**Challenges in Trust Investing:**

**The Settlor's Intent, the Beneficiaries' Interests, and the Duty to Prudently Invest Trust Assets**

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PART I: AN INHERENT CONFLICT
(PRUDENT INVESTING in the 20th CENTURY)

***"There are three voices to which the fiduciary must listen: the settlor . . . the beneficiaries . . . and the market."[1]***

**A. Three competing forces dominate modern trust investment law.**

1. The logic of Modern Portfolio Theory (MPT) as reflected in the Uniform Prudent Investor Act (UPIA)

2. The primacy of the settlor's intent and the settlor's power to trump default law.

3. The trustee's obligation to serve the needs of trust beneficiaries.

**B. Introduction to the UPIA**

1. Included among a Trustee's many responsibilities is the responsibility for investment management of trust assets.

2. For the better part of two centuries, fiduciaries exercising investment responsibility for trust funds have been held to the standard of "prudence." The oft-cited 1830 Massachusetts case of *Harvard College v. Armory,* 26 Mass. 446, 461 (1830) marks the starting point of case law on this issue. In *Harvard College,* the Massachusetts Supreme Judicial Court noted in dicta as follows:

> "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 intelligent 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."

3. However, in the decades that followed, legislatures and courts seeking to implement the standard soon began to circumscribe much of the "discretion" which the court in Harvard College seemingly had left to trustees. Rather, in most states, legal lists of approved investments became the norm, with trustees being limited to specified investments and favoring those asset classes yielding predicable income with absolute safety of principal. Generally, investments in common stocks were strictly limited or even expressly forbidden. Until 1939, for

[1] Will of Dumont, 2004 WL 1468746 (N.Y. Sur.) at 5.

example, Connecticut was a pure "legal list" state. See *Hartford National Bank and Trust Company v. Trinity Church,* 25 Conn. Supp. 23, 195 A.2d 566 (Super. Ct. 1963) for a detailed history of the evolution of Connecticut's law on this issue.

4. During the last part of the 20th Century, the landscape changed dramatically. The modern fiduciary operates in a climate where mere preservation of principal may be considered a dismal failure. Legal lists of approved assets are gone, replaced by "modern portfolio theory" which requires a fiduciary to understand the relationship between increased risk and increased return and to consider the impact of taxes and inflation.

5. The Uniform Prudent Investor Act consolidates several disparate sources of law into a single overall guide for fiduciary management of investment portfolios. In relevant part, it accomplishes the following:

   - It codifies a fiduciary's duties to be loyal, impartial, and to manage costs.

   - It authorizes fiduciaries to delegate investment and management functions where appropriate.

   - It establishes the appropriate standard of care as that of a prudent investor and directs a fiduciary to adopt an overall investment strategy with suitable risk and return objectives.

   - Finally, it mandates that a trustee diversify the investments of the trust "unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."

**C. The Logic of the UPIA: General (Some Unspoken) Considerations:**

1. Investment management often is more expensive than it is worth.

2. "Passive" investing may be superior to "active" investing. Put another way, "a blindfolded monkey throwing darts at a newspaper's financial pages could select a portfolio that would do just as well as one selected by the experts."[2]

3. Investing is no place to be sentimental.

4. Investors must understand risk and reward.

**D. The Logic of the UPIA: The Example of Investment Diversification**

1. Balancing risk with investment returns is a fundamental tenet of modern portfolio theory and cornerstone of the UPIA.

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[2] BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET: THE TIME-TESTED STRATEGY FOR SUCCESSFUL INVESTING 24 (2003)

2. Modern portfolio theory recognizes different types of risk:
   - "market" risk
   - "industry" risk
   - "company-specific" risk

3. The market doesn't compensate those who take company-specific risk. Thus, a prudent investor generally avoids company-specific risk.

   - "Don't put all of your eggs in one basket."
   - "If you are ever tempted to put lots of eggs in one basket, remember that while this is the surest way to make a fortune, it is also the surest way to lose one."[3]

4. The UPIA requires diversification as a default rule. UPIA Section 3

**E. The Settlor's Intent: American law long has recognized a "fundamental right" to direct the disposition of one's own property.**

1. The settlor's intent governs all aspects of trust administration.

2. Fiduciary law is (primarily) default law.

3. While the UPIA embraces diversification as a fundamental principal of modern trust investing, it does so with two important exceptions.

   - First, certain "special circumstances" may justify a departure from the general rule. UPIA Section 3.
   - Second, the UPIA is merely default law, which a trust settlor can trump in whole or in part. UPIA Section 1(b).

**F. When forces collide:**

1. Estate of Rowe ("Rowe")
   - 712 N.Y.S.2d 662 (N.Y.A.D. 2000) (IBM stock)

2. Estate of Saxton ("Saxton")
   - 712 N.Y.S.2d 225 (N.Y.A.D. 2000) (IBM stock)

3. Estate of Dumont ("Dumont")
   - 791 N.Y.S.2d 868 (N.Y.Sur. 2004); 809 N.Y.S.2d 360 (N.Y.A.D. 2006) (Kodak stock)

[3] LARRY E. SWEDROE, RATIONAL INVESTING IN IRRATIONAL TIMES: HOW TO AVOID THE COSTLY MISTAKES EVEN SMART PEOPLE MAKE TODAY.

4. Wood v. U.S. Bank, N.A ("Wood")
   - 160 Ohio App.3d 831 (Ohio App. 1 Dist. 2005) (Firstar stock)

**G. How did we get here?**

1. Unresolved tension between a settlor's autonomy to trump default fiduciary law and academic support for the prudence of diversification.

2. Poor fiduciary practices.

3. Settlors failing to speak clearly.

4. Judges failing to listen well.

## PART II: DIVERSIFICATION: DEFAULT LAW OR SOMETHING MORE? (PRUDENT INVESTING in the 21st CENTURY)

"A trust and its terms must be for the benefit of its beneficiaries."
U.T.C. § 404 (2004).

"The terms of a trust prevail over any provision of this [Code] except … the requirement that a trust and its terms be for the benefit of its beneficiaries, and that the trust have a purpose that is lawful, not contrary to public policy, and possible to achieve."
U.T.C. § 105(b)(3) (2004).

**A trust law question for the 21st Century: What do the above-quoted sections mean?**

**H. The Scholarly Debate:**

**John H. Langbein, *Mandatory Rules in the Law of Trusts*, 98 NW. U. L. REV. 1105 (2004):**

- The UTC codifies an "objective standard" which "sets outer limits on the settlor's power to abridge the default law"

- The UTC's formulation is an "intent-defeating" one which serves "an anti-dead-hand policy."

- "The characteristic sphere for the application of the anti-dead-hand rule has been the fringe world of the eccentric settlor: the crackpot who wants to brick up her house, or build statues of himself, or dictate children's marital choices. In the future, however, I believe that the benefit-the-beneficiaries rule will set limits upon a more common form of settlor direction, the value-impairing investment instruction."

- "In the future, I believe that the benefit-the-beneficiaries rule … will interact with the growing understanding of sound fiduciary investing practices to restrain the settlor's power to direct a course of investment imparting risk and return objectives contrary to the interests of the beneficiaries."

**Jeffrey A. Cooper, *Empty Promises: Settlor's Intent, the Uniform Trust Code, and the Future of Trust Investment Law,* 88 B.U. L. Rev. 1165 (2008):**

- At first blush, the emerging benefit-the-beneficiaries rule seems to offer great promises, steadfastly pursuing the interests of today's trust beneficiaries and casting aside the inefficient, dead-hand, dictates of yesterday's settlors. However, a closer review reveals the emerging rule's potentially undesirable consequences. It introduces significant confusion into the clear legal regime established by the UTC and UPIA. It accords too little deference to a settlor's unique vision and clear directives. It undermines crucial interpersonal and tax-planning elements of modern estate planning.

- Perhaps its greatest flaw, however, is its mandatory nature. Trust settlors concerned by the potential consequences of the emerging rule could easily draft around them were the rule a mere default. But this mandatory rule forces a far more dramatic confrontation. For, to avoid trust law's mandatory rules, settlors must find a way to avoid trust law. In this case, they easily can. A variety of competing legal regimes and a number of settlor-friendly jurisdictions stand ready to welcome trust settlors who wish to avoid the emerging rule. As trust settlors pursue those more desirable options, the emerging rule will undermine the very relevance of trust law.

- Despite its best intentions, the emerging benefit-the-beneficiaries rule simply cannot achieve its desired impact, and the promises it offers trust beneficiaries prove to be empty ones. As such, trust law would be better served by rejecting the emerging rule and turning instead to what some might consider less ambitious doctrines-- ones which seek to aid the beneficiaries of settlors who have made mistakes or failed to anticipate changed circumstances, but provide no aid in cases where a settlor intentional and thoughtfully impaired beneficiaries' economic rights. Trust law cannot meaningfully redress those latter cases. It should not destroy itself by trying.

**John H. Langbein, *Burn The Rembrandt?: Trust Law's Limits on the Settlor's Power to Direct Investments* 90 B.U. L. Rev. 375 (2010):**

- The rules found in the UTC are "old hat." The UTC "merely clarifies" those rules with "light refinement."
- UTC will have "virtually no effect in routine trust practice, because it is the rare settlor so perverse as to attempt to alter the default rules" in a way that would violate the UTC.
- "The UTC is not the radical and worrisome innovation that Cooper paints it to be, but is in fact a modest and helpful clarification of a longstanding and wholly benign rule of trust law."

*See also:*

**Jeffrey A. Cooper, *Shades of Gray: Applying the Benefit-the-Beneficiaries Rule to Trust Investment Directives* 90 B.U. L. Rev. 2383 (2010).**

***Jeffrey A. Cooper, Dead Hand Investing: The Enforceability of Trust Investment Directives* 37 ACTEC L. J. 365 (2011).**

**I. Statutory Conflicts?**

UPIA:

"A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."
UNIF. PRUD. INV. ACT § 3.

"The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust."
UNIF. PRUD. INV. ACT § 1(b).

UTC:

"A trust and its terms must be for the benefit of its beneficiaries."
U.T.C. § 404 (2004).

"The terms of a trust prevail over any provision of this [Code] except … the requirement that a trust and its terms be for the benefit of its beneficiaries, and that the trust have a purpose that is lawful, not contrary to public policy, and possible to achieve."
U.T.C. § 105(b)(3) (2004).

States that have previously adopted the UPIA are encouraged to recodify their *existing* UPIA as article 9 of the UTC.

**J. Other Undesirable Consequences?**

**1.** Alters the Trustee's traditional role?

- Is trustee interpreter and enforcer of the settlor's directives or skeptical challenger, constantly questioning the very source of authority under which he is empowered to act?

  Wither contractarian principles?

  Will this increase the cost of administering trusts?

  New ethical conflict: may lawyer serve both settlor and fiduciary?

**2.** Opens the Floodgates of Litigation?

- The emerging benefit-the-beneficiaries rule would provide beneficiaries with a new basis for seeking to overturn a settlor's estate planning regime.

**3.** Unleashes the Tyranny of the Majority?

- *Settlors Forced to Join the Investment Herd*. Prudence becomes synomyous with compliance with modern investment theory.
- *Repudiating Warren Buffett?* The emerging rule would structurally repudiate any settlors who rejected prevailing market wisdom or who wished to mandate contrarian investment styles. This significant flaw in the emerging rule is revealed by the fact that the list of investors so impacted would include the person whose name has become a synonym for investment success, Warren Buffett.

**4.** Ignores Key Goals of Estate Planning?

- The emerging rule narrowly defines "benefit" to mean wealth maximization. This approach fails to reflect the reality that many settlors engage in estate planning and establish trusts in order to benefit their chosen beneficiaries in a variety of ways – not only financially, but also personally and perhaps even spiritually. The emerging rule threatens a settlor's ability to pursue these other worthwhile types of benefits.

**5.** Undermines Estate Tax Planning?

- A final undesirable consequence of the emerging benefit-the-beneficiaries rule is that it would undermine some of the most sophisticated forms of estate tax planning. In particular, two common estate planning techniques, the Irrevocable Life Insurance Trust ("ILIT") and the Grantor Retained Annuity Trust ("GRAT"), could become largely unworkable under the emerging regime.

**6.** Creates Undesirable Incentives for Lawyers and Clients?

- Appointing ignorant or overly-compliant trustees.
- Manipulating beneficial interests in trusts.
- Choosing more favorable trust jurisdictions.
- Avoiding trust law entirely, *e.g.* by using secret trusts or limited partnerships.

## PART III: HOW TO RESPOND?

K. **The Legislature May Have Spoken.**

Be sure to review appropriate state version of UTC.
For example, compare:

- UTC VERSION (404):
  "A trust may be created only to the extent its purposes are lawful, not contrary to public policy, and possible to achieve. A trust and its terms must be for the benefit of its beneficiaries."

- NEW HAMPSHIRE VERSION:
  "the requirement that a trust and the terms of that trust be for the benefit of its beneficiaries as their interests are defined under the terms of the trust, and that the trust have a purpose that is lawful, not contrary to public policy, and possible to achieve."…
  "For the purposes of determining the benefit of the beneficiaries, the settlor's intent as expressed in the terms of the trust shall be paramount."

- MASSACHUSETTS AND CONNECTICUT VERSIONS:
  "A trust may be created only to the extent its purposes are lawful and not contrary to public policy."

L. **Helping Trust Settlors to Speak Clearly: Trust settlors (and their lawyers) must do a better job of expressing, and defending, unique investment directives.**

(See Jeffrey A. Cooper, *Speak Clearly and Listen Well: Negating the Duty to Diversify Trust Investments*, 33 OHIO N.U. L. REV. 903 (2007). Available at SSRN: http://ssrn.com/abstract=1005128.)

If trying to express a settlor's unique investment objectives, consider the following drafting techniques:

1. Show the Settlor's Rationality

   - Even if the settlor makes her voice heard, there are those who will have philosophical objections and/or financial reason not to listen.

   - Settlor confronts an emerging trend towards increased rights for trust beneficiaries.

- The "benefit the beneficiaries" rule.
- Trend towards "mandatory" state law provisions (UTC).

- The draftsman should explore and establish the basis for a settlor's desire to trump the duty to diversify.

  - Avoid capital gains taxes.
  - Desire to retain a family business or residence.
  - Access to superior information about a specific company.
  - Doubts about the integrity of many publicly-traded companies.
  - Belief that trend towards "passive investing" and index funds" is overdone.

- The draftsman should make the settlor's rationale explicit in the trust document.

  - A clear exposition of the settlor's intent can serve two purposes:

    (i) Formally negating default principles of trust law.
    (ii) Establishing "special circumstances."

  - Warning: a double-edged sword…

2. Use Mandatory, not Permissive, Language.

- Modern fiduciary law draws a significant distinction between trust language that *requires* a trustee to invest in a certain manner and that which merely *permits* such conduct.

  - Mandatory directions "are ordinarily binding on the trustee in managing the trust assets, thus often displacing the normal duty of prudence." Restatement (Third) of Trusts, P.I.R. Section 228e.

  - A merely permissive provision "does not relieve the trustee of the fundamental duty to act with prudence." Restatement (Third) of Trusts, P.I.R. Section 228f.

- The distinction between mandatory and permissive language seemingly has been lost on past settlors. Diversification either must be prohibited or it will be required. Precatory language has not been effective to establish a middle ground.

- Possible mandatory provisions trumping the duty to diversify:
  - forbid sale of the undiversified stock.

        - specifically negate the duty to diversify but add limited, objective, exceptions.

3. Use Clear, Customized, Language

    - Overarching statements and catch-all provisions can be dismissed as mere boilerplate

    - Wood court:
        - "Fuzzy drafting."
        - "The trust did not say anything about diversification."

    - A better result: *Americans for the Arts v. Ruth Lilly Charitable Remainder Annuity Trust* ("Lilly"). 855 N.E.2d 592 (Ind. App., 2006).
        - Document did contain a specific provision dealing with diversification
        - "Precisely the type of language" that was lacking in Wood
        - Warning: court ignored potential pitfalls

**M. Summary Guidance for Future Settlors:**

1. Use customized language that captures the settlor's clear intent.

2. Include the term "duty to diversify" in a clause seeking to negate that duty.

3. Reference the diversification provisions of the state's prudent investor act and explicitly direct that they should not apply.

4. Reference a concentrated holding by name.

5. Explain and defend settlor's rationale.

6. Be precise. Don't be fuzzy.

7. <u>BUT</u>, understand the extent to which benefit-the-beneficiaries rule may undermine settlor's planning goals and consider alternative trust language and/or planning techniques.

**N. Lessons for Administration:**

For modern professional fiduciaries and the attorneys who advise them, an analysis of prior case law yields a number of crucial lessons:

1. *Focus on the "process" rather than results*. The Uniform Prudent Investor Act is far more concerned with process than with mere results. "The prudent investor

rule expresses a standard of conduct, not outcome." Trustees often have been criticized for a failure of process. Investment losses alone do not yield liability.

2. *Follow your own guidelines.* A fiduciary violating its own investment guidelines effectively acts as an expert witness against itself. A prudent fiduciary may well have valid reasons to deviate from its own guidelines and courts have steadfastly avoided the establishment of any firm rules regarding maximum concentrations in a single security. However, reasons for deviation from printed guidelines should be carefully recorded and the situation frequently reviewed.

3. *Be sensitive to tax issues.* Do not ignore pending changes in tax rates or rules. Respond when tax attributes of assets change (e.g., when basis is stepped-up, tax laws change or when assets are contributed to a tax exempt trust).

4. *Review accounts and account officers actively and regularly.* Proactive supervisors should identify and manage improper portfolio allocations. A prudent fiduciary will establish a program of periodic trust reviews to consider asset allocation and other trust matters.

**5.** *Be the expert you claim to be.* UPIA holds professional trustees to a higher standard of conduct than non-professionals. Uninformed consent of beneficiaries may offer little protection when investments go awry. Demonstrate independence and logic in portfolio construction. Don't give undue deference to a family's "favorite" investment.

**6.** *<u>BUT</u>, understand the risk-management impacts of the benefit-the-beneficiaries rule.* Consider seeking court approval for investment decisions when trust document and modern portfolio theory conflict. Account more frequently than in the past.