

INVESTMENT TRUSTS AS TRUST INVESTMENTS

EDWARD CLARK LUKENS

The development and advertising of investment trusts has doubtless caused some trustees to consider utilizing these institutions as a means of investing trust funds. Possibly few are aware that there is any doubt as to their right to do so, in cases where they are not limited to so-called legal investments. The question I raise is whether the placing of trust funds in the hands of so-called investment trust organizations may not constitute an illegal delegation of fiduciary powers. As there is apparently no direct authority on the problem, the real function of this article is to call attention to the question rather than to urge the writer's opinion as to the answer.

I assume a situation where the will or other document creating the trust expressly permits the trustee to invest in securities that are not "legal investments". I am not concerned with the question of what are legal investments, the answer to which of course differs in the different states. I have in mind the ordinary provision in wills, under which the trustee can properly invest in standard issues of stocks and bonds. It is probable that in such cases trustees often assume that they can invest in anything offered by reputable bankers or traded in on the stock exchanges, and are thus not on the alert for other legal objections to such investments.

It is a well established rule that a trustee cannot delegate his powers, aside from merely ministerial duties.¹ It is thus clear that a trustee could not simply hand over the fund to someone else whom he modestly regarded as more competent to handle it than himself. It would plainly be improper for the trustee to

¹ Chicago Title & Trust Co. v. Zinser, 264 Ill. 31, 105 N. E. 718 (1914); Cheever v. Ellis, 134 Mich. 645, 96 N. W. 1067 (1903); Dodge v. Stickney, 62 N. H. 330 (1889); Bohlen's Estate, 75 Pa. 304 (1874); Woddrop v. Weed, 154 Pa. 307, 26 Atl. 375 (1893); Meck v. Behrens, 141 Wash. 676, 252 Pac. 91, 50 A. L. R. 207 (1927); White v. Baugh, 9 Bligh N. S. 181 (1835); 1 FERRY, TRUSTS AND TRUSTEES (7th ed. 1929) § 287.

place trust funds in the hands of a broker under a "discretionary account" or other arrangement by which the latter and not the former made the decisions and controlled the cash or securities. In the case of *Meck v. Behrens*,² individual trustees were surcharged and held as guarantors of the trust fund, when they had turned it over to a trust company, this being regarded by the court as an illegal delegation of their powers and duties.

To apply this principle to the case of investing through an investment trust, we must consider first the nature of the transaction, and second the reasons for the doctrine that fiduciary powers cannot be delegated.

A dissertation on the various types of investment trust is unnecessary, as their main features are well known. The question is whether one who exchanges his cash for the shares or obligations of such an organization is really making an investment therein, or whether he is merely turning over his cash to the management to invest it, or speculate with it, for him. If the investment trust, or trading company, or whatever it may be called, may properly be regarded as an institution *sui generis*, employing its own capital in its own business ventures, then its stock would be like any other stock in which a trustee with sufficiently broad powers might invest. If on the contrary, the true view is that the investment company is a mere agency for combining and investing the funds of its members, then a purchase of its stock or other evidence of participation does not in itself constitute an investment, but is merely a mechanical step in the process of getting the money invested, and constitutes an abdication of his powers by the trustee.

In the case of an unincorporated investment trust, the delegation seems perfectly clear. If the manager is literally a trustee, gives the participant a mere receipt or evidence of fractional interest, and proceeds to purchase stocks or "play the market" with the combined fund, he is certainly handling the member's money for him, and the money is not really invested until something is purchased by the manager. No elaboration of terminology can

² *Supra* note 1.

distinguish this from a mere "pool," and there can be no escape from the conclusion that a trustee could not enter such a pool. Even though the investments may be in the possession of a trust company under a deed of trust limiting the management's powers, the result would be the same. It can make no difference whether the fiduciary delegates the possession and the discretion separately or together, since he has no right to relinquish either.

It is difficult to see how the situation is changed by the incorporation of the managing body. The fact that the contribution is received by a corporate body rather than by an individual or group of trustees, and that the participant receives a certificate of stock instead of some other evidence of part ownership, does not really change the situation. It would seem that the purchase of such stock is merely a form, and that the delegation of authority to do the investing is still the substance.

If the stock certificate purports to certify to the direct fractional ownership of the securities in the "portfolio," it is hardly a certificate of shareholdership in the ordinary sense at all, as the ordinary corporation shareholder's rights are based on a wholly different conception from that of part ownership of the specific property. But even in a case where the stock certificate is in the ordinary form, so that it does not indicate on its face that the holder has delegated his job of investing to the company, we have still the more basic question whether the purpose of accumulating the several contributions of capital was to carry on a business with it or merely to invest it.

The supposed advantages of the investment trust are diversification and expert management. There is no objection to a trustee seeking diversification, and there is no reason from this standpoint why he should not purchase a piece of paper evidencing his ownership of a fractional interest in a stated group of investments, as in the "fixed" type of investment trust, but he would still be delegating the possession, if not the investing, of the trust funds. The risk might be much less serious, but it would still be his. In the ordinary type of investment trust, expert management is largely stressed. Management of the trust fund by others, even if they be properly called experts, is the very thing that runs

afoul of the delegation of discretion doctrine. If this is the primary object and characteristic of the investment trust, its impropriety for trust funds is clear.

The main reason for the rule that a trustee shall not delegate his duties is that the creator of the trust has chosen to rely upon his personal skill and judgment.³ The testator or grantor is the one to decide whose management is wanted, and he would not have chosen the particular trustee had he not preferred him. The question is not who the trustee thinks can handle it best, but who the testator thought could handle it best. The reason for the rule guides its application, and leaves little doubt that the duty of the fiduciary is to function himself, however much more "expert" some other person or organization may be.

The principle that the trustee must not let another organization do his investing for him cannot be carried quite to a logical conclusion. There are numerous business enterprises the success of which depends largely upon the ability of the management in the investment of the capital or surplus in the securities of other corporations. No one would maintain that the purchase by a trustee of bank or insurance company stocks would involve an illegal delegation, although the value of these stocks might depend more on choice of investments than on pure banking or underwriting activities. The value of stock in an incorporated brokerage house would be even more dependent on its success in investing and trading, but the capital contributed to such a corporation would clearly be employed in its own business activities.⁴ The incorporated investment trust, however, can be placed in this class only upon the dubious premise that trading in stocks

³ In *Chicago Title & Trust Co. v. Zinser*, *supra* note 1, it was held that the rule does not apply to a corporate fiduciary, since no individual judgment is relied upon. I question the validity of this exception, beyond the situation of the particular case, which was of a merger of two trust companies. Certainly a man may prefer one trust company to another, and at least when he chooses a trust company he relies upon the qualifications of such a company and expects the trust to be handled within its organization.

⁴ It should be noted that an investment may be improper for other reasons than the legal investment rule and the delegation of power doctrine. A trustee in any case must use due care and diligence, and permission to go outside the legal investment list does not relieve him of this. A purely speculative business might be an improper investment on this ground alone. See *Pray's Appeal*, 34 Pa. 100 (1859); *Hart's Estate*, 203 Pa. 480, 53 Atl. 364 (1902).

for one's own account, purely for profits and not for brokerage commissions, can be regarded as a business enterprise in itself.

Assuming that the courts would condemn the purchase with trust funds of securities of the pure investment trust or trading corporation, how far would they carry the principle into the various forms of quasi investment trusts, holding companies, or whatever they may be called? It is here that we reach the doubtful zone, but only because of the infinite possible variety of hybrid financial plans.

A true holding company, the purpose of which is to provide a centralized control over a group of corporations constituting a single business combination, would be readily distinguishable from an investment trust. On the other hand, an investment trust could confine itself to the securities of a single industry and purchase sufficiently large blocks of stock to obtain representation on boards of directors, and still cause no doubt as to its real purpose and character.

Some of the corporations recently formed by railroads, banks, and other organizations, for the purpose of holding title to securities that the parent company for some reason does not want in its own name, would be difficult to classify. It is perhaps sufficient to show that there are such border line cases, without attempting to prophesy as to just where the law will eventually draw the line.