

The New Limited Prudent-Man Rule in Ohio

BY CHARLES F. JOHNSTON*

On August 7, 1953, over the veto of Governor Lausche, the Ohio General Assembly passed Amended House Bill No. 138 which will permit fiduciaries to invest 35% of trust funds in securities other than those provided for in the so-called "legal" list in Section 2109.37 of the Ohio Revised Code.¹ The new law, effective November 7, 1953, represents a very limited acceptance of the Prudent-Man Rule in Ohio.

Since the inception of the modern trust into our society, there has always been the open question as to the proper investment selections for a trust corpus. Since a trustee was generally under a duty to make the trust property productive while conserving the principal, the trustee faced the task of combining "safety" with "income" in the same investment. After a period of liberality in trust investments, necessitated by the need of capital in early American business, the states caused the forms of investment to crystallize in governmental bonds and real estate mortgages. By 1900, the vast majority of states were legal list states following the so-called New York rule which permitted fiduciaries to invest only in securities prescribed by statute. Often such statutes did not allow investments in corporate securities. The role of a trustee during this era was mainly that of a conservator of principal.²

With the growth and expansion of our nation since 1900, the size of trust assets has grown to high figures and has called for a revaluation of trust investments in the light of a modern economy. Since 1937, there has been a rapid change by most states from the legal list to the "Massachusetts" or "Prudent-Man Rule" for fiduciary investments. Under this rule, the trustee is bound by no list of investments and may invest in corporate stocks and bonds as long as it is a prudent investment. Prior to 1940, only nine states followed the Prudent-Man Rule; now about 32 states have a similar rule in operation.³ Even New York, which has been conservative since the days of *King v. Talbot*,⁴ has accepted a modified

* Member of the Editorial Board, Ohio State Law Journal, The Ohio State University.

¹ OHIO REV. CODE § 2109.371.

² Shattuck, *The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century*, 12 OHIO ST. L. J. 491 (1951).

³ *Ibid*; see also Torrance, *Legal Background, Trends, and Recent Developments in the Investment of Trust Funds*, 17 LAW AND CONTEMP. PROB. 128 (1952).

⁴ 40 N.Y. 76 (1869).

35% Prudent-Man Rule in 1950.⁵ During the depression, states with legal lists fared no better than those with the Prudent-Man Rule since municipal obligations and real estate mortgages held up no better than equity securities. As stated in *Harvard College v. Amory*,⁶ the capital is always a hazard.

Since World War II, the cry by fiduciaries for further avenues of investment forced most states to adopt the Prudent-Man Rule or to widen "legal" lists to the breaking point. Funds caught in legal list investments during the last 15 years have returned much lower income and growth than in Prudent-Man Rule states because of the inability of the trustee to balance a portfolio with investments in corporate stocks. In recognition of this handicap, almost all trust indentures today contain clauses giving the trustee discretionary investment powers. Advocates of the rule feel that they have better opportunity for diversification, more income yield, more flexibility, and better ability to change investments with economic conditions.

Governor Lausche and other opponents of the Prudent-Man Rule feel that though stocks produce greater income, there is a corresponding insecurity in the investment which is overlooked in boom periods.⁷ They also feel that there is no need for the rule under legal lists, since a settlor can provide for non-legal investments by expressing such intention in the trust agreement.

The duty of a trustee under the Prudent-Man Rule is best exemplified by the classic statement from *Harvard College v. Amory*:⁸

All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise 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.

Generally, he is under a duty to combine safety with productivity, to avoid speculation, to diversify the risk, to exclude his selfish interest, and to turn to a court of equity for advice if needed.⁹ In states that have recently accepted the Prudent-Man Rule, fiduciaries have realized that with the greater freedom in investments,

⁵ N.Y. PERS. PROP. LAW § 21 (1).

⁶ 9 Pick. (Mass.) 446 (1830).

⁷ Senate Journal, 100th General Assembly, August 7, 1953 p. 1.

⁸ 9 Pick. (Mass.) 446, 461 (1830).

⁹ 3 BOGERT, TRUST AND TRUSTEES, § 611 *et seq.*; see also a collection of authorities upon the operation of the Massachusetts Prudent Man Rule given by Mayo A. Shattuck in 25 B.U.L. REV. 307 (1945) and 12 OHIO ST. L.J. 509 (1951).

they face greater pitfalls and have, therefore, been cautious in using their new discretion.¹⁰

For many years in Ohio, the rule has been that a trustee is without authority to place the funds in other than legal list investments, except where a trustee is given discretion as to choice of investments or is given definite instructions to place them in non-legal investments by the trust instrument.¹¹ The legal list in Ohio has generally consisted of various types of governmental obligations and bonds, bonds issued under various Federal home loan acts, and first mortgages on real estate.¹² The Ohio legal list was under considerable attack during the last decade and a limited Prudent-Man Rule bill was passed in 1950 but vetoed by Governor Lausche.

The new law, Section 2109.371 of the Ohio Revised Code, will allow trustees, administrators, executors, and guardians, other than guardians bound by the Uniform Veterans' Guardianship Act,¹³ to invest in stocks, bonds, debentures, notes, equipment trust obligations, or other evidences of indebtedness of a corporation organized and existing under the laws of the United States, District of Columbia, or of any state of the United States and in certain governmental obligations not eligible under the "legal" list up to a limit of 35% of the aggregate market value of the trust fund.¹⁴ Once the 35% is determined, the fiduciary need not sell because of a change in relative market value of such investments either in legals or non-legals. An executor or administrator must obtain the approval of a court for such investments in absence of permission in the instrument creating the trust. The new law does not affect the right of a fiduciary to retain investments in non-legals received by him in the creation of the trust, though such non-legals will necessarily be required to be computed in determining the 35% limit.¹⁵

The investment should be made in such securities "provided the same may be lawfully sold in Ohio" and as "would be acquired by prudent men of discretion and intelligence in such matters seeking a reasonable income and the preservation of their capital."

¹⁰ MacNeill, *How New York Trustees Invest under Modified Prudent-Man Rule*, 96 TRUSTS & ESTATES 432 (1951); and Torrance, *Investing Under Prudent Man Rule*, 91 TRUSTS & ESTATES 838 (1952).

¹¹ *Home Saving & Loan Co. v. Strain*, 130 Ohio St. 53, 196 N.E. 770, 99 A.L.R. 903 (1935).

¹² Former OHIO GEN. CODE § 10506-41.

¹³ OHIO REV. CODE §§ 5905.01 to 5905.19 inclusive.

¹⁴ See Sater, *Liberalization of Ohio's Legal List for Fiduciary Investment: "Prudent Man" Standard Engrafted*, 26 OHIO BAR 749 (1953), for a more extensive discussion of investments under the new statute.

¹⁵ OHIO REV. CODE § 2109.38.

Though "lawfully sold in Ohio" probably refers to securities exempted or registered under the Ohio "Blue Sky" laws,¹⁶ the language could stand to be more explicit as in the New York law.¹⁷

The new law also allows investment in securities of any open-end and closed-end management type investment trust company within the 35% limitation. Such a clause has been recently added by Mayo A. Shattuck to the Model Prudent-Man Rule Statute and passed in a few states.¹⁸ For small trusts such investments have been advised for diversification of the risk. Though such statutory authorization would probably not be needed under discretionary clauses or the Prudent-Man Rule, most fiduciaries favor such statutory permission to delegate their authority to trust companies.¹⁹

Though the new law provides for investment trusts, it fails to provide for the increasingly popular common trust fund which has been valid in Ohio since 1943.²⁰ Though such funds are in their infancy in Ohio and there is no case law on the subject, most states which have a modified Prudent-Man Rule like New York and New Jersey have had to correlate the two statutes.²¹ In computing the 35% which a trustee may invest under the New York law, the trustee should exclude the value of any investment made in a legal common trust fund.²² If the use of the legal common fund trust does take place in Ohio, the statutes should be correlated or clarified in the future. Such difficulties as correlation with common trust funds, difficulties in valuation, and restrictions on diversification have led to attacks on the limited Prudent-Man Rule.²³

Unless the trust instrument limited the trustee to legals at the time the trust was created, changes in investment statutes are valid to previously created trusts.²⁴ The courts of New York have tended to be liberal in extending the provisions of their new statute to existing trusts which are silent as to investments while to the

¹⁶ OHIO REV. CODE §§ 1707.01 to 1707.99 inclusive.

¹⁷ N.Y. PERS. LAW § 21 (1).

¹⁸ N.H. LAWS 1949, c.134; ME. LAWS 1951, c.24; WASH. LAWS 1951, c.218.

¹⁹ In re Estate of Rees, 53 Ohio L.Abs. 385, 85 N.E.2d 563 (1949); Stevenson, *Investment Company Shares*, 89 TRUSTS & ESTATES 228 (1950).

²⁰ OHIO REV. CODE §§ 1117.01 to 1117.07, inclusive.

²¹ N.Y. PERS. PROP. LAW § 21; N.Y. BANK LAW § 100(c); N.J.S.A. § 17:9A-36 *et seq.*

²² In re Prime's Will, 107 N.Y.S2d 19, 200 Misc. 410 (1951).

²³ Shattuck, *the Fallacies of a Modified Prudent-Man Rule*, 89 TRUSTS & ESTATES 848 (1950).

²⁴ Ritchie v. Farrelly, 16 N.J. Super. 214, 84 A.2d 468 (1952); In re Jones' Will, 221 Minn. 524, 22 N.W.2d 633 (1946); and Reiner v. Fidelity Union Trust Co., 126 N.J. Eq. 78, 8 A.2d 175 (1939), *rev'd. on other grounds*, 127 N.J. Eq. 377, 13 A.2d 291 (1940).

contrary have been strict in extending it to trusts with special investment provisions.²⁵

The new Ohio law is definitely a welcomed step forward, but was taken with great conservatism. Since the fiduciary is still bound to a legal list, the new law is only a liberal extension of the old legal list to new securities and not a true Prudent-Man Rule. As in other states, the new discretion probably will be taken with caution, and, if good times persist, there undoubtedly will be new efforts to pass a 100% Prudent-Man Rule in Ohio.

²⁵Torrance, see footnote 10, *supra*.