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# Delegation of Investment Powers by Charitable Trustees

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# DELEGATION OF INVESTMENT POWERS BY CHARITABLE TRUSTEES

Over the past few years the activities of philanthropic organizations[1] have been undergoing considerable critical scrutiny. Congressional committees,[2] private commissions,[3] and individuals[4] have extensively analyzed institutionalized charity. An area of particular concern involves problems created by the investment policies of charitable organizations.[5] One investment problem that has not received much attention, however, is the plight of the natural person trustee of a charitable trust[6] who, in general, is legally prohibited from delegating his responsibility for investment of trust funds.[7] Almost one-third of all charitable foundations take the legal form of trusts.[8] Of the foundations organized as charitable trusts,[9] over 60 percent are administered by natural person trustees.[10] Therefore, any investment problem of the natural person trustee, such as an inability to delegate investment responsibility, is faced by the great majority of charitable trusts. The economic effect of poor investment policy is significant

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1 The term "philanthropic organization" is used here rather than "foundation" because of the differing meanings of the latter. *See* Pifer, *Assessment of the Law and Its Effect on Foundations*, in 1 FOUNDATIONS AND THE TAX REFORM ACT OF 1969 41 (1970). Whenever the term "foundation" is used, it refers to the definition in Section 509(a) of the INTERNAL REVENUE CODE of 1954.

2 *See Hearings on H.R. 13270 Before the Senate Comm. on Finance*, 91st Cong., 1st Sess., pt. 6 (1969); *Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess., pt. 1 (1969) [hereinafter cited as *Tax Reform Hearings*].

3 *See* COMM'N ON FOUNDATIONS AND PRIVATE PHILANTHROPY, FOUNDATIONS, PRIVATE GIVING AND PUBLIC POLICY (1970) [hereinafter cited as COMM'N ON FOUNDATIONS].

4 *See* M. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT (1965); D. YOUNG & W. MOORE, TRUSTEESHIP AND THE MANAGEMENT OF FOUNDATIONS (1969).

5 *Tax Reform Hearings*, *supra* note 2, at 23-24 (testimony of Rep. Wright Patman).

6 *See* Part II *infra*.

7 *See* notes 19-29 and accompanying text *infra*.

8 FOUNDATION DIRECTORY 13 (3d ed. M. Lewis 1967) [hereinafter cited as FOUNDATION DIRECTORY]. This percentage has remained approximately the same since 1919. *Id.*

9 A charitable organization may take two forms. The donor may choose either the trust or the corporate structure to administer his gift. The charitable trust is the focus of this article since almost all states presently permit nonprofit corporations to delegate investment matters. *See* Committee on Charitable Trusts, *Duties of Charitable Trust Trustees and Charitable Corporation Directors*, in 2 ABA REAL PROPERTY, PROBATE AND TRUST J. 545, 558, n.98 (1967). A charitable trust is defined as

> a fiduciary relationship with respect to property arising as a result of a manifestation of an intention to create it and subjecting the person by whom the property is held to equitable duties to deal with the property for a charitable purpose.

RESTATEMENT (SECOND) OF TRUSTS, § 438 (1959).

10 For example, in the state of New York, *over* 60 percent of charitable trusts are administered by natural person trustees. *See* FOUNDATION DIRECTORY, *supra* note 8, at 493-742.

since "each percentage point of added total return on foundation investments would yield between two and three hundred million dollars of additional funds for charity."[11] The ultimate loser is society, since smaller return on investment means a smaller payout for charitable purposes.[12]

Private foundations can no longer resign themselves to a low investment yield resulting from a lack of investment expertise. The Tax Reform Act of 1969[13] has made maximum investment yield and a high rate of income distribution imperative, for an inefficient investment policy now subjects the charitable trust to a prohibitive tax burden.[14] Thus, not only society's interest, but also the continued functioning of the charitable trust necessitates expert and aggressive management of the trust's principal and income by the trustees. Refusal to allow the charitable trustees to delegate their investment responsibilities to knowledgeable investment counsel could impede efficient management.

## I. THE CURRENT STATE OF THE LAW

American common law evolved two rules governing the investment practices of the natural person trustee. One of these was the "prudent man rule." The original statement of the rule appeared in *Harvard College v. Amory*,[15] a case involving a charitable remainder trust. The trustees were given discretion either to lend the money or invest it in stocks. They chose to invest it. Subsequently, the stocks that had been purchased declined in value, and the charitable beneficiaries sued the surviving trustee for breach of fiduciary duty and sought to have him surcharged. The Massachusetts Supreme Judicial Court refused to allow the beneficiaries' suit, holding that a trustee need only exercise the discretion that a prudent man would ordinarily employ in the management of his own business affairs.[16] This statement of law has remained largely unchanged in America[17] and is widely accepted. Forty states have now adopted the rule, either by statute or by judicial decision.[18]

Common law also developed the rule that any delegation by the trustee

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[11] COMM'N ON FOUNDATIONS, *supra* note 3, at 75.

[12] *Id.* at 76.

[13] 83 Stat. 487 (codified in scattered sections of 26 U.S.C.).

[14] *See* notes 44-62 and accompanying text *infra*.

[15] 26 Mass. (9 Pick.) 446 (1830).

[16] Writing for the court, Justice Putnam stated that:

> 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.

26 Mass. at 461. Thus, a trustee's prudent investment involves a consideration of both the long and the short term needs of the trust. *See generally* G. BOGERT, TRUSTS AND TRUSTEES, §§ 396, 612 (1960).

[17] RESTATEMENT (SECOND) OF TRUSTS, § 379(a), at 174 (1959).

[18] G. BOGERT, *supra* note 16, § 612, at 55 n.18 (Supp. 1973).

of his investment function was impermissible.[19] The leading American decision, *Winthrop v. Attorney General,*[20] like *Amory,* arose out of a dispute concerning a charitable trust created for Harvard University. The trustees, rather than investing the money themselves, made an agreement with the President and Fellows of the University that the trust monies were to be placed in the Harvard general fund and invested and administered with it. The delegation agreement specifically provided that the trustees were not to interfere with the University's management of the investments. The court invalidated this agreement for three reasons. First, it held that the delegation of investment power violated the settlor's intent since the trust instrument evidenced the desire that "the care and management of the principal of the fund, as well as the income, should be permanently in the trustees."[21] Second, the court found that the trustees failed to show that it was impossible to carry out the trust in the way the settlor had specified. Therefore, this was not a proper case for the exercise of the judicial power to modify trust instruments, *cy pres.*[22] Finally, the court held that even though the trustees acted as prudent men would have done in administering their own affairs, this delegation was "a disposition which the trustees are not at liberty to make."[23] Thus, in essence, the Supreme Judicial Court overrode the prudent man rule of *Harvard College v. Amory* in so far as prudence would dictate delegation of the trustees' investment responsibilities.

Other courts have come to the same conclusion about the nondelegability of trustee investment powers, although employing a different analysis. These courts draw a distinction between duties of a trustee which are discretionary and those which are ministerial;[24] the latter may be delegated, but the former may not. Selection of investments is always found to be discretionary. The validity of this distinction has been criticized,[25] but it continues to be used by the courts.[26] Still other courts anchor their rule of nondelegability upon the principle that the trustee himself should perform all tasks that he can reasonably be expected to do.[27] This principle is essentially an application of the prudent man rule to the issue of delegation, even though the rule originated in the context of investment

[19] Although Rowland v. Witherden, 42 Eng. Rep. 379 (Ch. 1851), holds only that a trustee is liable for negligent supervision of an agent's investments, it is now read as an absolute prohibition against the trustee's delegation of investment selection. *See* A. SCOTT, LAW OF TRUSTS § 171.2 (6th ed. 1970).

[20] 128 Mass. 258 (1880).

[21] *Id.* at 261.

[22] *Id.* at 261.

[23] *Id.* at 262.

[24] *See, e.g.,* Turnbull v. Pomeroy, 140 Mass. 117, 3 N.E. 15 (1886); Belding v. Archer, 131 N.C. 287, 42 S.E. 800 (1902). *See also* G. BOGERT, *supra* note 16, § 555, n.46 and cases cited therein.

[25] G. BOGERT, *supra* note 16, § 555.

[26] *See, e.g., In re* Harzel's Will, 43 Ill. App. 2d 118, 192 N.E.2d 697 (1963).

[27] *See, e.g.,* Peach v. First Natl Bank, 247 Ala. 463, 25 So. 2d 153 (1946); Matter of Whipple, 19 N.Y.S.2d 105 (1940). *See also* A. SCOTT, *supra* note 19, § 171, n.1.

management.[28] Every rationale leads to the same general rule of nondelegability of investment discretion.[29]

Judicial decisions have made very few inroads into the well-entrenched rule of nondelegation. Several courts have allowed trustees to circumvent the rule by labeling a trustee's action the procurement of investment advice, rather than the delegation of investment discretion. In *Attorney General v. Olsen,*[30] five trustees were empowered to sell certain trust real estate and stock and to invest the proceeds. The income was to be accumulated until a sum sufficient to build a museum was acquired. Since none of the trustees possessed investment expertise, they entered into an agency agreement with a local bank. The bank was to "act as custodian of the securities, advise the trustees as to investments and handle the bookkeeping for the trust."[31] Because of this delegation of authority and other irregularities, the attorney general brought suit to remove the trustees.[32] The trial court found the agency agreement to be a delegation of the trustees' investment duties. The Supreme Judicial Court of Massachusetts reversed this finding, reasoning that the trustees did not abrogate their duties, but rather properly sought expert advice.[33] The Restatement position is similar: as long as the trustee makes the final decision, obtaining investment advice does not constitute delegation.[34] The position taken by the Restatement may ultimately be adopted by a majority of courts.

At least two other jurisdictions concur with Massachusetts' position concerning the trustee's ability to seek investment advice.[35] There is au-

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28 A. SCOTT, *supra* note 19, § 171.2.

29 RESTATEMENT (SECOND) OF TRUSTS, § 171, comment h (1959).

30 346 Mass. 190, 191 N.E.2d 132 (1963).

31 *Id.* at 193, 191 N.E.2d at 134.

32 Since charitable trusts have no specified beneficiaries, there can be no suit by the beneficiaries to force the trustee to act. For enforcement of the charitable trustee's obligations, the law has placed the responsibility on the state attorney general. G. BOGERT, *supra* note 16, § 411; A. SCOTT, *supra* note 19, § 391. *But cf.* Kutner & Koven, *Charitable Trust Legislation in the Several States,* 61 NW. U.L. REV. 411, 423 (1966). Anyone else wishing to sue the trustee must prove special interest to obtain standing. G. BOGERT, *supra* note 16, § 411; A. SCOTT, *supra* note 19, § 391. Even the settlor has generally been held not to possess the requisite special interest, although one court has apparently altered the rule. Lokey v. Texas Methodist Foundation, 479 S.W.2d 260 (Tex. 1972). It has shown, however, that attorneys general seem to concentrate on the more obvious breaches of fiduciary duty, rather than on improving the efficiency of trust investments. *See* M. FREMONT-SMITH, *supra* note 4, at 328-29.

33 Specifically, the court found that:

> None of the trustees had had much, if any, experience in the field of investments, and it was entirely proper for them to seek expert advice. The record reveals that the trustees were consulted on the investments made and gave their approval to such investments . . . . While a trustee cannot surrender to another his duties with respect to investments, he may seek the advice of those better qualified. That is what was done here . . . . The agent's power over investments was subject to the approval of the trustees . . . .

346 Mass. at 197, 191 N.E.2d at 136. *Contra,* City of Boston v. Curley, 276 Mass. 549, 177 N.E. 557 (1931); Winthrop v. Attorney General, 128 Mass. 258 (1880).

34 RESTATEMENT (SECOND) OF TRUSTS, § 171, comment f. (1959).

35 *In re* Sellers' Estate, 31 Del. Ch. 158, 67 A.2d 860 (1949); *In re* Greata's Will, 172 Misc. 955, 17 N.Y.S.2d 776 (1939). *See also* A. SCOTT, *supra* note 19, § 188.3.

thority, however, refusing to permit such advice by characterizing it as an improper delegation.[36] Therefore, regarding the trustee's ability to seek investment advice, there is a division of authority,[37] but the case law is not extensive and perhaps is inconclusive.[38]

An alternative limitation on the rule of nondelegation is judicial ability to alter the purposes of charitable trusts and to permit administrative modifications. The power to change purposes is known as *cy pres*,[39] and the power to modify trust administration is derived from the "doctrine of deviation."[40] However, these limitations have not been regularly used to restrict the rule of nondelegation because not all states accept them,[41] and the states which have adopted the limitations apply them in widely divergent manners.[42]

Furthermore, the purpose of these doctrines is simply to solve internal problems of the trust, that is, those created by the trust instrument. Neither is designed to alter a rule imposed by the courts in the absence of specific provisions in the instrument creating the trust.[43]

It is, therefore, unlikely that the natural person trustee will be able to escape the rule of nondelegation simply by means of a petition to the state court. Nevertheless, although the common law rules appear to pose some problems for the individual trustee, they could best be described as an inconvenience, causing the often inexperienced trustee to devote a considerable amount of his time to the planning of trust investments.

The Tax Reform Act of 1969,[44] however, has placed new and signif-

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36 *In re* Gutman's Estate, 171 Misc. 680, 14 N.Y.S.2d 473 (1937).

37 Horowitz, *Uniform Trustees' Powers Act,* 41 WASH. L. REV. 1, 3 n.18 (1966).

38 Haskell, *Some Problems With the Uniform Trustees' Powers Act,* 32 LAW & CONTEMP. PROB. 168 n.26 (1967).

39 G. BOGERT, *supra* note 16, § 394.

40 *Id.* The distinction between these doctrines is not always clear:

> Sometimes an order which merely relieves the trustee of a handicapping limitation found in the trust instrument or merely permits the trustee to use funds to forward the original purposes of the trust in new ways is called the use of cy pres; whereas in reality it is a departure from the prescribed methods of operation without in any way varying the end results which the donor envisaged. While the effects of using these two powers are similar, the procedure, formalities, and evidence required for the use of one power may be different from the requirements applying to the use of the other power.

*Id.*

41 D. YOUNG & W. MOORE, *supra* note 4, at 29-30. The use of these doctrines may be described as follows:

> Not all American legal jurisdictions even recognize the *cy pres* doctrine, though in some the doctrine of *deviation* has been extended to include a change of purpose . . . .
>
> Among those jurisdictions where the courts at least nominally recognize the *cy pres* doctrine, or will extend the doctrine of deviation to include purpose, there is a substantial variation in the willingness of the courts actually to exercise discretionary powers. Strict construction, both as to purpose and as to procedure, is the general rule.

*Id.*

42 *Id.*

43 G. BOGERT, *supra* note 16, § 394.

44 83 Stat. 487 (codified in scattered sections of 26 U.S.C.)

icant restrictions on the trustee. These restrictions take the form of taxes upon certain activities of private foundations.[45] One such tax encourages a foundation to distribute to charity all of its investment income.[46] Congress attempted to assure this result by fixing a minimum amount which must be distributed annually. In the Tax Reform Act this amount was set at 6 percent[47] of the fair market value of the foundation's assets.[48] Failure to pay out to charity at least this amount results in an initial tax of 15 percent of the undistributed income.[49] If the foundation fails to pay out the minimum amount after the initial tax is levied against it, a tax of 100 percent of the undistributed income is assessed.[50]

This tax presupposes the trustee's involvement in one of three possible situations. First, the trustee could achieve a 6 percent investment return and distribute this amount, less taxes,[51] to charity. This action would constitute compliance with the statute. A second possibility is that the trustee manages to achieve a return of more than 6 percent. The excess in this case can not be accumulated, for it is the higher of the minimum investment return or adjusted net income which must be distributed.[52] Thus a foundation must distribute all its investment income.[53] Finally,

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45 The Tax Reform Act has made the distinction between charitable trusts and nonexempt trusts, all of whose interests are devoted to charitable purposes, largely unimportant. "A trust which is not exempt from tax under section 501(a)" and which devotes its interest to "religious, charitable, scientific, literary, or educational purposes" and for which a deduction was allowed is to be treated in the same way as an exempt organization. INT. REV. CODE of 1954, §§ 170(c)(2)(B), 4947(a). Both kinds of trusts are deemed to be "private foundations." INT. REV. CODE of 1954, § 509(a). This treatment prevents taxpayers from circumventing the restrictions which the Tax Reform Act of 1969 imposed on exempt charitable trusts by using the nonexempt trust form. *See* GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, at 88 (Comm. Print 1970) [hereinafter cited as GENERAL EXPLANATION].

46 INT. REV. CODE of 1954, § 4942.

47 *Id.* § 4942(e)(3).

48 *Id.* § 4942(e)(1). Six percent is the multiple originally set by Congress in the Tax Reform Act of 1969. However, the Commissioner of Internal Revenue, pursuant to the power granted him in Section 4942(e)(3), has twice changed the multiple. *See* Treas. Reg. §§ 53.4942(a)(2)(c)(5)(a)-(b) (1973); Treas. Reg. § 53.4942(a)(2)(c)(5)(a)(ii) (1973). These changes supposedly correspond to the original multiple of 6 percent since any determination of the multiple by the Commissioner "shall bear a relationship to 6 percent which the Secretary or his delegate determines to be comparable to the relationship which the money rates and investment yields for the calendar year immediately preceding the beginning of the taxable year bear to the money rates and investment yields for the calendar year 1969." § 4942(e)(3). If these new multiples do correspond to the original 6 percent multiple in reflecting current market conditions, the discussion in the text concerning the effect of the original multiple should be equally applicable to the multiples for 1973.

49 INT. REV. CODE of 1954, § 4942(a).

50 *Id.* § 4942(b).

51 *Id.* § 4942(d)

52 *Id.* § 4942(d)(1).

53 This statement must be qualified somewhat, since there is a limited carryover provision. INT. REV. CODE of 1954, § 4942(i). The Staff of the Joint Committee on Internal Revenue Taxation described this exception as follows:

> A[n] . . . exception is provided where a private foundation distributes more than the minimum required payout in a given year. Such excess distributions may be applied against required payouts in the next 5 years.

GENERAL EXPLANATION, *supra* note 45, at 38.

the trustee may fail to achieve an amount equal to the fixed minimum investment return. For example, he may invest too heavily in growth stocks. Nevertheless, the trustee must distribute the statutory minimum to charity. Such a distribution may frequently require reaching into the trust's corpus.[54]

A second potential tax liability results from the federal embodiment of the prudent man rule.[55] A tax is imposed on any foundation and its managers which invest "any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes."[56] The Commissioner of Internal Revenue has explained this phrase in language reminiscent of *Harvard College v. Amory*:[57]

> [A]n investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time, in providing for the long and short-term financial needs of the foundation to carry out its exempt purposes.[58]

If found guilty of violating this standard, both the trust and its trustees suffer. The initial tax on the foundation is 5 percent of the amount imprudently invested.[59] The initial tax on any foundation manager who knowingly participates in such investment is also 5 percent of that amount.[60] Failure to correct this investment results in an additional tax of 25 percent on the foundation and 5 percent on any uncooperative foundation manager.[61] A trustee who imprudently handles trust funds not only faces liability for violation of the common law prudent man rule, but he also may incur potentially crippling tax liability, both personally and on behalf of the trust. The Act imposes a $5,000 ceiling on the trustee's initial liability and a $10,000 ceiling on the trustee's liability for failure to correct the jeopardizing investment.[62] There is no limit on the liability of the trust. Despite this ceiling, the trustee's liability can exceed $15,000, for the trust may seek indemnification from the trustee for its tax liability because of imprudent investment. Such indemnification is made possible by the common law rule that the trustee's

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54 *See* GENERAL EXPLANATION, *supra* note 45, at 37. The effect of Section 4942 was described as follows:

> [Section 4942] . . . does not mean that a foundation may not make low yield investments if it so desires. However, if it does so it is likely that the foundation will find either that it periodically must sell shares to enable it to meet the payout requirements or that it must distribute shares to public charities in partial satisfaction of those requirements.

*Id.*

55 INT. REV. CODE of 1954, § 4944.

56 *Id.* § 4944(a).

57 *See* notes 15-18 and accompanying text *supra.*

58 4 P-H 1974 FED. TAXES ¶ 34,976.5. *See* note 16 *supra.*

59 INT. REV. CODE of 1954, § 4944(a)(1).

60 *Id.* § 4944(a)(2).

61 *Id.* § 4944(b).

62 *Id.* § 4944(d)(2).

negligence or misconduct concerning investments, such as a violation of the prudent investment rule,[63] is a breach of fiduciary duty.[64] For this breach of fiduciary duty, the trustee's liability for money damages depends on the principle that the injured party is to be put in the position he would have been in had the trustee not breached his duty.[65] Thus, theoretically, the trustee, through indemnification, can be made to bear the entire burden of the taxes imposed on foundations by the Tax Reform Act of 1969.[66]

The same theory of indemnification can be applied to the trustee who invest too heavily in growth stocks, thus achieving a low investment yield and requiring a distribution of part of the corpus to satisfy the minimum distribution requirements of the Internal Revenue Code.[67] The recovery in this case would be the amount by which the trust was forced to reduce its corpus in order to satisfy the distribution requirements.

The trustee thus faces a serious problem. The type of investments which he selects will have to return a sum equal to the Internal Revenue Code's minimum investment return. If this amount is fixed at a percentage of the trust's assets necessitating investment in securities which have a high yield in current markets,[68] the trustee may be forced into an investment portfolio that inadequately provides for the future development of the trust. Such a portfolio might subject the trustee to liability for violating the prudent man rule,[69] with the financial burden ultimately coming to

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[63] *See* Lynch v. John M. Redfield Foundation, 9 Cal. App. 3d 293, 88 Cal. Rptr. 87 (1970). The court stated:

> We are satisfied . . . that the directors failed to meet the standards of the prudent investor rule . . . . There is substantial evidence of good faith and the trial court so found. But good faith is no defense in an action based on negligence.

*Id.* at 301-02, 88 Cal. Rptr. at 91.

[64] G. BOGERT, *supra* note 16, § 862 n.56.

[65] *Id.* § 701 n.20.

[66] Apparently this theory of indemnification has not been used to hold the trustee liable for the increased tax liabilities of the trust caused by his negligent investment, although it is a recognized remedy for losses caused by the trustee's violation of the common law prudent man rule. *See* Lynch v. John M. Redfield Foundation, 9 Cal. App. 3d 293, 88 Cal. Rptr. 87 (1970).

This lack of authority does not present an insurmountable obstacle to an indemnification remedy, however. Both the common law rule and the federal statute establish a similar standard for trustee investments. *See* notes 15-18, 55-62 and accompanying text *supra*. Furthermore, the policy which produced both rules is the same: the protection of the trust from a trustee's speculative investments. In *Harvard College v. Armory*, the court emphasized the need to consider the "probate safety of the capital" as well as the "probable income." 26 Mass. (9 Pick.) 446, 461 (1830). Similarly, in enacting the new tax liabilities for imprudent investment, "the Congress determined that investments which jeopardize the foundation's corpus should not be permitted." GENERAL EXPLANATION, *supra* note 45, at 46. Since the policy and the standard of both rules are similar, violation of either rule would probably be treated as negligence on the part of the trustee, thus making him liable to the trust for taxes or losses which resulted from his breach of fiduciary duty.

[67] *See* notes 46-54 and accompanying text *supra*. *See also* INT. REV. CODE of 1954, § 4942.

[68] *See* note 48 *supra*.

[69] *See* notes 15-18, 55-62 and accompanying text *supra*.

rest on the trustee alone.[70] On the other hand, if the trustee tries to provide for the future of the trust but fails to generate an adequate current investment yield, he may be forced to meet the minimum payout requirements by invading the trust corpus. Again, it is possible for ultimate liability to be placed upon the trustee.[71]

The extent of the trustee's potential liability underlines the necessity for investment expertise in the management of a charitable trust portfolio. However, in many instances,[72] such expertise can be utilized only by delegating the trustee's investment discretion.

## II. DELEGATION: PRO AND CON

### *A. Arguments for Delegation*

After completing a study of the rules governing directors of charitable corporations and trustees of charitable trusts, the American Bar Association's Section on Real Property, Probate and Trust Law concluded that delegation of investment powers is needed in the operation of many charities, whether they are corporations or trusts, because the trust rule seems unduly restrictive.[73] Critics of the status quo have advanced three arguments which support this conclusion in its application to investments. First, it has been argued that most restrictions on the power of trustees are outmoded and ill-suited to present needs, since the type of trust for which the rules were designed no longer exists.[74] Thus, evolution in the

[70] *See* notes 62-66 and accompanying text *supra*.

[71] *See* note 67 and accompanying text *supra*.

[72] *See* notes 6-12 and accompanying text *supra*.

[73] Committee on Charitable Trusts, *Duties of Charitable Trust Trustees and Charitable Corporation Directors*, in 2 ABA REAL PROPERTY, PROBATE AND TRUST J. 545, 564 (1967).

[74] *See* Fratcher, *Trustees' Powers Legislation*, 37 N.Y.U.L. REV. 627 (1962). The historical evolution of trusts has been described as follows:

> [T]he rules were crystallized two centuries ago by precedents developed in the interpretation of the terms of trusts of that period. These were primarily settlements of ancestral land made by the heads of great English families . . . . [U]sually trustees were introduced only for the purposes of preserving contingent remainders, protecting the eldest son during minority and raising portions for daughters and younger sons. With such trusts, narrow construction of express powers and reluctance to find implied powers were beneficial to the primogenitary heir and ordinarily reflected the true intention of the settlor. The principal purpose of the settlement was to keep the ancestral land in the family and to preserve it in the condition in which it had been received from the settlor's ancestors.
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> In this country today trusts are commonly created for the investment and active management of a fund. The settlor is not interested in keeping particular land or other property in the family or in preserving its ancient condition. He ordinarily intends that the trustee shall have all the powers needed for efficient and economical management with a view to the production of adequate income and enhancement of the principal for the benefit of the cestuis qui trust. The application of the old restrictive rules to this type of trust tends to thwart the real intention of the settlor by depriving the trustee of powers essential to the achievement of the settlor's true purposes.

*Id.* at 658.

subject matter and purposes of the trust has not been matched by a corresponding development of trust law. Consequently, some restrictions, such as nondelegation of discretionary functions, may have ceased to serve the purpose for which they were originally intended.

A second argument in favor of delegation is based on the allegedly inadequate investment management of charitable foundations. Foundations' investment returns have been significantly below average when compared with other investment funds,[75] and one of the major factors cited as responsible for this phenomenon is that "the managers of the foundations have not given a high priority to the effective management of the funds."[76] The solution advocated by critics is not for the trustee to devote more of his time to investments, but rather for the investments of charitable trusts to be managed by professionals. Furthermore, the need for professional expertise has become especially acute because of the imposition of minimum distribution requirements by the Tax Reform Act of 1969.[77]

A third argument advanced in support of delegation rests upon a premise which conflicts with that of the preceding argument. This premise is that trustees spend too much time solving investment problems and not enough in distributing trust income to charity.[78] The trustee who devotes most of his time to management of the investment portfolio of the trust may not make a very efficient distribution of the trust income. He may simply not have much time left to investigate adequately the projects and people to whom he distributes the trust's income. Much waste and inefficiency can occur.[79] If responsibility for trust investments could be shifted

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[75] *See, e.g.*, COMM'N ON FOUNDATIONS, *supra* note 3, at 74-75, comparing the investment performance of charitable foundations with that of mutual funds.

[76] The Commission found four factors influencing the poor investment performances of foundations. Aside from the inadequate attention g iven to trust management, the other factors are the prudent man rule, a high percentage of foundation assets consisting of controlling stock interests in a single corporation, and legal restrictions in the trust instrument upon selling certain securities. *Id.* at 75. *See also,* Murray, *Foundation Investments: Problems of Investment Policy,* in 10 N.Y.U. CONFERENCE ON CHARITABLE FOUNDATIONS 29 (H. Sellin ed. 1971).

[77] Heimann, *Discussion of the Peterson Commission Report,* in 10 N.Y.U. CONFERENCE ON CHARITABLE FOUNDATIONS 19 (H. Sellin ed. 1971). The reason for the distribution requirement has been described as follows:

> The subject of investment management has not been given adequate attention. And it isn't just a question of more detailed supervision by trustees. As in the management of university portfolios, what we are suggesting is that foundation investment ought to receive continuing professional management. The importance of the payout requirement is that it imposes an external discipline which will insure that adequate attention is given to investment management.

*Id.* at 21. *But see* B. MALKIEL, A RANDOM WALK DOWN WALL STREET (1973); N.Y. Times, Jan. 17, 1974, at 56, col 5.

[78] *See* U.S. DEP'T OF TREASURY, REPORT ON PRIVATE FOUNDATIONS 89th Cong., 1st Sess. 53 (Senate Finance Comm. Print 1965).

[79] The problem has been noted by the Treasury Department:

> Foundation trustees or directors who attempt to predict hourly, daily or weekly market fluctuations, who purchase puts, calls and straddles in an effort to profit from these fluctuations, who shift their positions in securities frequently, and who endeavor to assay the potentialities

to professional investment counsel, the trustee would be free to devote himself to distributing the trust's proceeds more carefully than is possible under the present system.

Whether one accepts the argument that the present rule has outlived its purpose, or that the trustee spends too little time managing investment funds, or that he spends too much, delegation of his investment function seems to offer an acceptable solution to the investment problems of the charitable trustee.

### *B. Arguments Against Delegation*

The arguments in favor of allowing delegation of investment authority by trustees have not received unanimous acceptance. Three objections to the idea of abolishing the present rule of nondelegation have been raised. *Winthrop v. Attorney General,*[80] which first articulated the rule of nondelegation, justified its holding primarily on the grounds that delegation of investment discretion violated the settlor's intent.[81] Under this view, delegation is thought to neutralize the choice of the settlor, a choice which involved the settlor's assessment of a trustee's ability and discretion regarding matters such as sensitive family relations.[82] This reasoning has evidently lost none of its persuasiveness, for it is still advanced in defense of the nondelegation rule.[83] While this logic may be persuasive with respect to noncharitable trustees and their responsibilities to the settlor's family, it loses much of its force when applied to charitable trustees.[84] In fact, the Tax Reform Act of 1969 penalizes almost all transactions between the foundation and a "substantial contributor" or members of his family.[85]

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> of untried businesses, the worth of untested mineral land, or the future value of unproven building locations must necessarily expend considerable amounts of time and attention in those endeavors. Little scope is likely to remain for charity. Charitable enterprises deserve—indeed, they require—analysis, evaluation, planning; they are not matters to be lightly undertaken or perfunctorily carried on; they merit the genuine interest and undivided attention of the persons to whom society has entrusted their accomplishment. Consequently, the efforts of the speculator or the trader . . . are intrinsically inconsistent with proper management of the affairs of a foundation.

*Id.*

[80] 128 Mass. 258 (1880).

[81] 128 Mass. at 261. *See also* Hallgring, *The Uniform Trustees' Powers Act and the Basic Principles of Fiduciary Responsibility*, 41 WASH. L. REV. 801 (1966). The author observes:

> The duty not to delegate derives from the nature of the trust relationship, not from the terms of the trust instrument. It recognizes that a settlor often selects a trustee because of personal confidence in him. Because a settlor has confidence in the ability of a given person to invest his money, we can not infer that he wishes to subject his estate to the decisions of some agent selected by that person, even in good faith.

*Id.* at 831-32.

[82] Hallgring, *supra* note 81, at 832.

[83] *Id.*

[84] *Cf.* note 74 *supra.*

[85] INT. REV. CODE of 1954, § 4941.

Furthermore, charitable trusts, because of their exemption from the rule against perpetuities, may continue indefinitely.[86] Even if personal considerations about the trustee's investment ability influenced the settlor's original choice, the trust and its needs will outlast the original trustee, and a successor may be chosen by the court on a different basis than the one the settlor used; for example, the successor trustee may not possess the same background for dealing with the members of the settlor's family. Therefore, it is unlikely that a settlor would choose a charitable trustee because of the trustee's expected ability to deal with family matters.

Finally, in analyzing the validity of this objection to delegation, one might ask how a solution which may both improve a trust's investment return and increase the effectiveness of its disbursements could possibly violate the intent of the charitable donor. In regard to the administration of his gift, the settlor's sole intention would seem to be that the trustee manage the corpus in the most efficient way. If delegation would increase the efficiency of trust administration, it could not conflict with the purpose of the donor. Thus, the objection that delegation does not comport with the intent of the settlor is unpersuasive in the setting of charitable trusts.

A second objection to delegation by the natural person charitable trustee is also derived from an inference about the settlor's intent. It has been argued that since the settlor could have selected a corporate trustee, which has the power to delegate its investment discretion, his selection of the natural person trustee evidences an intent that the trustee should have no power to delegate. Furthermore, if this difference in the powers of various trustees were to be eliminated, a certain flexibility inherent in the present system would be lost.[87] However, it is not at all clear that the choice of form reflects the settlor's intent as to the applicable law.[88] Additionally, the conclusion that delegation would result in the destruction of the present system's flexibility presumes the inability of the settlor to delineate the trustee's powers in the trust instrument. Yet, a settlor could provide for delegation of investment authority in the trust instrument and present courts would enforce it.[89] It is only in the absence of an express grant of delegation power that present law does not allow the trustee to delegate. The solution to the problems suggested by this objection to delegation is simply a matter of careful drafting of the trust instrument.

A final objection to delegation of investment management by the charitable trustee is that delegation will undermine the trustee's liability for improper investments since the present liability would be imposed on the trustee's agent.[90] The relative lack of effective state control over the in-

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[86] G. BOGERT, *supra* note 16, § 391. A. SCOTT, *supra* note 19, § 62.19(f), at 365.

[87] *See* Committee on Charitable Trusts, *Duties of Charitable Trust Trustees and Charitable Corporation Directors,* in 2 ABA REAL PROPERTY, PROBATE AND TRUST LAW J. 546 (1967).

[88] *Id.*

[89] Martin, *Settlor's Rights to Authorize Trustees to Delegate Investment Decision to Investment Counsel,* 60 ILL. BAR J. 392, 393 (1972). *See* also Haskell, *supra* note 38, at 169.

[90] Hallgring, *supra* note 81, at 833.

vestment activities of charitable trusts compounds the problem.[91] As a result, it is feared that the standards of trustee conduct will be lowered.[92]

Even if the trustee is allowed to delegate investment management, he would not be permitted to delegate all of his trust responsibilities,[93] and the trustee's liability for misconduct would remain the same in all areas except investment. Thus, control of the trustee by the attorney general probably would not diminish significantly if delegation were allowed. Additionally, although the trustee will not be directly responsible for particular investments, he will retain an indirect responsibility for all of them because of his duty to use reasonable care in his choice of investment managers.[94] He has a further duty to generally supervise the activity of the agent.[95] Since the trustee will be receiving the income realized from the trust's assets in order to disburse it, he will have an excellent opportunity to determine if the agents are performing competently, and if the trustee is negligent in his appraisal of the investment advisor's effectiveness, he will be liable for breach of trust.

While the attorney general would have to supervise investment agents if he desires to maintain control over charitable trust investments, the trustee need not be freed from all scrutiny. Trustees would probably delegate their investment authority to financially responsible agents like banks and trust companies. Therefore, the attorney general could have a larger fund out of which to collect damages for improper investment.

### *C. Delegation as a Solution*

Changing the present rule of nondelegation is likely to produce better investment of trust funds since investment will be handled by those with expertise. Equally beneficial will be the more effective use of funds as the trustee concentrates on efficient distribution of money to charity and deserving beneficiaries. When considering both the reasons for and objections to the delegation of the charitable trustee's investment function, delegation emerges as a feasible and practical solution to the problems of the natural person charitable trustee.

## III. PROPOSALS FOR REFORM

Various approaches have been suggested to change the present rule of nondelegation. These proposals can be placed into two general categories: the drafting solution and the legislative solutions.

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[91] *See* note 32 *supra*.

[92] *See* Hallgring, *supra* note 81, at 833-36 for a discussion of the results of delegation permitted under the Uniform Trustees' Powers Act. *See also* note 105 *infra*.

[93] RESTATEMENT (SECOND) OF TRUSTS, § 171(c) (1959):

> The trustee cannot properly commit the entire administration of the trust to an agent or co-trustee or other person, unless he is permitted to do so by the terms of the trust.

[94] *Id.* § 225(2)(c), at 522.

[95] *Id.* § 225(2)(c), at 522.

### *A. The Drafting Solution*

One solution to the charitable trustee's problems would involve no change in existing law, for a clause permitting delegation can be included in every trust instrument and will be upheld by the courts.[96] This remedy would require careful drafting of the trust instrument since an overly broad grant of power may be voided by a court as contrary to public policy.[97] Yet, if the instrument is well drafted and the trustee can show that a prudent investor would have delegated in similar circumstances,[98] the courts will permit delegation.[99] However, the drafting solution provides no relief for the unfortunate trustee whose trust instrument does not contain a delegation provision. A second drawback of this approach is that it overlooks the fact that even the most careful draftsmen make mistakes. If counsel should erroneously omit the delegation clause from the instrument, the trustee would still find it necessary to conform to the current rule of nondelegation. Therefore, while certainly a possible solution to the trustee's delegation problems, the drafting proposal is an incomplete one.

### *B. Legislative Solutions*

To afford all trustees the advantages of delegation, legislative intervention would be necessary. The legislation could take the form of a statute which would provide the natural person charitable trustee with the option of delegating investment management if a prudent man would do so.[100] A possible model for this kind of legislation is a California statute which allows the directors of nonprofit corporations to delegate investment authority.[101] Even the method of adopting a specific statute is not without difficulties. Charitable trust law is cluttered with narrow legislative directives,[102] and the practice of enacting a specific statute for each trust problem as it comes to the attention of the lawmakers has been criticized as producing "an unsatisfactory patchwork" of legislation.[103] More piecemeal legislation can only add to the confusion.[104]

The objection to adding another item to the legislative catalogue of remedies must be weighed against the alternatives. The drafting of a trust

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96 Martin, *supra* note 89, at 392-93.

97 *Id.* at 394-95.

98 *See* notes 15-18 and accompanying text *supra.*

99 Martin, *supra* note 89, at 394-95; Haskell, *supra* note 38, at 169.

100 *See* notes 20-22 and accompanying text *supra.*

101 The relevant provision reads:

> The directors or trustees of any such common trust fund, or trust funds, so organized, may employ such officers or agents as they think best, define their duties, and fix their compensation. They may also appoint a trust company or bank as custodian of the trust estate and may employ an investment advisor or advisors, define their duties and fix their compensation.

CAL. CORP. CODE § 10250(b) (West 1955).

102 Haskell, *supra* note 38, at 168.

103 *Id.*

104 An alternative to piecemeal alterations to present laws is the complete revision of a state's trust law, including a provision allowing delegation of investment authority by charitable trustees. Support for such a revision is evidenced by the promulgation of two uniform trust acts, both of which contain provisions allowing delegation.

instrument to permit delegation is an incomplete solution[105] for it would not prevent the trustee from suffering from the mistake or omission of the draftsman.[106] On the other hand, a statute would alter the law applicable to all trustees by a single act, rather than depending upon case by case adjudication.[107] Enactment of a specific statute is not a perfect solution, but, when balanced against the flaws in competing proposals, it seems to offer the most sensible approach to this problem.

## IV. CONCLUSION

The common law rule of nondelegation[108] combined with the effects of the prudent investor rule and the foundation reforms of the Tax Reform Act of 1969[109] place the natural person charitable trustee in an untenable position. Delegation of the trustee's discretionary function of investment selection will not only benefit him by freeing him from the threat of potential liability, but will also result in more efficient administration of charitable trusts. The ultimate beneficiary of legislation which permits delegation in appropriate cases will not be the trustee. Rather, delegation will encourage a better allocation of charitable resources, benefiting society generally, as settlors intend.

—*Richard B. Urda, Jr.*

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*See* UNIFORM TRUSTEES' POWERS ACT § 3(c)(24); UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT § 5. The latter only applies to institutional trustees. UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT § 1(a). However, the Trustees' Powers Act allows individual trustees to

> employ persons, including attorneys, auditors, investment advisors, or agents, even if they are associated with the trustee, to advise or assist in the performance of his administrative duties; to act without independent investigation upon their recommendations; and instead of acting personally, to employ one or more agents to perform any act of administration, whether or not discretionary.

UNIFORM TRUSTEES' POWERS ACT § 3(c)(24). The primary limitation on this act as a solution to the problem of delegation is the fact that it is a comprehensive revision of the law as it applies to natural person trustees. Many provisions of the act have provoked strong criticism by commentators. *See* Haskell, *supra* note 38, *passim*; Hallgring, *supra* note 81, *passim*. It thus appears that a single statute, specifically directed toward the natural person trustee's current problems in regard to the delegation of investment discretion, is more feasible than the attempt to bring about enactment of a uniform act.

105 *See* Part III *A supra*.

106 *See* Haskell, *supra* note 38, at 169. Haskell observes:

> It may well be said that the law as it presently stands, to the extent that it is restrictive of fiduciary power where freedom of fiduciary action is desirable, or to the extent that the existence or nonexistence of such power is in doubt, only serves to penalize those whose counsel did not anticipate the particular power that subsequently seemed to be called for.

*Id. See also* Part III *A supra*.

107 *See notes* 30-43 and accompanying text *supra*. Furthermore, the legislature would not have to enact reforms of other aspects of trust law to change the delegation rule. The statute would deal with only the specific investment dilemma of the natural person charitable trustee and not grant him powers inappropriate or useless to his administration. The limited purpose of the statute enhances its chances of political acceptability. *See* note 104 *supra*.

108 *See* notes 19-29 and accompanying text *supra*.

109 *See* notes 15-18, 44-72 and accompanying text *supra*.