The Evolution of Prudence in Trustee Investing

C. Raymond Radigan and Jennifer F. Hillman

New York Law Journal

2013-07-09 00:00:00.0

The past 50 years have seen rapid changes in finance including enormous rises in stock markets, increased inflation, and recently, bouts of extreme volatility in financial markets. It is undeniable that finance now plays a critical role in the global economy. Alongside the rise in its importance, the academic study of finance and financial markets has deepened our understanding of risk, return and market behavior. In particular, Modern Portfolio Theory, a mathematical theory that describes the relationship between risk and return of a financial security, has come to dominate the industry's approach to investing.

These changes and increased understanding necessitated a change in the standard governing a trustee's investments. Previously, trustees were among the more conservative investors in the marketplace. As a result, trusts were not experiencing the historic appreciation of stock markets around the world, and, trustees were finding it increasingly difficult to provide for all income and remainder beneficiaries in the face of rising inflation.

The 1990s saw the implementation of reforms which effectively unshackled trustees, allowing them to consider a wide array of investments and rely on the most modern theories of investing to more effectively manage trust assets and provide for the beneficiaries. The Modern Portfolio Theory has had an enormous impact on recent reforms and the application of a new standard in New York.

A Historical Perspective

In 1719, English parliament authorized trustees to invest in shares of the South Sea Company.[1] This was less than 120 years after the emergence of the British East India Company, one of the earliest and most famous joint-stock companies. In a pattern that would become familiar throughout subsequent history, the 1719 authorization came at the height of what was arguably the first stock bubble. From the early 1700s up until 1720, a great number of stock companies were formed.[2] During this short time, the amount of capital invested in stock went from just above zero to 13 percent of England's national wealth.

After the 1719 authorization, many English trustees took advantage of the opportunity to invest in stock.[3] However, just one year after trusts invested in the South Sea Company, the shares declined 90 percent as the bubble burst. Consequently, the law quickly did a fast turnaround and became much more conservative. "Legal lists" were developed which contained the exclusive options available for trustees to invest the assets under their control.

American trust law developed along similar lines. Legal lists restricted trustee options to specific investments approved by

statute or court holdings, and were generally limited to government debt, first mortgages, and select corporate issues.[4]

The first step in the evolution away from legal lists occurred in Massachusetts in 1830. In *Harvard College v. Amory*, the Supreme Judicial Court of Massachusetts, Massachusetts' highest court, laid out what would become known as the "prudent man rule." Essentially, the prudent man rule states that a trustee must "conduct himself faithfully and exercise a sound discretion…[and] to observe how men of prudence, discretion and intelligence manage their own affairs…" *Harvard College and Massachusetts General Hospital v. Armory*, 26 Mass. 446, 469 (1830). In applying this new standard, the court held that stocks were not prohibited per se as risky, because anytime money was invested in any type of security—even government debt—there is some risk to the capital.[5]

Despite this progress toward expanding investment options, the concept of legal lists remained. For example, in *King v. Talbot* the New York Court of Appeals enunciated a standard that "necessarily excludes all speculation, all investments for an uncertain and doubtful rise in the market."[6] While giving lip service to the prudent man rule, the holding effectively limited what a trustee could invest trust assets in. Securities which by their terms did not promise a return on principal of the investment (stocks as opposed to bonds) put such principal at risk, and thus were too speculative. By the 1880s, many state legislatures responded to *King* by adopting "legal list" regimes.[7]

Over the ensuing years, the principle of prudence evolved and developed. By the 1940s, state legislatures began adopting the prudent man rule to govern trust investments, and by 1980 45 states employed some form of a prudent man rule over legal lists.[8]

The Prudent Man

Up until the Restatement (Third) Trusts was published in 1992, the prudent man rule remained largely intact from the *Amory* decision. A trustee was only to make "such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived."[9] Under this standard, a trustee had to exercise the "skill of a man of ordinary intelligence," and was not allowed to delegate his authority.[10] Importantly, in determining whether a trustee was liable under this standard, a court would analyze "[the fiduciary's] consideration and action in light of the history of *each individual investment*, viewed at the time of its action," without the benefit of hindsight.[11]

Courts continued to strive to view an investment decision from the perspective of the trustee at the time the decision was made; however, hindsight bias could still be found. One of the most egregious examples of such hindsight bias was a case from the Prerogative Court of New Jersey which had jurisdiction over estate disputes. The 1931 case *In re Chamberlain's Estate* dealt with trust losses sustained in the stock market crash of 1929. In holding that the trustee was liable for the losses, the court held that "[i]t was common knowledge, not only amongst bankers and trust companies, but the general public as well, that the stock market condition at the time of testator's death was an unhealthy one, that values were very much inflated, and that a crash was almost sure to occur." The court continued that based upon this "common knowledge" it was the "duty of the executors to dispose of these stocks immediately."[12] This argument defies logic: if everyone knew that a crash was "almost sure to occur," then everyone would have sold earlier, causing an earlier crash of the market.

Aside from the risk of hindsight bias, the prudent man rule analyzed each investment separately from the rest of the portfolio. Even if a trustee constructed a well-diversified portfolio of investments, if one of those investments lost money the trustee may still be liable for that loss—even if the portfolio as a whole was performing exceptionally well.[13]

The restrictions imposed by the prudent man rule drew several other criticisms from the legal and investment worlds including that: (i) the rule left trustees unable to protect trust assets from the rising risk of inflation;[14] (ii) the rule was unnecessarily rigid; and (iii) the rule deprived trust beneficiaries of the newest and (arguably) best understanding, knowledge and practice of investing. The prudent man rule actually hindered a trustee from making investments that had become favored by prudent investors of the modern times.

Restatement (Third) of Trusts

As a result of these criticisms, the American Law Institute promulgated the Restatement (Third) of Trusts in 1992. The Restatement (Third) implemented many of the changes advocated by the prudent man rule's critics and updated the standard for trustee investing.[15] In 1994, the National Conference of Commissioners on Uniform State Laws adopted the Uniform Prudent Investor Act (UPIA), incorporating many of the concepts from the Restatement (Third) of Trusts.[16] The UPIA, by adopting principles of the Restatement, made five important changes to the standard guiding trustee actions.[17]

First, the prudence of any investment is to be judged with regard to the entire portfolio.

Second, the tradeoff in all investing between risk and return is recognized as a fiduciary's prime consideration.

Third, the categorical restrictions on types of investments are removed such that no investment is per se imprudent; instead any type of investment could be prudent if it meets the rest of the newly enumerated standards.

Fourth, the principle of diversification, long established by case law, was codified into statute as a mandatory requirement (subject to certain exceptions).

And finally, the UPIA eliminated the rule forbidding a trustee from delegating investment decisions.

These changes embody a modern understanding of investment risks and return known as Modern Portfolio Theory. Modern Portfolio Theory is a mathematical theory that describes the relationship between risk and return of a financial security[18] and it rests on three central tenets: (i) riskier investments offer a "risk premium," meaning the investment will offer a greater return on capital to compensate for the increased risk of the loss of capital; (ii) diversification can reduce risk to a portfolio without lowering the return on the portfolio's investments; and (iii) allocation between riskier assets and safer assets will determine exposure to broad market risk.[19]

Under Restatement (Third) Trusts §227(a), a trustee's investments are not to be analyzed in isolation, but "in the context of the trust portfolio and as a part of an overall investment strategy."[20] The benefits of diversification espoused in Modern Portfolio Theory were also incorporated into the reforms such that a duty to diversify trust assets is imposed on trustees unless under the circumstances it would be more prudent not to.[21] Additionally, the UPIA and Restatement included the principle that "specific investments or techniques are not per se prudent or imprudent."[22] So long as an investment has a level of risk appropriate for the trust, no type of investment is automatically imprudent.

This principle can be summed up as "process over performance," or "conduct over outcome." If the securities were appropriate for the trust and well diversified, a trustee cannot be held liable for the losses of any individual investment since it is now recognized the trustee cannot reasonably be expected to foresee such losses. As far as trustees are concerned, this is arguably the most important change from the prudent man rule to the modern prudent investor rule, because it greatly limits their liability for trust investment losses.

Otherwise, the reforms lifted the ban on trustee delegation of duties.[23] This change allows a trust to benefit from the expertise, tools, and experience of a professional investment advisor—practically a necessity in today's world of increasing financial complexity.

The reforms also imposed a limitation on the trustee's ability to run up costs in managing the trust by requiring that trustees "incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship."[24] Thus a trustee must act judiciously to guard trust assets from excessive or unreasonable fees.

New York EPTL §11-2.3

Based on the Restatement, New York's Prudent Investor Act includes all the major principles of Modern Portfolio Theory discussed above. The law requires trustees to diversify in most cases, allows for delegation of investment functions, imposes a reasonableness standard on incurring costs, declares that no investment is per se imprudent, and requires that the prudence of an investment be judged as part of the entire portfolio, and not in isolation.[25] The language in New York's EPTL §11-2.3 also emphasizes that a trustee will be judged by whether the entire trust portfolio is in substantial compliance with the prudent investor rule, and if it is, then the trustee will be insulated from liability.[26]

The prudent investor rule expressly "requires a standard of conduct, not outcome or performance."[27] Thus, "the prudent investor standard (EPTL 11–2.3) now in effect judges prudence by reference to risk management and the underlying determination of the appropriate level of risk for a particular portfolio."[28] It also applies to any "trustee," which includes trustees, guardians, and any personal representative.[29]

As discussed above an essential element in forming an optimal portfolio, and in satisfying the requirements of EPTL §11-2.3, is diversifying the securities held by a trust portfolio. New York courts have held that "[t]he diversification mandate of the new rule was generally consistent with the diversification standards already developed by the courts under the prudent [man] rule."[30] Several recent cases have looked closely at this diversification mandate. See, e.g., *Matter of Knox*, 98 AD3d 300 (4th Dept.), lv to appeal den, 98 AD3d 1327 (4th Dept.), lv to appeal 2012 dismissed, 20 NY3d 860 2013; *Matter of Hyde*, 44 AD3d 1195 (3d Dept. 2007), lv to app den 9 NY3d 1027 (2008); *Matter of Hunter*, 100 AD3d 996 (2d Dept. 2012).

Conclusion

The reforms to trust investments and the new standard for measuring trustee prudence is much friendlier to the trustee. By focusing on the process and conduct of the trustee, instead of a post hoc judgment of the prudence of each investment, the prudent investor rule eliminates the ever-present risk of hindsight bias and reduces the risk of being surcharged for any losses to trust assets. Trustees are now able to use the best strategies available for protecting trust assets from losses and inflation while providing income and capital growth for the beneficiaries.

C. Raymond Radigan *is a former Surrogate of Nassau County and of counsel to Ruskin Moscou Faltischek.* ***Jennifer F. Hillman*** *is an attorney at Ruskin Moscou. This article was based on a research paper by* ***Dennis Lyons****, a recent law school graduate.*

Endnotes:

1. John H. Langbein, "The Uniform Prudent Investor Act and the Future of Trust Investing," 81 Iowa L. Rev. 641, 643 (1996).

2. C.E. Walker, "The History of the Joint Stock Company," The Accounting Review, Vol. 6, No. 2, (June 1931), pp. 95-107.

3. Langbein at 644-45.

4. Id. See also, Bogart's *The Law of Trusts and Trustees* (2012) §613.

5. *Harvard College and Mass. General Hospital v. Armory*, 26 Mass 446, 468-69 (1830) ("It will not do to reject those stocks as unsafe, which…may involve a total loss. Do what you will, the capital is at hazard. If the public funds are resorted to, what becomes of the capital when the credit of the government shall be so much impaired as it was at the close of the last war?").

6. *King v. Talbot*, 40 N.Y. 76, 86 (1869).

7. W. Brantley Phillips Jr., "Chasing Down the Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts," 54 Wash & Lee L Rev 335, 341 (1997).

8. Bogert's *The Law of Trusts and Trustees* (2012) §613.

9. Restatement (Second) Trusts at §227(a).

10. Id. See comments, generally.

11. *Matter of Janes*, 90 NY2d 41, 51 rearg den, 90 N.Y.2d 885 (1997) (emphasis added).

12. *In re Chamberlain's Estate*, 156 A 42, 43 (NJ Prerog Ct 1931).

13. Max Schanzenbach and Robert Sitkoff, "The Prudent Investor Rule and Trust Asset Allocation: An Empirical Analysis," 35 ACTEC Journal 314, 318 (2010).

14. W. Brantley Phillips Jr., "Chasing Down the Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts," 54 Wash & Lee L Rev 335, 336 (1997) ("Increasingly, low-risk, interest-bearing securities fail to keep pace with inflation, and thus, inflation becomes the roaring lion, walking about, seeking to devour the trust. Unfortunately, the traditional restrictions on fiduciary investment largely remain in place. Such restrictions now hamper a trustee's ability to be vigilant against this new adversary—the devil of inflation.").

15. *Bogert's Law of Trusts and Trustees* §612 (2012).

16. *Bogert's Law of Trusts and Trustees* §613 (2012).

17. *Bogert's Law of Trusts and Trustees* §613 (2012) ("The Prefatory Note to the UPIA describes the objectives of the UPIA as follows: UPIA makes five fundamental alterations in the former criteria for prudent investing").

18. Charles F. Gibbs and Colleen F. Carew, "Taking Stock of the Prudent Investor Act," NYLJ, Feb. 29, 2009.

19. Stewart E. Sterk, "Rethinking Trust Law Reform: How Prudent is Modern Prudent Investor Doctrine?" 95 Cornell L. Rev. 851, 867-68 (2010).

20. Restatement (Third) of Trusts, §227(a) (1992).

21. Restatement (Third) of Trusts, §227(b) (1992).

22. Stewart Sterk, "Rethinking Trust Law Reform: How Prudent Is Modern Prudent Investor Doctrine?," 95 Cornell L. Rev.

851, 874(2010), citing Restatement (Third) of Trusts §90 cmt. f (2007).

23. Restatement (Third) of Trusts, §90(c)(2) (1992) (a trustee must "act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents").

24. Restatement (Third) of Trusts, §90(c)(3) (1992).

25. NY EPTL §11-2.3.

26. NY EPTL §11-2.3(b)(1).

27. Id.

28. *Matter of Siegel*, 174 Misc.2d 698, 700 (Sur. Ct. N.Y. Co. 1997).

29. NY EPTL §11-2.3(e)(1).

30. *Matter of Hyde*, 44 AD3d 1195, 1198 (3d Dept. 2007).