Winter 1982

Fiduciary's Investment Duty - The Peril of the Prudent Man Rule

J. Rodney Johnson
University of Richmond, rjohnson@richmond.edu

J. RODNEY JOHNSON

A Fiduciary's Investment Duty—The Peril of The "Prudent Man Rule"

THE purpose of this article is (1) to report on the recent decision in *Hoffman* v. *First Virginia Bank*,[1] (2) to identify the several problems this decision has created for the public and for the bar, (3) to propose a statutory solution to these problems, and (4) to suggest an interim approach to these problems that draftsmen of wills and trusts might take while awaiting the passage of an appropriate statute.

The Facts

Complainants alleged that, pursuant to decedent's will, a marital trust was established on August 15, 1972, with assets valued at approximately $104,000; that between December 7, 1972 and January 4, 1973, approximately $40,000 of these assets (38% of the trust's corpus) were sold and the proceeds were invested in securities of three REITs (real estate investment trusts); that the securities of all REITs declined in value during the next seven months, until September, 1973, at which time they "plummeted"; and that the market for such securities had "substantially collapsed" by the end of 1973, in consequence of which the trust's REIT securities became "substantially worthless." Complainants further alleged that the trustee committed various acts of negligence in making and maintaining these investments. The trustee demurred, contending that the acts complained of were authorized by the language of decedent's will.

The Issue

"In this appeal, the principal question is whether a testator, in providing for a testamentary marital trust, waived the 'prudent man rule' otherwise applicable in the investment of trust assets."[2]

The Holding

The Court recognizes that a Virginia fiduciary, in the performance of its investment duties, may rely upon the legal list contained in Code Sections 26-40 and 26-40.1, which expressly state that certain enumerated securities are "legal investments"; or the fiduciary may elect to invest pursuant to the much broader "prudent man rule" which, as codified in Section 26-45.1, reads in part as follows:

> ... in acquiring, investing, reinvesting, exchanging, retaining, selling and managing property for the benefit of another, an executor, administrator, trustee or other fiduciary, both individual and corporate, shall exercise the judgment of care under the circumstances then prevailing, which men of prudence, discretion and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital. Within the limitations of the foregoing standard, an executor, adminstrator, trustee or other fiduciary, both individual and corporate, is authorized to acquire and retain every kind of property, real, personal or mixed, and every kind of investment, specifically including but not by way of limitation, debentures and other corporate obligations and stocks, preferred or common, and securities of any open-end or closed-end management type investment company or investment trust registered under the Federal Investment Company Act of 1940, as from time to time amended, which men of prudence, discretion and intelligence acquire or retain for their own account ...

The Court also notes the complainant's concession that the "prudent man rule" may be waived by a testator, adds, that "[a]lthough there was no express waiver (in this will), a waiver may arise by necessary implication from the language used in the will," and then the Court proceeds to its conclusion on this point in the following language:

> In Article V, the testator gave his executor and trustee "full discretionary powers of management ... without being restricted to those investments authorized by statute in Virginia for the investment of trust funds. ..." This provision authorized the fiduciary to invest in

assets other than those specifically listed in Code §§ 26-40 and 26-40.1.

The testator was especially interested in giving his executor and trustee power to retain any or all of his investments, and he exonerated the fiduciary, acting in either capacity, from liability for depreciation in the value of securities so retained. This provision was important to afford flexibility in protecting the testator's interests in the closely-held, family corporations listed in the inventory of his estate.

The powers of the trustee alone were then stated. The will authorized investment "in any type of real or personal property ... regardless of diversification or State laws, and ... in common stock, unimproved real estate, non-productive items, common trust funds, investment company shares. ..." This language, the Trustee maintains, gave it the broadest possible investment authority and waived the application of the "prudent man rule." We agree.

Having already provided that the executor and trustee could invest without being restricted to the list of legal investments under Code §§ 26-40 and 26-40.1, (emphasis added) the testator clearly intended to grant more comprehensive powers to the trustee alone. Accordingly, he specifically waived any requirement of diversification of investments, and then removed any further restrictions upon the trustee's investment powers by eliminating the constraints of laws otherwise applicable. We cannot agree with the contention of the beneficiaries that the testator intended by these provisions only to reaffirm his waiver of the "legal list" of investments set forth in Code §§ 26-40 and 26-40.1. The terminology is too broad to be construed as applying to a single investment law, embraced within the two statutes, that had already been eliminated. The language is clear and unambiguous, so that no extrinsic evidence is admissible to explain its meaning. We conclude that the testator's language must be construed as a waiver of the "prudent man rule" that had been incorporated into the statute law of the Commonwealth.[3]

J. Rodney Johnson is a professor of law at the University of Richmond Law School. He received a J.D. from William and Mary School of Law and an LL.M. from New York University School of Law. He is the editor of Virginia Trust and Will Manual, an Academic Fellow of the American College of Probate Counsel and the author of a number of articles in the fields of estate planning and fiduciary administration.

Comment on the Decision

There are two separate and distinct investment questions regularly encountered in fiduciary administration. One question is posed at a very early stage as the fiduciary asks "Which of the investments that the decedent made during his lifetime, and which were passed to me by reason of his death, may I properly retain?"[4] In addition to this question, the fiduciary must ask itself throughout the term of its administration "What investments are proper for me to make as an original matter?"[5] As the fiduciary is faced with these two separate investment questions it is customary to also deal separately with the fiduciary's powers concerning these questions. An examination of the form-books furnished to the bar by five Richmond banks discloses that all of them deal separately with the power to retain and the power to invest. Indeed, the statutory "boiler-plate" furnished to the entire State bar by the General Assembly in Code 64.1-57[6] provides separately for these separate aspects of the overall investment responsibility of a fiduciary.

The major premise in the foregoing decision (see the italicized language) is that *because* the testator, by his prior language, had already eliminated the legal list as a restriction upon the trustee's power to invest, the necessary result of the testator's latter language was to waive the "prudent man rule" as a restriction upon the trustee's power to invest. It is respectfully submitted that the decision is incorrect at this point. Instead, it is believed that the prior language (which is found in context at 220 Va. 837, in paragraph 3; and at 263 S.E. 2d 405, in paragraph 1) merely states the fiduciaries' powers to retain investments made by the decedent during his lifetime, and leaves the matter of the trustee's own original investments to be dealt with by the latter language.[7] If this writer's conclusion concerning the prior language is correct then, of course, the Court's basis for its conclusion that the latter language necessarily waived the "prudent man rule" is incorrect and so also is the holding of the case. In all fairness to the Court, however, it must be noted that the distinction between "retention" and "investment" powers was not presented to the Court by complaints.

The Problems Created

Whether the foregoing analysis is correct or not, it is submitted that the *Hoffman* decision has definitely generated great confusion concerning the present applicability of the "prudent man rule" to Virginia trusts that contain standard "boiler-plate" investment provisions. The form-books referred to earlier in this article all contain provisions granting additional discretionary investment powers upon the trustee. To what extent, if any, do these provisions result in an implied waiver of the "prudent man rule"? The *Hoffman* opinion also states that

> ... the express authorization to invest in nonproductive items and unimproved real estate shows an intent to permit the fiduciary in its discretion to invest in speculations.[8]

It is submitted that this is not necessarily true, as a matter of law, and it is typically wrong as a matter of fact. From a legal standpoint the rule is that "[t]he provisions of the trust instrument are ordinarily strictly construed against an enlargement of the scope of permissible investments beyond those allowed under the ('prudent man rule'),"[9] and the language in question is clearly capable of a construction other than an intent to permit speculations. From a factual standpoint, it borders on the incredible to believe that the typical testator actually intends to enable his trustee to speculate, i.e. to gamble with the trust fund at the beneficiary's expense, absent specific language to that end. Indeed, the primary purpose of most persons in creating trust funds for the benefit of another is to insure that the beneficiary will receive either a certain income or else will receive whatever amount may be necessary to insure the beneficiary's support. This intent is totally inconsistent with an intent to allow the trustee to gamble with the corpus that the beneficiary's income or support is dependent upon. Yet, in the light of *Hoffman*, standard "boiler-plate" administrative provisions are capable of being construed as impliedly waiving the "prudent man rule."

Moreover it is believed that if a testator, after reading through all of the "boiler-plate" contained in his trust (a dubious assumption, perhaps, considering the technical nature of the language regularly used therein and the length that runs to 214 lines in the statutory version) should ask the drafting attorney what it all means, he probably would not receive a detailed explanation but instead would receive a short, tranquillizing statement to the effect that "It is just standard, form language that the bank likes to have to enable it to do its job more efficiently, certainly nothing to be concerned about, merely provisions that provide for flexibility in administration in the future as times and circumstances change in order to enable the trustee to better carry out your wishes, etc."

In addition to not conforming to the desires and expectations of the consumer, and the assurances of the draftsman, this implied waiver of the "prudent man rule" may also create a tax problem for a decedent's estate. One of the purposes of the testator in creating a "marital" trust in *Hoffman* presumably was to obtain for his estate the benefit of the federal estate tax marital deduction. Yet, if the IRS should agree with the Court's conclusion concerning the trustee's powers, the testator's estate would be denied the benefit of this deduction. The basic rationale of the federal government is that the allowance of the marital deduction where a spouse is given a life income right and a general power of appointment is based on the assumption that there will, in fact, be a "right" to income for life. The unfettered power of a trustee to eliminate such an income through the selection of permissible investments is quite inconsistent with the beneficiary having a "right to income," and thus the marital deduction is not allowable where the trustee has such a power.[10] Of course the federal tax audit in the present case was concluded long before the present litigation was begun. But what about those estates that will pass through federal estate tax proceedings in the future? What will be the decision concerning the allowability of the federal estate tax marital deduction if the trust contains investment provisions such as the following:

> (c) To invest and reinvest all of the funds of the estate as said fiduciary, in his sole discretion, may deem best, including investment in stocks, common and preferred, and common trust funds, without being restricted to those investments expressly approved by statute for

> investment by fiduciaries; and to change investments from realty to personalty, and vice versa.
>
> (c1) To invest and reinvest all of the funds of the estate as said fiduciary, in his sole discretion, may deem best, including investment in interests in investment trusts and mutual funds, without being restricted to those investments expressly approved by statute for investment by fiduciaries; and to change investments from realty to personalty, and vice versa.[11]

It was formerly thought that the foregoing language, taken from the statutory "boiler-plate," might be immune from such an attack, even by a zealous IRS agent. In the wake of *Hoffman,* however, one must anticipate the very real possibility of IRS taking the position that all such broadly worded investment powers will result in the implied waiver of the "prudent man rule," and thus in the denial of the federal estate tax marital deduction. One can almost hear the agent saying, "Well, the language in '(c)' authorizes the trustee to depart from the legal list, therefore having already eliminated the legal list by the language in paragraph (c), the language in (c1) must logically manifest an intent to grant more comprehensive powers to the trustee by impliedly waiving the 'prudent man rule'." Of course any agent who comes to such an absurd conclusion could be proven wrong by reference to the statutory history of these two "boiler-plate" powers. However, this ability to prove the agent wrong will be of little comfort (i) to those who are unaware of the remedy, (ii) to those who will find it less costly to suffer the unwarranted loss of the marital deduction than to litigate in order to obtain it, and (iii) to those who must ultimately bear the cost of educating the Service concerning this aspect of Virginia law. Lastly, even if one is unconcerned about the foregoing statutory "boiler-plate," what about the "boiler-plate" contained in the formbooks furnished to the bar by corporate fiduciaries, which typically contain broader investment provisions as a part of their "boiler-plate"?

A Permanent Solution

A somewhat similar problem, i.e. unintended extension of an administrative provision, was presented to estate planners by the Tax Reform Act of 1976. The problem then was the possibility that a standard direction to one's executor to pay all death taxes from the residue of one's estate without apportionment might be construed as also applying to a "generation skipping transfer tax" under IRC § 2601. In order to prevent this unintentional, though literal, construction of a rather standard administrative provision, the General Assembly enacted the following statute:

> A general direction in a will to pay all taxes imposed on account of a testator's death or similar language shall not be construed to include taxes imposed on a "generation skipping transfer" under § 2601 of the Internal Revenue Code or taxes imposed upon the estate of a prior decedent in which the testator had no power of appointment or similar power of disposition, unless the testator shall expressly manifest an intention that such taxes be paid out of his estate by reference to § 2601 of the Internal Revenue Code or otherwise.[12]

It is believed that a similar statute would be the simplest and best solution to the present problem. Such a provision, which would logically be added to the end of Section 26-45.1, might read as follows:

> (e) A general authorization in a will or trust authorizing a fiduciary to invest in such assets as the fiduciary, in his sole discretion, may deem best, or other language purporting to expand the fiduciary's investment powers, shall not be construed to waive the rule of paragraph (a) hereof unless the testator or settlor shall expressly manifest an intention that it be waived (i) by reference to the "prudent man rule," (ii) by reference to the power of the fiduciary to make "speculative" investments, or (iii) by other language synonymous with (i) or (ii) immediately preceding.

Not only is it important that the General Assembly codify this rule in Virginia, it is also important that the General Assembly establish that the "prudent man rule" has always been the proper rule of decision in Virginia (absent specific language to the contrary), notwithstanding the abberational holding in *Hoffman.* Accordingly, in order to establish the foregoing and to insure that *Hoffman* is confined to its unique facts, it is further submitted that the bill introducing the above-suggested statute should also contain a statement that "The provisions of this act are declaratory of existing law." Such was the course taken by the General Assembly in 1978 when Section 64.1-74(d) was added to the Code[13] in order to prevent an unintended extension of the rule against perpetuities, and it is believed that the clarification is equally if not more important in the instant case.[14]

An Interim Solution

Earlier in this article it was suggested that the typical draftsman might give a tranquillizing response if queried concerning the "boiler-plate" administrative provisions in a will or trust. It is also believed that quite often the client doesn't even bother to ask about the effect of such language because it is recognized that this is the lawyer's part of the document (as opposed to the dispositive portion of the document) and the client alternatively doesn't know to ask, is for some reason reticent, or simply trusts the lawyer to do what is in the client's best interest. What attorney hasn't, on numerous occasions, heard "Well, I don't know what all that legal mumbo-jumbo means, but if you say its what I want I'll sign it." And, of course, when the draftsman incorporates the statutory "boiler-plate" by reference, the client typically doesn't even see the language in question. In the aftermath of *Hoffman,* is there an added responsibility of an estate planner to his client viv-a-vis administrative provisions? It is submitted that if an attorney prepares a will or trust containing "boiler-plate" that might be construed to impliedly waive the "prudent man rule," and thereby enable a trustee to speculate at the beneficiary's expense, as well as to endanger the allowance of the marital deduction without advising the client of these consequences, he is failing to carry out his own fiduciary duty to that client. Therefore it is suggested that, until this matter is resolved by an appropriate statute, the prudent attorney may wish to (1) have a letter in the files of all future clients stating that they understand these risks and wish to take them, or else (2) add appropriate limiting language to the administrative powers, such as, for example:

> Nothing contained herein shall be construed as a waiver of the "prudent man rule" contained in Section 26-45.1(a) of the Code of Virginia as it is written on the date of this will.

Conclusion

Regardless of the correctness of the decision in *Hoffman,* the present uncertainty concerning the applicability of the "prudent man rule" in Virginia when the governing document contains "boiler-plate" investment powers is intolerable. It is imperative that the General Assembly end this uncertainty with an appropriate statute. Pending the passage of such a statute, the prudent draftsman may well wish to consider including appropriate limiting language in his wills and trusts.

Footnotes

1. 220 Va. 834, 263 S.E. 2d 402 (1980).
2. 220 Va. 834, 836, 263 S.E. 2d 402, 404 (1980).
3. 220 Va. 834, 841, 263 S.E. 2d 402, 407 (1980).
4. Restatement, Second, Trusts § 230. Duty to Dispose of Improper Investments.
5. Restatement, Second, Trusts § 227. Investments Which A Trustee Can Properly Make.
6. § 64.1-57(a) allows the fiduciary "[t]o keep and retain any or all investments. . . as they may be at the time they come into the custody of said fiduciary. . ." and §§ 64.1-57(c) and (c1) grant investment powers. Two of the five bank form-books referred to above provide for the incorporation of the statutory powers instead of supplying their own language.
7. It may seem to the reader that this distinction between the "prior" and the "latter" language is not justified because, as presented in the opinion, all of the language may appear to be part of one continuous matter. Such is not the case. The "prior" language dealing with the power to retain (as quoted by the Court) is found in the second paragraph of Article V, on page 4 of the will, and the "latter" language dealing with the power to make new investments (as quoted by the Court in the third paragraph of the same long quotation) is found in the eighth paragraph of Article V, on page 6 of the will. The will is reproduced beginning at page 8 of the Appendix to the Record (No. 780549) in the case.
8. 220 Va. 834, 842, 263 S.E. 2d 402, 408 (1980).
9. Restatement, Second, Trusts § 227, Comment u. Interpretation of the terms of the trust.
10. IRS Reg. 20.2056(b)-5(f)(4), Rev. Rul. 66-39, 1966-1 C.B. 223. This would also be true when using the "qualified terminable interest" trust concept that was created by Section 403(d) of the Economic Recovery Tax Act of 1981.
11. Va. Code Ann. §§ 64.1-57(c) and (c1).
12. Va. Code Ann. §§ 64.1-66.1.
13. 1978 Va. Acts, ch. 481.
14. For purposes of completeness, it is also suggested that the statutory "boiler-plate," Va. Code Ann. § 64.1-57, be amended by adding a new paragraph "(5)" as follows:

> (5) This section is not intended and shall not be construed to affect the application of the "prudent man rule" set forth in § 26-45.1(a).