trust in "legals" at an average price of 95. The entire list appreciates to an average of 105. The trustee may shift the investment, take his profits and look for re-investment opportunities. He will hardly find them within the legal list, for all bonds are likely to be up. Possibly he turns to mortgages. But he is under no compulsion to do anything. On the other hand, let the bond list decline, let the earnings of the obligors fall below the legal standard and the security forthwith becomes non-legal. The trustee may retain it, but it is his own responsibility if he does. By the time this question arises the bonds will have depreciated considerably in price. And here is a fundamental flaw in the statutory prescription of investment standards. An incentive is given for selling out at a low price but no incentive is given for selling out at a high price. Now as a matter of investment management any rule or condition which provides an incentive to dispose of first lien bonds at a time of the obligor's adversity and no corresponding incentive to dispose of them at the height of its prosperity is fundamentally unsound. It is conducive to buying at the top and selling at the bottom. An investment manager tries to do exactly the opposite.

\textit{B—Institutional Trustees}

In this connection there is the interesting question whether management standards may not be adapted to the presumed skill and ability of the trustee. Relativity in the degree of skill required or the degree of care expected is a familiar principle in other branches of the law.\textsuperscript{65} We

\textsuperscript{64} DEWING, op. cit. supra note 43, at 1193-1195.

\textsuperscript{65} For example, the familiar category of ordinary care and exceptional care depending upon the nature of the bailment. Here we have the range from the care exacted of a gratuitous bailee to the higher responsibility of a common carrier, the latter because of the nature of its calling. Dalton v. Hamilton Hotel Operating Co., 242 N. Y. 481, 152 N. E. 268 (1926); Coggs v. Bernard, 2 Raym. 909 (Q. B. 1703); STORY, BAILMENTS (1878) §§ 11-19. If a carrier, holding itself out to transport the goods of all who apply for the service and comply with the tariffs and regulations, is held to a higher degree of responsi-
have had, in comparatively recent years, a considerable growth of specialization in the management of estates. Where the settlor a generation ago appointed close relatives or valued friends as trustees, he now selects an institution which not only has an organization and equipment far superior to that of the average individual for handling investments, but which holds itself out to the public as a specialist. An occasional recognition of the legal consequence of this situation is to be found. Thus, in a recent case there is this significant comment, "Holding itself out as a specialist in trust affairs it should be held to a high degree of care."

It is not inconceivable that, with a continued growth of specialization, the organization which offers itself to the public as expert and skilled in the management of trust estates may be held to a degree of care and skill more exacting than that which is required of the layman trustee. With the growth of a body of institutional investment specialists, should not the degree of skill expected of them be enlarged—and to compensate, should not their discretion be given wider play?

C—Why Not a Commission?

Finally, a revision is needed in the concept of the trustee's management. His primary duty is to conserve the trust estate, but that con-

67. "... while the will authorized the executors to continue the investments and relieved them from surcharge for losses arising from such retention, it would seem to me that common business experience should have suggested to the executors, at least to the Executor Trust Company, which is supposed to be a specialist in this line of work and holds itself out as such, that immediate sale of these stocks at the then market prices would have been most advisable, and that their retention might very possibly result in a loss to the estate." In re Chamberlain's Estate, 156 Atl. 42, 43 (N. J. Prerog. Ct. 1931).

An interesting suggestion in this connection is that of Mr. Harold Eckhart, Vice-President and Secretary of the Harris Trust & Savings Bank of Chicago in an address June 5 at the convention of Iowa Bankers Association at Des Moines.

"As we know, the proper handling of trust accounts involves not only a thorough knowledge of the duties and responsibilities of a trustee, but also a knowledge of investments and accounting. Moreover, it involves the rendering of a personal service and because of the intricate nature and importance of the work performed by trust men, their relation to the public may well be compared with that of accountants and lawyers. Therefore if it is thought necessary to have lawyers and accountants pass rigorous examinations before they may be permitted to embark upon their careers, why allow men to enter the trust business without any such requirement?

It seems to me, therefore, that instead of undertaking to secure competent trust administration by elaborate and expensive examinations, it would be far better for the several states to require that no bank or trust company could be permitted to enter the trust
servation ought not to be a wooden, unthinking matter. The tenor of the courts' construction of trustee-responsibility is toward flexibility. He is judged in the light of a reasonable standard of diligence and prudence as applied to the situation at hand. The implication is very strong that a need exists for more flexible statutory standards. Possibly the solution is not to be found in a rehabilitation of old norms so much as in a change in the machinery for establishing standards. Investment is a practical matter and one where expert opinion and management should be superior to any code.

Why not establish a commission with the duty and power of supervising and reviewing the investment and types of investment prescribed by the legislature as lawful for trust funds? It may be taken that, as the foundation of any system, the legislature will prescribe the types of security eligible for trust funds and prescribe within some definite limit the standards for determining eligibility. But once this has been done there is room for a commission, operating within the framework of the statute, to review the list, not as a matter of routine but as a matter of supervision within the law. More than one activity might be envisaged for such a commission. It is not unlikely that a permanent body of this sort would be able to make recommendations to the legislature from time to time which would aid in keeping the basic structure of trustee law abreast of the times. And it is exceedingly likely that an alert commission might act to remove individual securities or whole classes of securities from the list at a time considerably in advance of any date when an automatic standard would dictate such changes. Such a commission, too, might provide trustees with an incentive to sell when securities are high or of removing securities from the list when the return is abnormally low. For instance, with trustee investments selling at prices well above par or where individual issues are well above call prices, a commission might say, in effect, "We are removing these securities, for the time being, from the authorized list. Their grade is high but so is their price and we think the funds of estates may be better conserved by being placed in some type of security less subject to the hazard of the loss of a great many points in the event of a declining bond market." 60 TRusT Companies (1935) 641 et seq.

For an interesting illustration of the supervisory function, see In re Mallon, Ill, Prob. Ct. June 20, 1935, where a petition to invest funds of a ward in United States government securities was denied because "this Court does not consider that an investment in government obligations at this time, when they yield only about 2% return, is a judicious investment" and the petitioner was instructed "to hold said funds on deposit and make diligent effort to find investment in the class of real estate mortgages . . . or some other legal investment which will pay a comparable return."
It might be desirable to endow such a body with enough of the status of a Special Master to enable a court, confronted with a matter involving investment policy, to refer the facts to the commission for consideration and recommendation for the court’s consideration. The establishment of a commission along these lines was discussed in England last year. The point was made there that a commission on which the bar, the stock exchange, the banks, the state, actuaries and accountants had a representation would give an expert supervision to trustee lists which could not be accomplished by other means. But there is a precedent nearer at hand. Recent legislation in New Hampshire provides for the creation of a Board of Investment appointed by the governor with the advice and consent of the Council with power to certify as legal investments, subject to approval of the Bank Commissioner, securities of designated classes. The classes include mortgage bonds and senior obligations of railways, public utilities and industrial corporations except holding companies, doing business in the United States. Standards of a general nature as to quality and of a specific nature as to the corporate existence of the mortgagor are provided.

The New Hampshire experiment, admittedly temporary, may contain the germs of a permanent plan to expand the flexibility of a trustee’s discretion subject to the regulations and constant supervision of an advisory commission.

69. 119 Economist (1934) 688.