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Investment Provisions of Wills and Trust Agreements

By GILBERT T. STEPHENSON*

The investment provisions of a will or trust agreement should, as a matter of course, be drawn in the light of the investment statutes and decisions of the state in which the trust is to be administered and in which the property is situated. Accordingly, the investment provisions of this article are suggested in the light of Kentucky statutes and decisions.

In this article the term "investment" is used in a somewhat broader sense than is customary in everyday conversation. Ordinarily, when a layman speaks of his investments, he means only his mortgages, bonds, and stock, not his real property nor business. In the discussion that follows, "investments" include not only these conventional types of investment but also every other kind of property or property interest that may constitute a trust *res*. The term embraces real property, businesses and business interests, and property rights of every kind—anything and everything that is "property" in legal contemplation.

Furthermore, the investment provisions of a will or trust agreement should contain a great deal more than the mere discretion or direction of the trustee as to what investment to retain or to dispose of and what new investment to make or not make. They should set forth clearly and simply the trustee's powers and duties with respect to the management of the trust property. And the management of trust property must be adapted to its nature. Analysis and review of stocks and bonds for retention, conversion, or acquisition involve fundamentally different activities and responsibilities from those of the management of businesses or operation of farms.

The consequence of this broad definition of the terms, "investment" and "investment provision," in this discussion is that the suggested provisions of wills and trust agreements are much

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longer and more detailed than they would need to be if only retention, conversion, sale, or purchase were involved. Brevity is not one of the cardinal virtues of modern draftsmanship; clarity and simplicity are.

Kentucky is classified as a prudent-man-rule state, although its investment statutes are not worded according to the conventional prudent-man rule. After specifying certain types of bonds, obligations, and warrants issued or insured by the State or Federal Government or by some governmental agency, real property approved by the county court, and life insurance and annuity contracts in which a fiduciary *may* invest trust funds, the statute goes on to say that a fiduciary may invest also in "real estate mortgage notes, bonds and other interest-bearing or dividend-paying securities which would be regarded by prudent businessmen as safe investments."¹

It is and long has been the rule in Kentucky that the creator of a trust may direct the mode of investment, and that such directions are binding unless they are impossible of fulfillment or unless intervening circumstances make the safety of such investment doubtful.²

In Kentucky the creator of a trust has the privilege of making the investment powers of his trustee as broad or as narrow as he pleases, provided he does not make provisions that are impossible of fulfillment. The statute expressly declares that its own provisions shall not be construed to permit a sale, investment or loan in conflict with the provisions of the will, deed or other instrument creating the trust, or under which the funds or property may be held.³

The statute also covers the retention of original investments—that is, property turned over to the trustee at the time of creation of the trust or added later in the selection of which the trustee himself had no part nor responsibility. The statute provides:

Where securities originally received by a fiduciary do not meet the requirements for the investment of trust funds, or where securities in which trust funds have been properly invested become ineligible for investment of trust

¹ KY. REV. STAT. 386.020.

² *Citizens' National Bank v. Jefferson* 88 Ky. 651, 11 S.W. 767 (1889) and *Hacketts' Executors v. Hacketts' Devises*, 180 Ky. 406, 202 S.W. 864 (1918).

³ KY. REV. STAT. 386.060.

funds, such ineligible securities shall be sold at such time and upon such terms and conditions, or shall be held or otherwise handled in such manner as prudent businessmen would consider proper.⁴

Thus the prudent-man—or, technically, it would be more accurate to say, the prudent businessman rule—is applied (1) to the retention of original investments that did not meet the requirements for the investment of trust funds from the beginning and (2) to investments properly made by the trustee himself that had ceased to be proper investments for trust funds. As to each kind of ineligible investments the trustee is placed under a duty to sell, hold, or otherwise handle as a prudent businessman would do.

It is in the light of the foregoing very brief sketch of the present trust-investment legislation—statutory and judicial—in Kentucky that the following investment provisions of wills and trust agreements are suggested for the consideration of the draftsmen of Kentucky wills and trust agreements.

Original Investments

The executor or trustee is authorized to retain any of the original property constituting my estate at my death, including any stock that I may own in Bank and Trust Company or its successor, regardless of the character of such property or whether it is such as then would be authorized by law for investment by trustees or whether it leaves a disproportionately large part of my estate invested in one type of property, for such time as to the executor or trustee shall seem best, and to dispose of such property by sale, exchange, or otherwise as and when it shall seem advisable to the executor or trustee.

With only slight changes of wording, this provision, drawn for a will, would be equally appropriate for a trust agreement.

The executor as well as the trustee is included in order to relieve either of them of any doubt of his power to retain what otherwise would be ineligible investments.

Bank's Own Stock. The present statute possibly covers amply the retention of the bank's own stock where it is the executor or

⁴ KY. REV. STAT. 386.070,

trustee of the estate of one of its own stockholders. The statute provides:

... if shares of its own capital stock or shares of the capital stock of an affiliated institution are received by any bank or trust company direct from the testator or donor, as an original investment in an estate or trust, the fact that they are shares of the fiduciary institution, or an affiliate thereof, shall not, of itself, be sufficient to cause them to be considered improper investments, regardless of the number of said shares or value thereof, but said shares together with any additional shares subsequently acquired through the exercise of rights issued in respect thereto shall be regarded as proper investments in the hands of such fiduciary bank or trust company, if they would be so regarded if held by an individual acting in such fiduciary capacity.⁵

Diversification. The retention of original investments under the blanket authority of this provision may run afoul the principle of diversification⁶. A major portion of a businessman's estate may consist of stock in his family corporation; of a farmer's estate, in his farm land and equipment. The retention of the stock or of the farm lands and equipment would disregard the principle of diversification. Yet this, very likely, is what the testator or settlor would want. If so, he should relieve the trustee of the duty to diversify so long as and to the extent that the retention of original investments would prevent usual or even adequate diversification.

New Investments

The trustee is authorized to invest and reinvest in stocks (common or preferred), including stock and stock-rights in the Bank and Trust Company or its successor; in bonds, notes, or mortgages on property in or outside the State of Kentucky; in insurance contracts on the life of any beneficiary or of anyone in whose life a beneficiary has an insurable interest or in annuity contracts for any beneficiary; in real property, whether productive or not at the time of investment; in participations in common trust funds or in real estate mortgage investment funds established and administered by the Bank and Trust Company or its successor for the exclusive use of its estates, trusts, and guardianships; and, generally, in such property as to the trustee seems advisable and in such pro-

⁵ KY. REV. STAT. 386.025.

⁶ SCOTT, TRUSTS SECS. 228, 230.3 (1939).

portions of such property as to him seems advisable, even though such investments or such proportions are not of the character or the proportions approved by the applicable law for the investment of trust funds.

Although the statutes and decisions cover most of the points in the foregoing provision, it may be a convenience and assurance to the trustee and his legal adviser to find these new-investment powers spelled out in the will or trust agreement.

Bank Stock and Stock-Rights. In Kentucky, although a bank or trust company can retain its own shares and exercise stock-rights as to original investments, it cannot make new investments in its own shares unless it is expressly authorized to do so by the instrument. The statute provides:

No bank or trust company empowered to act as a fiduciary under the laws of this State shall purchase shares of its own capital stock or shares of the capital stock of an affiliated institution as an investment for any estate or trust under its management, unless expressly authorized to do so by the instrument creating the estate or trust, or unless acquired through the exercise of rights issued in respect of stock originally received.⁷

If the stockholder of a bank or trust company names it his executor or trustee and wishes it to have power to invest his trust funds in its own shares, he should expressly authorize the executor or trustee to make such an investment.

Mortgages on Out-of-State Property. If the settlor or testator or if the executor or trustee resides near the state line and if a portion of another state is within the trade-area of the estate or trust and there is any real likelihood that the trustee ever may desire to invest in bonds or notes secured by a mortgage on out-of-state property, it will be advisable for the will or trust agreement to contain this express power.

Life Insurance and Annuities. In the foregoing provision the trustee is authorized to invest in life insurance and annuity contracts.

The Kentucky statute authorizes a fiduciary to invest in:

⁷ KY, REV. STAT. 386.025,

Life insurance, endowment and annuity contracts issued by legal reserve companies authorized to do business in this State, after obtaining the approval of the county court for such investment. Said fiduciary may select any optional settlement provided in the policy maturing by death or as an endowment.⁸

Here the fiduciary is not authorized by statute to invest in life insurance or annuity contracts except with the approval of the county court. If the creator of the trust desires to put the full responsibility upon the trustee, he should grant the trustee such power and relieve him of the duty to go to the county court for approval.

The brief clause about life insurance and annuity contracts in the foregoing provision, as it stands, might relieve the trustee of the duty to obtain the approval of the county court; but, in the light of the statute, it might be advisable to add to the clause the phrase, "without the approval of the county court."

Professor Casner thinks that the insurance and annuity clause might be amplified to read somewhat as follows:

The trustee is authorized, in his uncontrolled discretion, to insure the life of any beneficiary whose trust is involved, the face amount of such insurance not to exceed (\$.....) Dollars, and the proceeds of said life insurance to be payable to the trustee of the trust for such beneficiary. The trustee may pay the premiums on said life insurance from the income or the principal of the trust for such beneficiary. The trustee may apply any or all dividends on said life insurance to the payment of the premiums thereof. If at any time the trustee deems it unwise to continue any of said life insurance, he may surrender the policy or policies therefor and collect the amount due upon such surrender. The proceeds of said life insurance which are collected on the death of the insured or on the surrender of the policy or policies of insurance shall be added to the principal of the trust for such beneficiary. Insurance taken out by the trustee in the exercise of the authority given herein may be term insurance or straight life insurance, or any other kind of life insurance, as the trustee in his uncontrolled discretion determines is in the best interest of the beneficiary of the trust.⁹

⁸ KY. REV. STAT. 386.020.

⁹ CASNER, ESTATE PLANNING 1953 Supplement 17 (1953).

Unproductive Property. Occasion frequently arises when it is to the best interest of the beneficiary for the trustee to invest in unproductive property. For example, the trustee, as would a prudent businessman, may deem it wise to invest trust funds in woodlands or even in wastelands adjoining productive real property for privilege sake or some other perfectly sound reason.

However, in investing in unproductive property, no matter how wisely or prudently, the trustee should have these two things in mind: (1) The possible effect upon the marital deduction and (2) the effect upon the immediate beneficiary's income.

1. Effect upon marital deduction. Since investment in unproductive property (unless it can be and will be converted into productive property within a reasonable time) is not an allowable marital deduction, the draftsman should limit the power of the trustee in this respect, that his power to invest in unproductive property shall not be exercised nor be exercisable in any way that would affect the marital deduction.

2. Effect upon income of immediate beneficiary. A substantial investment in unproductive property will, as a matter of course, reduce the income payable to the immediate beneficiary, and this may have serious consequences. This can be avoided by giving the trustee power, in his uncontrolled discretion, to make up out of principal what the beneficiary loses in income.

Common Trust Funds and Real Estate Mortgage Investment Funds.

Present statutes authorize Kentucky banks and trust companies to establish and operate common trust funds¹⁰ and real estate mortgage investment funds.¹¹ The draftsman should explain to his client what is meant by each of these funds, what purposes they are designed to serve, and have the client himself say whether or not he wants his trustee to purchase for his trust participations in either or both of these types of commingled funds.

The draftsman would, of course, make it clear to his client that, if he named an individual trustee, he need not say anything

¹⁰ KY. REV. STAT. 287.230.

¹¹ KY. REV. STAT. 287.240-287.270.

about these funds because, under present law and regulation, they can be operated only by corporate fiduciaries. He should make it clear also that at the present time one bank or trust company cannot purchase participations in the funds of another bank or trust company. If the client, after the matter has been explained to him, decides that he would like to give his bank or trust company such power, he should incorporate in his will or trust agreement some such provision as the foregoing even though at the time the bank or trust company does not have such a fund; it might later.

Businesses and Business Interests

The executor and trustee are authorized to continue and operate any business owned by me at my death and to do any and all things deemed needful or appropriate by the executor or trustee, including the power to incorporate the business alone or in conjunction with others and to put additional capital into the business for such time as to him shall seem advisable, without liability for loss resulting from the continuance or operation of the business except for his own negligence; and to close out, liquidate, or sell the business at such time and upon such terms as to him shall seem best.

To an increasing extent businessmen want their businesses carried on after their death. The profits may be greater than income from stocks and bonds. They may want to pass the business on to their sons. If the client wants his business carried on after his death, in his will he not only should say so but also give his executor and trustee power to carry it on in the way a prudent businessman carries on his business.

Incorporation. If the business is a proprietorship or partnership, the general estate of the deceased proprietor or partner should be protected against business liabilities by the prompt incorporation of the business.

Capitalization. The executor or trustee should not be left in any doubt as to his duty or his power with respect to the capitalization of the business. The will or trust agreement should contain definite answers to such questions as these: Shall it be limited to the capital already in the business? Shall there be authority to put additional capital into the business? If so, what, if any, limit upon the amount or percentage of additional capital?

Trustee's Liability. Whoever carries on a business takes risks of losses. This is the main reason why a business normally is not an approved trust investment. But, carrying out the wishes of the deceased businessman, if, on the one hand, the trustee does his full duty, he should not be liable for losses for which he was not to blame. But, on the other hand, under no circumstances should he be relieved of liability for losses traceable to his own negligence; and the foregoing provision so covers the point.

Real Property

The executor or trustee is authorized to improve, manage, protect, and subdivide any real property in my estate or trusts; to dedicate parks, streets, highways, or alleys; to vacate any subdivision or part thereof and to re-subdivide the same as often as desired; to contract to sell; to grant options to purchase; to sell on any terms; to convey either with or without consideration; to convey to a successor trustee and grant to such trustee all of the title, estate, and powers vested in my executor and trustee; to donate; to mortgage, pledge, or otherwise encumber any such property or any part thereof, from time to time, in possession or reversion, by leases to commence at the present time or in the future, and upon any terms and for any period or periods of time, although extending beyond the duration of the trust, and to renew or extend leases upon any terms and provisions thereof at any time or times hereafter; to contract to make leases and to grant options to lease and options to renew leases and options to purchase the whole or any part of the reversion and to contract respecting the manner of fixing the amount of present or future rentals; to partition or to exchange said property or any part thereof for other real or personal property; to grant easements or charges of any kind, release, convey or assign any right, title, or interest in or about any easement appurtenant to any property or part thereof; and to deal with any such property and every part thereof in all other ways and for all such other purposes or consideration as it would be lawful for any person owning the same to deal with the same either similar to or different from the ways specified, at any time or times hereafter.

This provision is designed primarily for the management of urban and suburban property. It is largely an adaptation of the provision suggested by the attorneys for one of the trust com-

panies of Chicago that makes a specialty of managing urban and suburban real property. Under this provision it would be hard to conceive of any power with respect to the management of such property that the trustee did not have.

Leases for a period beyond duration of trust. The one clause of the foregoing provision to which special attention is called is the one authorizing the trustee to make leases which may extend beyond the duration of the trust. In trusts, especially those for the testator's children, that terminate upon the beneficiary's attainment of a comparatively early age—say, 21 or 25 years—unless the power is granted to the trustee, it is not at all unlikely that the lease may expire and not be renewable or a new lease not be obtainable for the remaining years of the trust nor the years immediately following the termination of the trust. This might work to the disadvantage of a beneficiary who was dependent upon the rentals.

Farms

The executor or trustee is authorized to carry on any farming operation in which I may be financially interested at the time of my death and operate any other farm which may be acquired by the trust and, in so doing, by way of illustration and not limitation of his powers, to operate the farm with hired labor, tenants, or share croppers; to lease or rent the farm for cash or for a share of the crops; to determine what cash rents shall be credited to income and what to principal and, if apportioned, in what proportions; to determine what farm expenses shall be charged against income and what against principal and, if apportioned, in what proportions; to purchase or otherwise acquire farm machinery and equipment and livestock; to construct, repair, and improve farm buildings needed for the operation of the farm; to make or to obtain loans or advances at the prevailing rate or rates of interest for farm purposes, such as for production, harvesting, or marketing, or for the construction of farm buildings or for the purchase of farm machinery or equipment or livestock; to employ approved soil conservation practices in order to conserve, improve, and maintain the fertility and productivity of the soil; to protect, manage, and improve the timber and forests on the farm and sell the timber or forest products as and when, in the judgment of the trustee, it is to the best interest of my estate; to establish and maintain irrigation sys-

tems; to ditch and drain damp and wet fields and areas of the farm when and where needed; to engage in livestock production and marketing and breeding and in dairying, if it is deemed advisable, and to construct such fences and buildings and plant such pastures and crops as may be needed to carry on such a livestock or dairy program; and, generally, to employ the methods of carrying on the farming operation and practices that are in common use by other farmers in the community in which the farm is situated.

The foregoing provision is largely the handiwork of two lawyers of Eastern North Carolina who themselves are engaged in farming—cotton, tobacco, peanuts, beefcattle, dairying, forestry—on a rather substantial scale. In drafting this provision, they were aided by an experienced draftsman of the same section of the State who also was familiar with local farm practices. These three lawyers incorporated every power they could think of that, reasonably, might be expected to be needed in the operation of a farm in that section of the State. There is no doubt that, on account of differences in farm practices between the two States, the farm-management provision of a Kentucky will or trust agreement would contain other or different powers from those in the foregoing, North Carolina provision.

Mortgages

The executor or trustee is authorized to continue mortgages upon and after maturity with or without renewal or extension upon such terms as to him may seem advisable without reference to the value of the security at the time of such continuance; to reduce interest rates at any time and from time to time on any mortgage constituting a part of my estate or trusts; to consent to the modification or release of any guaranty of any mortgage in my estate or trusts or to join with other mortgagees in the modification or release of any guaranty in which my estate or trusts may have a partial interest; to foreclose, as an incident to the collection of any bond or note secured by mortgage, and bid in the property at such foreclosure sale, or to acquire the property by deed from the mortgagor or obligor without foreclosure; and to retain as a trust investment property so bid in or taken over without foreclosure.

In a period of easy money certain of these powers may be needed; in one of tight money, other powers. The provision should be drawn to cover each segment of the economic cycle.

In a period of easy money the executor or trustee should have power to reduce interest to the prevailing rate in order to hold good mortgages.

In a period of tight money the trustee should have power to renew or extend mortgages without reference to the value of the security at the time in order to work out a bad situation; also, to modify or release guaranties if by so doing he can improve the security; and to take over mortgaged property without foreclosure or to bid in the property at his own foreclosure sale in the hope of avoiding or reducing a loss.

There are many, many other administrative provisions of wills and trust agreements that relate to the investment of trust funds.¹² But the foregoing are the ones that relate directly to investment and management of investments in estates and trusts.

If some of the foregoing suggested provisions seem to be needlessly long and detailed, let the draftsman be reminded that trusts usually are long-term arrangements; that one trust may extend over an entire economic cycle; that an excess of powers, many of which never may be exercised, is better than a dearth of powers, some of which may be essential to the proper administration of the trust; and that it is better to find the power expressed definitely and clearly in the will or trust agreement than to have to go to the time, expense, and uncertainty of trying to obtain a court order while the trust property and the trust beneficiary may be suffering because of the lack or uncertainty of the power of the trustee. In the hands of a competent and experienced trustee, the greater the trustee's power, the better his administration.

¹² STEPHENSON, DRAFTING WILLS AND TRUST AGREEMENTS: ADMINISTRATIVE PROVISIONS 8-44, 101-128, 129-155, and 302-317 (1952).