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ECONOMIC CONSEQUENCES OF THE VIRGINIA LEGAL INVESTMENT STATUTE

In recent years there has been a widespread move under way to liberalize and broaden the present rules pertaining to fiduciary investment. Many attorneys and trustmen feel that, in light of today's social and economic conditions, reform of existing legislation is in order. It is felt that it would be wise to examine Virginia Law on the subject to see if perhaps there is a present need for reform in this field.

Today in the various American States, the trustee must conform in his selection of trust investments to the high standards expressed either by the Massachusetts Trustees Investment Rule, more commonly called the Prudent Man Rule, or limit himself to the more rigid New York Rule or legal-list theory. The Prudent Man Rule was laid down in the now famous case of *Harvard College v. Amory*¹ by the Supreme Judicial Court of Massachusetts, March, 1830. In discussing the propriety of the purchase and retention of certain securities, by fiduciaries of the estate of one M'Lean, Mr. Justice Putman said:

"All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."²

It will be observed that the Massachusetts Rule has a double-barrelled purpose: a consideration of probable income along with the probable safety of capital.

Opposing the Prudent Man Rule is the New York Rule which was laid down in the leading New York case of *King v. Talbot*.³ Dealing with substantially the same question that was before the Massachusetts Court, the highest court of the Empire State ruled that corporate stocks and other "securities" of like character were not the type of investments which a prudent man would acquire. Thus where *Harvard College v. Amory* approved a trustee's action in retaining and investing in stocks, the New York Court took the

1. *Harvard College v. Amory*, 9 Pick. 446, 461 (Mass. 1830).

2. *Id.* at 461.

3. *King v. Talbot*, 40 N.Y. 76 (1869).

opposite view. What was the reasoning behind this decision? The New York Court said:

“The moment the fund is invested in bank, or insurance, or railroad stock, it has left the control of the trustees; its safety and the hazard or risk of loss is no longer dependent upon the skill, care, or discretion, in its custody or management, and the terms of the investment do not contemplate that it ever will be returned to the trustees. If it be said, that, at any time, the trustees may sell the stock (which is but another name for their interest in the property and business of the corporation) and so repossess themselves of the original capital, I reply, that is necessarily contingent and uncertain; and so the fund has been voluntarily placed in a condition of uncertainty . . .”⁴

With this prohibition against common stocks announced in *King v. Talbot*, subsequent laws controlling trust investments were passed in the majority of states specifying those securities which would be considered lawful investments. These states have come to be called “Legal-List” states.⁵ Thus the battle lines were drawn. Today we find states which follow either the Prudent Man Rule or the Legal-List Rule along with a minority of states which have moved toward the Prudent Man Rule without adopting it in its pure form. Which view does Virginia have?

Mr. Lewis F. Powell, Jr., writing in the Jan. 1948 Virginia Law Review⁶ on “The Virginia Prudent Man Rule of Trust Investments,” made a thorough study of the legal questions involved. He reached the conclusion that although not expressly adopted, the Massachusetts Prudent Man Rule is believed to be the law of Virginia based on more than 100 years of judicial decision.⁷ To reach this conclusion Mr. Powell discussed at length early and modern Virginia decisions on the subject in conjunction with pertinent Virginia Statutes pertaining to fiduciary investment. To date no Virginia decision has been found which specifically makes mention of either the Massachusetts or New York Rules. However, as early as 1845 the Virginia Court of Appeals announced in *Kee’s Executor v. Kee’s Creditors*⁸ its own “Prudent Man Rule.” In that case the Court sustained the action of executors in paying off certain debts

4. *Id.* at 85-86, 88-89.

5. This applies where the trust instrument is silent as to investment powers.

6. Lewis F. Powell, Jr., *The Virginia Prudent Man Rule of Trust Investments*, 34 VA. L. REV., 102, Jan. 1948.

7. *Id.* at 102.

8. 2 Gratt. 117 (Va. 1845).

and in effecting compromises involving the assets of the trust estate saying in part :

“The duties of the executor . . . are yet to be performed under the obligations of sound judgment, acting on those considerations of worldly prudence, which affect the safety of the pecuniary interests confided to his care. When such judgment, so governed, is fairly exercised, and (tested by the facts existing and known at the time it is exercised) is such as would probably be formed by the judicious man, managing his own affairs, with reference to considerations of mere worldly prudence, the executor is justified in acting on such judgment; and so acting, is not responsible for alleged losses, resulting from his conduct.”⁹

This test of prudence laid down in this landmark case as to the performance of a fiduciary's duties has been followed by subsequent decisions¹⁰ up to the present day. Perhaps the most notable modern decision that deserves mention is *Harris v. Citizens Bank*.¹¹ In that case the Citizens Bank & Trust Co. of Blackstone, acting as executor for the estate of Mr. J. M. Harris, retained in the estate a substantial number of securities. Included in these holdings were both common and preferred stocks plus stock in the executor bank. Under the terms of the will, no express powers of retention were granted to the bank. After some two years had elapsed, the bank disposed of the securities, realizing very substantial losses to the estate. The Court refused to surcharge the bank for its actions, declaring that its retention of the securities had been with the express consent of all the beneficiaries. The Court then said :

“The standard by which the conduct of trustees, executors and other fiduciaries is to be measured has been many times stated and restated, both in this State and elsewhere. They are required to do those things which a man of reasonable intelligence and prudence would be expected to do in the management of his own affairs, but this rule, like most rules, is to be construed in the light of conditions obtaining when it is applied. More would be expected of the Guaranty Trust Company of New York than of a county bank at Churchville, which is but to say that negligence itself is an elastic term.”¹²

9. *Id.* at 129.

10. For other interesting cases see *Elliott v. Carter*, 9 Gratt. 541 (Va. 1853); *Powers v. Powers*, 174 Va. 164, 3 S.E.2d 162 (1939); *Southall v. Taylor*, 14 Gratt. 269 (Va. 1858); *Koteen v. Bickers*, 163 Va. 676, 177 S.E. 904 (1934); *Clemons v. Dennis*, 165 Va. 18, 181 S.E. 387 (1935).

11. *Harris v. Citizens Bank*, 172 Va. 111, 200 S.E. 652 (1939).

12. *Id.* at 125, 200 S.E. at 657.

The three most recent decisions involving fiduciary investments in Virginia have reaffirmed the Prudent Man Doctrine.¹³ Mr. Justice Browning, who wrote the opinion in *Commercial & Savings Bank of Winchester v. Burton* said:¹⁴

“The test of what a reasonably prudent person would do with his own is seen in what a large number of persons, some of them presumably of that character, did do. The evidence surely discloses that the vast number of stockholders, of the banks in question, in the light of existent conditions, did not sacrifice their holdings, but clung to them, hoping for a brighter day.”

The above review, though brief in nature, shows rather conclusively that Virginia has followed by judicial decision the more liberal Massachusetts Rule. Unfortunately, for all concerned, the fiduciary finds himself confronted with § 26-40 of the present Code of Virginia. This statute is commonly called the “Legal Investment” Statute, and specifies that “fiduciaries, both individual and corporate, may invest the funds held by them in a fiduciary capacity in the following securities, which are and shall be considered lawful investments . . .”¹⁵

The statute then goes on to list a fairly large number of carefully defined types of investments. In general § 26-40 includes:

- a) state and governmental securities,
- b) bonds, notes, and preferred stocks of public utility and industrial corporations, (which meet strict specifications),
- c) other bonds and notes secured by real estate,
- d) securities of the Richmond, Fredericksburg and Potomac Railroad,
- e) other railroad securities which meet certain specifications.

In general the list excludes:

- a) virtually all common stock,
- b) many preferred stocks,
- c) many corporate bonds.

It is well settled that the above statute is permissive and not mandatory, and that a fiduciary is not required as a matter of law to invest the trust estate in only those types of securities described

13. *Buckle v. Marshall*, 176 Va. 139, 10 S.E.2d 506 (1940); *Parsons v. Wysor*, 180 Va. 84, 21 S.E.2d 753 (1942); *Commercial & Savings Bank of Winchester v. Burton*, 183 Va. 133, 31 S.E.2d 289 (1944). (Since this latter case, no Virginia decision has been found which discusses the particular issue under consideration.)

14. *Id.* at 150, 31 S.E.2d at 296.

15. Common phraseology among attorneys and trustmen.

as "lawful investments."¹⁶ However, should the trustee make an investment as prescribed by § 26-40, he is relieved from liability.¹⁷ Therefore we have a very unique situation before us. The fiduciary in Virginia has a choice of two roads to take:

- a) He may rely on more than 100 years of judicial decision that Virginia has the Massachusetts Rule and invest the trust assets the way a prudent man would, or
- b) invest exclusively in "legals" and enjoy the dubious immunity afforded him under § 26-40.

How can these two completely divergent views be reconciled? It is obvious at first glance that he who seeks protection under § 26-40 is in effect relieving himself from all responsibility. Under the legal-list approach, the fiduciary needs no other talent than to be able to pick investments which satisfy the requirements of § 26-40. As Mr. Lewis F. Powell, Jr. pointed out in his excellent analysis of "The Virginia Prudent Man Rule Of Trust Investments,"¹⁸ the interpretation that the "legal investment" status affords immunity to those who exclusively follow its provisions has caused most fiduciaries to make only those investments which meet the specifications of the rule. The argument for following this course of action is that it is safer to the trustee and removes the possibility of surcharge. As a result of investing the trust estate in "legals," however, the life beneficiary will find himself heavily penalized by the low yields afforded by the securities offered under § 26-40. When one considers today's interest rates, which are at an all time low, in conjunction with a dollar whose purchasing power is at an all time low, it is not a pleasant picture.¹⁹ Thus the testator whose estate will be governed by this Statute has inadvertently loaded the dice against those very people he most wanted to protect.

Viewing the situation in terms of one trust fund does not show the immensity of the problem. Although one is prone to think of a trust fund as large, it may come as a surprise that by far the larger number of trusts are comparatively small. In a survey made by the Trust Division of The American Bankers Association, more than

16. *Powers v. Powers*, 174 Va. 164, S.E.2d 162 (1939); *Koteen v. Bickers*, 163 Va. 696, 177 S.E. 904 (1934).

17. *Koteen v. Bickers*, *supra*, at 690, 177 S.E. at 909.

18. Powell, *op. cit.* p. 128.

19. Consumers' Price Index, Bureau of Labor Statistics; Wholesale Price Index, Bureau of Labor Statistics, 1800 through 1950. For an interesting discussion of this problem see Marriner S. Eccles, *Beckoning Frontiers* 499 (1951).

half of all trusts administered (54%) had an annual income of less than \$1200. A little over 73% had an income of less than \$3,000., with an average income of only \$788. Of the 144,000 trusts on which this survey was based, not quite 3% had an income of more than \$25,000.²⁰ Mayo Adams Shattuck estimates that today the total trust funds in the nation may exceed two hundred billion dollars, and that this figure is increasing geometrically every year.²¹ Therefore it is fair to conclude that the trust is not exclusively reserved for the "rich man" but is more and more becoming a device to be utilized by the average American. Quoting Shattuck, "the nation had become after World War I, a growing aggregation of modest "capitalists."²² Therefore, a sizable portion of this nation's economic wealth may be found in trust portfolios.

Let us now turn to the economic side of the picture and briefly discuss giving the fiduciary greater freedom in investments, as opposed to the legal-list approach. The latter guarantees comparative regularity and continuity of income. Should the purchasing power of our dollar follow a steady and stable course, the magic formula for future security could be had by those who have based their future welfare on the yearly production of a specific number of dollars. Unfortunately the buying power of the dollar is now at about its lowest point in the past 150 years. Anyone who has shopped at the corner grocery recently can testify that five or ten dollars will no longer buy the family's needs for the week. Thus in a period of rising prices, and a cheap dollar, the individual living on a fixed income finds it harder and harder to make ends meet. Yet in spite of these plain facts, the belief still exists that bonds and mortgages are inherently safe, while stocks and other equity participations are speculative and thus to be frowned upon. Would the testator in attempting to provide for his loved ones measure the success of his endeavor by the specific number of dollars produced yearly, or by the purchasing power which his dollars have provided? The "safe" trustee using the legal-list finds no way to hedge against present inflationary pressures and protect the life beneficiary the way the

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20. Bascom H. Torrance, *Legal Backgrounds, Trends and Recent Developments in the Investment of Trust Funds, Law and Contemporary Problems*, Vol. 17, Winter 1952, No. 1, School of Law, Duke University, p. 142.
 21. Mayo A. Shattuck, *The Development Of The Prudent Man Rule For Fiduciary Investment In The United States In The Twentieth Century*, Ohio State Law Journal, Autumn, 1951, p. 499.
 22. *Id.* at 499.

testator would have wanted. It would seem that § 26-40 allows the fiduciary the unhealthy legality, therefore, of not keeping abreast with the times in regard to purchasing power and values.

It is interesting to note that one of the prime reasons for the legal-list, whether mandatory or permissive, is that the bonds and mortgages classified therein offer inherent safety. Unfortunately the secured obligation during the past decade or so, has lost much of its original character.²³ There has been a marked change in the attitude of both our courts and legislatures toward the calling of obligations and foreclosures.²⁴ The so-called legal moratorium has indeed transformed the position of the creditor.

During this process, however, the common stock has shown it deserves a place in any well balanced investment portfolio. This does not mean that the trustee may buy any stock, nor does it mean that he may speculate, for this certainly would not constitute a permanent disposition of one's funds. Similarly, short-haul buying, the idea of buying today and selling tomorrow for a half-point profit, is not proper. It does mean that the common stock of one of our blue-chip corporations, yielding a consistent and reasonable income through periods of both prosperity and depression, with an able management at the helm, deserves the tag of "safe" investment.²⁵ This view would seem justified from the security viewpoint when one compares such a stock to a "first mortgage on some distant bricks or mortar, or railroad trackage, or even a government-sponsored bridge, turnpike, water district or school district; where prosperity may depend upon local conditions utterly beyond the knowledge and control of the investor."²⁶

The principal reasons for using stocks in a well balanced trust portfolio have often been pointed out.²⁷ Briefly they are: 1) increased diversification, 2) increased income, 3) the possibilities of future growth, 4) the fear of inflation and a desire to protect against it.

The S. E. C., known for its conservative policies, stated, "A

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23. Edgar Lawrence Smith, *Common Stocks As Long Term Investments*, The Macmillan Company, New York, 1930.
 - Chelcie C. Bosland, *The Common Stock Theory of Investment*, The Ronald Press Company, New York, 1937.
 24. Mayo Adams Shattuck, *The Massachusetts Trustees Investment Rule—Its Virtues And Defects*; An address before the 23rd Mid-Winter Conference of The Trust Division, American Bankers Association, New York, Feb. 4, 1942, p. 17.
 25. *Id.* at 18.
 26. *Id.* at 18.
 27. Torrance, *op. cit.* p. 143.

reasonable capital structure calls for a substantial amount of common stock equity both as a protective cushion for the bonds and preferred stock and to prevent temporary declines in earning from resulting receivership."²⁸

In his discussion of "Investment Practices Of Trust Companies," Mr. Bascom H. Torrance had this to say about why trustees invest in stocks: "Stocks have become more and more an accepted part of the investment field and the capital markets. Information about them and facilities for studying them are more extensive than ever before. The markets in which they are traded are more firmly regulated and less subject to the deliberate manipulation which at times past gave them risks wholly unrelated to investment values . . . They have their own characteristics, and it is for these that they are bought by understanding investors. But it is important that they be bought for what they are, and not something else. As the New York committee stated, the form of an investment alone should not be the sole determinant of its usefulness."²⁹

In practice, trustees who have been able to utilize the Massachusetts Rule and include common stocks in their investment portfolios have fared far better than their legal-list cousins. The average yield in recent years has never greatly exceeded 2% for this latter group, while trustees operating under the Prudent Man Rule have averaged at least 4%.³⁰ It is a hollow victory for "prudence" when one considers the countless wealth that might have gone to life tenants but for the legal-list.

For many of the reasons mentioned, in recent years there has been a veritable parade of states which have adopted the Massachusetts Rule. Perhaps the most notable departure was New York itself, which now joins a small minority of states taking an intermediate position between the mandatory legal-list and the full freedom of the Prudent Man Rule.³¹ On April 5, 1950 Governor Dewey signed a bill which granted to New York fiduciaries a "35% Prudent Man Rule." Although short of the complete freedom desired by many fiduciaries in the Empire State, it shows conclusively that New York is headed in the right direction. Other states which

28. 6 SEC. ANN. REP. taken from Shattuck, *Ohio State Law Review Journal*, Autumn, 1951. p. 500.

29. Torrance, *op. cit.* pp. 151-2.

30. Shattuck, *op. cit.* p. 501.

31. N. Y. Laws 1950 (Chapter 464, July 1, 1950).

have adopted (in certain cases with slight variations) the Prudent Man Rule, or The Model Prudent Man Rule Statute prepared and written by the Trust Division of the American Bankers Association, include:³²

1941—New Hampshire	1947—Oregon
1943—California	1947—Washington
1943—Delaware	1949—Idaho
1943—Minnesota	1949—Kansas
1945—Illinois	1949—Oklahoma
1945—Maine	1951—Utah
1945—Texas	1951—Colorado
1947—Nevada	1951—New Mexico
	1951—Tennessee

Other states which have moved towards the Prudent Man Rule without adopting it in unrestricted form during 1951 include New Jersey, North Dakota, and South Carolina.³³ As discussed earlier, Virginia finds itself in the unique classification of being of being a Prudent Man Rule State while allowing statutory protection for those who wish to follow the legal-list theory. The economic and social consequences resulting from this confusion demand legislative reform. With this view in mind, trustees and attorneys have been recommending that our Commonwealth adopt the Model Prudent-Man Statute, or a slight variation of that Statute. The standard of prudence has been prepared by the Committee on Fiduciary Legislation of the Trust Division of The American Bankers Association. A reading of its provisions (see appendix) will show that it has made rather extensive use of the language used in *Harvard College v. Amory*. At the same time, however, the Model Statute will bring to those states which adopt it the wealth of judicial decisions applying the rule since 1830.

It is important to point out that by adopting the Model Statute, we would not merely give permission to purchase stocks. We would be adopting a well knit pattern of restraints and a body of principles to guide the fiduciary in the discharge of *all* managerial functions. No longer would the Virginia fiduciary be confronted by two sets of rules, but by one—

“what would a man of prudence, discretion, and intelligence do under the circumstances?”

32. For a more complete listing of all states see appendix.

33. *Ibid.*

The past two generations have witnessed both social and economic changes tremendous in their scope. Viewed from the standpoint of ever-changing circumstances, it is apparent that we need a rule which permits change.³⁴

STATES FOLLOWING THE PRUDENT MAN RULE

California	Kansas	Minnesota	Rhode Island
Colorado	Kentucky	Missouri	Tennessee
Connecticut	Maine	Nevada	Texas
Delaware	Maryland	New Mexico	Utah
Idaho	Massachusetts	Oklahoma	Vermont
Illinois	Michigan	Oregon	Washington

STATES RESTRICTING LEGAL INVESTMENTS TO BONDS

Alabama	Indiana	Louisiana	Ohio
Florida	Iowa	Montana	Wisconsin
Georgia			Wyoming

STATES WHICH HAVE MOVED TOWARD THE PRUDENT MAN RULE WITHOUT ADOPTING IT IN UNRESTRICTED FORM

Nebraska	New York	North Dakota***	South Carolina
New Hampshire	North Carolina*	Pennsylvania	West Virginia**
New Jersey			Virginia*

* Permissive states

** Prudent Rule authorized for fiduciaries acting for educational and charitable institutions

*** Prudent Rule authorized for corporate fiduciaries and to the extent of 50% of trust.

Source: Trust Division—American Bankers Association, as taken from *Investment Practices of Trust Companies*, Bascom H. Torrance, Law And Contemporary Problems, School Of Law—Duke University, Vol. 17 Winter, 1952. No. I.

NOTE: 4 states not included in the above list—Arizona, Arkansas, Mississippi and South Dakota—are difficult to classify in simplified fashion.

34. Other texts and materials greatly aided in the preparation of this review. Of particular value were: Benjamin Graham and David L. Dodd, *Security Analysis*, McGraw Hill Book Company, Inc. New York, 1934. Charles B. Standsbury, *The Dow Theory Explained*, Barron's Publishing Company, Inc. New York, 1938.

THE MODEL PRUDENT-MAN INVESTMENT STATUTE

1. § 1. In acquiring, investing, reinvesting, exchanging,
2. retaining, selling and managing property for the benefit of
3. another, a fiduciary shall exercise the judgment and care
4. under the circumstances than prevailing, which men of prudence,
5. discretion and intelligence exercise in the management of their
6. own affairs, not in regard to speculation but in regard to the
7. permanent disposition of their funds, considering the probable
8. income as well as the probable safety of their capital. Within
9. the limitations of the foregoing standard, a fiduciary is au-
thorized
10. to acquire and retain every kind of property real, personal or
11. mixed, and every kind of investment, specifically including but
not
12. by way of limitation, bonds, debentures and other corporate
13. obligations, and stocks, preferred or common, which men of
prudence,
14. discretion and intelligence acquire or retain for their own ac-
count.

* * * *

- 14a and within the limitations of the foregoing standard, a fiduciary
- 14b may retain property properly acquired, without limitation as to
- 14c time and without regard to its suitability for original purchase.

Note: The foregoing addition to § 1 is included for the consideration of those states which desire particular treatment of the retention of trust property.

15. § 2. Nothing contained in this Act shall be construed
16. as authorizing any departure from, or variation of, the express
17. terms of limitations set forth in any will, agreement,
18. court order or other instrument creating or defining the fidu-
ciary's duties and powers, but the terms "legal investment" or
19. "authorized investment" or words of similar import, as used in
20. any such instrument, shall be taken to mean any investment
which
21. is permitted by the terms of § 1 hereof.
22. § 3. Nothing contained in this Act shall be construed as
23. restricting the power of a court of proper jurisdiction to permit a
24. fiduciary to deviate from the terms of any will, agreement, or
other
25. instrument relating to acquisition, investment, reinvestment,
26. exchange, retention, sale or management of fiduciary property.
27. § 4. The provisions of this Act shall govern fiduciaries
28. acting under wills, agreements, court orders and other instru-
ments
29. now existing or hereafter made.

GORDON CUMMING MURRAY