1-1-1940

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Recommended Citation
Sidney D. Kline, Trust Investments Under Pennsylvania Law, 44 Dick. L. Rev. 69 (1940). Available at: https://ideas.dickinsonlaw.psu.edu/dlra/vol44/iss2/2

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TRUST INVESTMENTS UNDER PENNSYLVANIA LAW

SIDNEY D. KLINE

[Editorial Note: The following article is, in the words of the author, "a discussion of existing laws of Pennsylvania as to investment powers of fiduciaries with emphasis upon their present rigidity which results in unfairness to beneficiaries of trust estates, and suggested remedies therefor." It does not purport to be an exhaustive legal analysis, but is rather a discussion of the practical problems facing fiduciaries seeking to invest money under present conditions. Mr. Kline seeks to stimulate thought and insight upon the practical questions involved by presenting realistically the basic problem and the purpose for which the trust was set up.]

On November 7, 1933, a new era began in the law of permitted legal investments for fiduciaries. At the municipal election held November 7, 1933, a joint resolution of the Senate and the House of Representatives proposing to amend Article Three, Section Twenty-two of the Constitution of Pennsylvania, to read as follows:

"Section Twenty-two. The General Assembly may, from time to time, by law, prescribe the nature and kind of investments for trust funds to be made by executors, administrators, trustees, guardians and other fiduciaries"

was approved by a majority of votes cast on said proposed amendment.

The General Assembly was not long in making use of this new power. On May 28, 1937, an amendment was made to the Fiduciaries Act of 1917, Section 41 (a) 1, as amended in subsequent years up to and including the Act of 1935. This 1937 Act relating to fiduciary investments was both a codification of preceding laws and a broadening of the field of permitted investments for fiduciaries. Briefly, under the amendment, trustees were authorized to purchase, with immunity (as described in the Act) against any liability for subsequent loss however occasioned, the following permitted legal investments:

United States obligations, direct or guaranteed,
Commonwealth of Pennsylvania obligations, direct or guaranteed,
Local Pennsylvania municipal obligations,
First mortgages on improved real estate located within Pennsylvania not exceeding two-thirds of the fair value thereof,
Bonds, Mortgage Pools, Mortgage fractional interests secured by first mortgages having the same characteristics as individual mortgages,

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1 P. L. 1037, 20 PURD. STATS. (Pa.) §801.
2 P. L. 545, 20 PURD. STATS. (Pa.) §801.
Ground rents,
Certain obligations of railroads, gas, water, electric, and telephone companies selected by a complicated formula on a very conservative basis,
First mortgages insured by the Federal Housing Administration up to ninety percent of the fair value of real estate securing said mortgages, regardless of the location of the real estate, within or without the Commonwealth of Pennsylvania,
Federal Land Bank bonds,
Deposits of $500 (now $1,000 by amendment passed in 1939) in savings accounts of an institution which is not the trustee of the fund being invested,
Consolidated Federal Intermediate Credit Bank Debentures,
Shares of building and loan associations insured by the Federal Savings and Loan Insurance Corporation,
Obligations of General State Authority and Housing Authorities, Home Owners Loan Corporation bonds.

The Fiduciaries Act, Section 41 (a) paragraph 3 then provides:
"In case the said moneys shall be invested as set forth in paragraph one of clause (a) of this section, or conformably to the directions of the court, under paragraph two of clause (a) of this section, the said fiduciary shall be exempted from all liability for loss on the same, in like manner as if such investments had been made in pursuance of directions in the will creating the trust, it being hereby declared that the investments mentioned in this section are legal investments of moneys by fiduciaries: Provided, however, That if any such investment shall cease to be a legal investment, it shall be the duty of such fiduciary to exercise due care and prudence in the ascertainment of such fact, and in the disposition or retention of any such investment thereafter."

This paragraph gives the fiduciary its reward for following the dictates of the General Assembly. If the wisdom of the General Assembly is followed, the trustee will not have to pay for any loss, if a loss occurs, provided, however, the trustee is able to show due care and skill in selecting investments within the limits of the legal list. Practical experience reveals that it is easier to prove the use of proper care, caution, and skill in making legal investments than in selecting securities not so enumerated.

It is important to remember that the General Assembly has not seen fit to rely entirely upon the due care and prudence of the fiduciary in the making of an original investment. Instead, it prescribed the list indicated heretofore, but in Section 41 clause (a), paragraph 3, and also in Section 41 clause (a) paragraph 1, sub-section 19, paragraphs (a) and (c) of the Fiduciaries Act, it provides that
the fiduciary shall use due care and diligence in holding or disposing of an investment after it becomes illegal, or if an illegal investment was received in kind. It seems inconsistent to vest this partial discretion in the fiduciary after a situation has become prospective of a loss, and not to give the free choice of investments to the fiduciary in the first place.

In 1937 after the passage of the Act under discussion, certain underlying issues of at least fourteen railroads were designated as legal for trust investments, including the following:

Western Maryland,
Virginian,
Atchison, T. & S. F.,
Chesapeake & Ohio,
Louisville & Nashville,
Pennsylvania,
Reading Co.,
Union Pacific.

Today statisticians say that only certain issues of four railroads are legal because of the sharp decline in earnings of railroads during the calendar year of 1938. If the trustee, after due investigation and exercise of caution, determines to hold certain first lien bonds of the Pennsylvania Railroad (they are no longer legal) in accordance with the terms of the Act, the fiduciary would not be surcharged with the subsequent decline in price of such bonds. But, if the fiduciary should today purchase such a bond as an original investment, and it should decline in price, the trustee could be held liable for the loss. It is difficult to find a distinguishing reason for such diverse conclusions.

The present state of law as to legal investments is superior to the conditions existing during the "nineteen twenties" as to broadness of class but not as to yield to the life tenants. Basically, investments made from the legal list of the "twenties" yielded a fair return to the beneficiary. If selected with care and prudence such investments did not involve too great a risk of loss of principal. From this conclusion there must be one exception. The narrow list of available legal investments caused the Pennsylvania fiduciary, more and more, to buy a larger proportion of mortgages, either entirely for trusts, or by way of participations in mortgages, or participations in mortgage pools, for various trust accounts. This resulted in an unsound concentration in mortgage investments. The mortgages in the main were honestly placed, based on an appraisal in line with actual construction costs and sales consummated during said period. There were isolated cases of mortgages being placed with more care in fitting the record to the requirements of the statute (as to the two-thirds limit against an appraisal of fair market value) than regard to merit. These isolated cases received broad publicity, but percentage-wise these cases were negligible compared to the total amount invested by fiduciaries during the period.
When the precipitous decline of real estate values occurred, mortgage investments of trust estates became frozen and unliquid; losses were incurred; beneficiaries suffered. Perhaps there would have been a more satisfactory record if fiduciaries had had a broader base for trust investments. Undoubtedly, there would have been less litigation for the purpose of securing surcharges on mortgage investments during the past eight or nine years. To repeat, it is the opinion of many having practical experience in the problem of investing trust funds, that the abuses in the mortgage field of trust investments were caused in part by the pressure of funds seeking investment with no substantial class of investments available excepting mortgages.

The legal list today is broadened. The supply of money seeking investment today is rising faster than the available investments appear. Interest rates are going down. Yield for life tenants becomes less and less. In addition, for purposes of unemployment relief, a tax of eight mills per annum, per dollar of investment of money at interest is levied jointly by the counties of Pennsylvania and the Commonwealth of Pennsylvania, regardless of the yield of such investment. A mortgage yielding six percent interest and a mortgage yielding four percent interest are taxed at the same rate on the principal amount. Investors and insurance companies, non-resident of Pennsylvania, need not pay these taxes. Consequently, they are buying the better mortgages throughout Pennsylvania, taking them away from the Pennsylvania fiduciary on the competition of a lower interest rate (which to them is free of the eight mills tax). Thus the field of permitted legal investments becomes still narrower. Just recently a new issue of United States Treasury bonds, maturing in eleven years and bearing a two percent coupon, was oversubscribed by a very large margin, and the bonds subsequently sold above par.

Under present conditions, Pennsylvania law tends to drive money seeking investment out of Pennsylvania, and deprives Pennsylvania fiduciaries of business which should stay at home. If a trust is created locally, the life tenant is deprived of a return comparable with that which can be earned by fiduciaries in other states under more favorable legislation.

Present laws permit the purchase of Federal Housing Administration mortgages and bonds of railroads and public utilities where the basic security is located in other states, but at the same time prohibit the purchase of direct obligations of other states and municipalities of other states. Does the General Assembly wish to say that the municipal obligation of the City of Camden, New Jersey, is an inferior investment to the bond of some utility company operating in the State of New Jersey? No reasonable basis for such differentiation seems evident.

In 1939 the General Assembly further attempted to broaden the scope of legal trust investments by elaborating on the method of investing trust funds through the media of fractional interests in mortgages, and by enacting legislation

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approving the plan known as the Common Trust Funds Act. Neither of these Acts gives any true measure of relief to the problem heretofore discussed because they are both limited to the field of legal investments, which was not enlarged as a result of the passage of the Acts.

The discussion up to this point has dwelt upon the inflexible limitations of legal investments. Necessarily these limitations are felt only in trusts created by a court order, or those in which the creator, either by will or by other instrument, did not give discretion to the fiduciary to invest estate funds in securities other than legal investments. The skilled investor, or the individual skillfully advised by his attorney, who has come to realize the limitations of the permitted list of fiduciary investments, has remedied the situation heretofore pictured by giving his fiduciary powers of investment which are substantially broader than those granted by the General Assembly. With that class of trusts this article is not concerned. The fact that in the investment programs of the estates of most skilled investors, or those advised by skilled attorneys, there has been a definite departure from the limitations of Pennsylvania legal investment law is evidence of the failure of the Pennsylvania law to meet the current demands for the investment of idle money. The defects described are concerned with the average small trust account where heretofore the broad power of investment was not granted to the trustee, and also the many trust accounts which will arise in the future with no provision for a broader field of investments than that prescribed by the General Assembly. Unless some measure of relief is granted, beneficiaries of these small estates may have to be satisfied with a much smaller return on their security funds. It seems, therefore, that it is time for Pennsylvania to come of age in its investment policies so far as trust estates are concerned.

It is not well to give the impression that the latitude desired is one of wild speculation, because truly it is not the function of a trustee to attempt to appreciate the principal of the trust, but it is to earn a fair return for the life tenant and preserve the principal for the remainderman. The suggested remedies which follow have that purpose and no other.

It is sometimes supposed that courts and judges in interpreting statutory law tend toward the conservative point of view, and to a degree act in check upon the liberal tendencies of legislatures. Recently there have been some dicta in opinions which seem to indicate that the judges are abandoning this conservative point of view toward an investment policy. The Pennsylvania Superior Court said in Wood's Estate:5

"There is much less objection to investment in stocks than there was a century ago. This is shown by the fact that the shrewd, conservative, and experienced financier frequently authorizes trustees appointed by him to invest in stocks, realizing that circumstances arise

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where they may be safer than bonds, although this is not the general rule. In periods of threatened inflation arising from a depreciated currency, common stocks may be a safer investment than bonds."

The Orphans' Court of Philadelphia County in a majority opinion reached the conclusion that it was empowered to issue a declaration that the trustees were authorized to invest in shares of stock after the trustees sought the guidance of the court. The Supreme Court, in Carwithen's Estate, reversed the decision and repudiated the effort of the Orphans' Court of Philadelphia County to assist the trustees in determining their investment policy. The reversal was based on the lack of an existing controversy, and not on a disagreement with the tenor of the lower court's decision. More and more, there seems to be a tendency on the part of courts to indicate that not all wisdom in investing is concentrated in the so-called legal list. Decisions point toward the recognition that there are many securities outside the legal list which in many respects have qualities equal, or superior, to those contained within the legal list.

The judges in this attitude are merely following the considered conclusion of various economists who for some time have been advocating a broader base for trust investment. Dr. F. Cyril James, formerly of the University of Pennsylvania, now of McGill University, in a recent address has said, in part:

"Investments in stocks and in real estate—the only possible hedges against long-run inflation—must become as important as, if not more important than, investments in bonds and mortgages.

"On the legal side, it is apparent that the regulations imposed on trustees by courts and legislatures must be liberalized along lines that will allow greater freedom of action in the selection of desirable investments, while trustors must be encouraged to refrain from rigid instructions in wills and other deeds of trust.

"If a particular trustee is considered capable of assuming the management of an estate he is entitled to expect that he will be allowed to use all his ability and intelligence in administering the trust."

What then can be done to give fiduciaries in Pennsylvania broader investment powers? As a minimum concession, the General Assembly can give the trustee as much authority in the investing of trust assets as it has given to life insurance companies for investing the reserves which secure the payment of life insurance policies. This gives them the authority to buy all of the investments which have been listed heretofore, and in addition thereto, state and municipal bonds of other states than Pennsylvania and mortgages on real estate located in any state of the United States. Besides these two material enlargements, the General Assembly has given this broad discretion:

7Act of May 17, 1921, P. L. 682, § 404 (h), 40 P.URD. STATS. (Pa.) §504.
“First encumbrances upon standard steam railroads, street and inter-
urban railways, or upon their rolling stock equipment, or of water, 
gas or other public utility companies, or bonds issued to retire a prior 
debt, or bonds prior thereto or any other bonds or notes of the above-
named corporations, upon which no default in interest exists at the 
time of purchase.”

Life insurance companies for the past thirty-five years have had an excellent 
record in earning fine returns on their invested reserves, and in discharging their 
obligations under their contracts. This record is due in part to the excellent way 
in which their carefully selected personnel has handled the investment problems 
of the insurance companies. If this personnel had been hampered with a narrow 
list of investments such as legislation has wound around the Pennsylvania fiduciary, 
the results undoubtedly would have been less successful. The principle of a 
very broad base of investment so as to give a maximum spread of risk of principal 
is entirely sound, as proved by the experience of the life insurance companies. 
This initial step would prove most helpful to the Pennsylvania fiduciary.

A further step would be to enlarge upon the common trust fund idea which 
met the approval of the House of Representatives and the Senate in 1939, but 
which did not aid in solving the problem in Pennsylvania because the idea was 
limited to legal investments. This would permit the formation of a mutual non-
profit corporation to invest in the same securities as life insurance companies are 
permitted to buy for use of their capital and reserves, and to sell investment con-
tracts secured by such investments to various corporate fiduciaries throughout Penn-
sylvania so as to obtain the advantage of the broad diversification which such policy 
gives. Such corporation would be exposed to the income tax of the Federal govern-
ment, but since the obligation to pay interest on the investment contracts would act 
as a deduction, the burden of income tax would not be great enough under present 
laws to offset the advantage obtained from a broad spread of risk of principal and 
increased income. In addition to these advantages there would be the greater 
flexibility of investment program in buying and selling which cannot be obtained 
in small units.

This suggestion is not purely theoretical. A corporation has been organized 
in the State of Massachusetts called “Trust Funds, Inc.” It attempts to do for 
fiduciaries in Boston on a profit basis what is contemplated for Pennsylvania 
fiduciaries on a mutual basis. The projected company could be organized for 
Pennsylvania fiduciaries, manned by a Board of Directors selected from the per-
sonnel of Pennsylvania banks. The investment and statistical force would neces-
sarily be of the best. No officer or employee would be permitted to have any 
relation to, or connection with, any other financial, or stock or bond distributing 
house, so that their conclusions would be free of any outside influence.

The third suggestion for Pennsylvania is the most drastic but is more in line 
with present trends in the New England states and apparently with the thinking
of our judges and economists who have studied the problem. A study of sur-
carges and attempted surcharges through the judicial process undoubtedly will
reveal that the successful investment of trust funds was not obtained because of
iron-clad restrictions and rules, but in spite of such rules. Successful trusteeship
in the past was the result of sound management exercising due care, prudence, and
diligence. Losses were incurred within the so-called legal limits of trust invest-
ments as they existed in the "twenties." The form of the investment in many
cases gave protection to the trustee against liability for the losses incurred. Par-
ticularly was this true in the case of mortgages placed in accordance with statutory
law after due caution was taken to have the real estate securing the same properly
appraised, and to limit the amount of the mortgage to two-thirds, or less, of the
appraisal. United States Liberty Bonds were bought at par during the World
War and sold at eighty-four cents on the dollar several years later, and the trustees
were not held liable for the loss. It would seem better to give the trustee greater
freedom and less regulatory statutes. Massachusetts for years has regulated its
fiduciaries with a very simple rule which provides that—

"trust funds may be invested in bonds, or stocks, or other securities
selected by the trustee, with the care of a prudent investor."

Connecticut in 1939 passed a similar statute adopting the Massachusetts rule.
Pennsylvania would do well to adopt a similar statute.

We in Pennsylvania have been accustomed to an accepted legal list accom-
panied by an immunity clause which provides that if a trustee buys such investments
after using due care and prudence it shall not be held liable for loss. Most per-
sons involved in investing trust funds reached the conclusion that the converse
was law, namely, if a trustee with due care and prudence buys a security which is
not a legal investment but which statistically is sound, and a loss is incurred, the
trustee is a guarantor of the fund and must pay the loss. An incomplete study of
the cases does not reveal a statement of facts where this situation actually occurred
with a resultant surcharge to the trustee. It would be interesting to have such a
case arise and to ascertain whether the courts would follow it to such logical conclu-
sion. It may be possible that underlying the legal list which gives immunity as de-
scribed heretofore, the Pennsylvania court would, or could, still create the equiva-
lent of the Massachusetts rule by decreeing upon due proof of proper care and
prudence in the purchase of what statistically is a sound investment, that the trustee
will not be held liable for loss. In any event if the courts cannot create such
interpretation by judicial process, it would be helpful in the administration of trusts
for the benefit of the life tenant and remainderman to have the enactment of such
a rule by the General Assembly.

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