# Prudent Investment of Trust Funds

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# Goals:

Review Basic Investing and Principles of Portfolio Construction.

Understand How MPT, the UPIA, and the UTC Inform Trust Investing.

Consider Implications for Drafting and Administration.

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

**Three competing forces in trust investing:**

- The primacy of the settlor's intent and the settlor's power to trump default law.
- The trustee's obligation to serve the needs of trust beneficiaries.
- The logic of Modern Portfolio Theory (MPT) as reflected in the Uniform Prudent Investor Act (UPIA)

*Will of Dumont, 2004 WL 1468746 (N.Y. Sur.) at 5.

# The (Very) Basics of Investing and Portfolio Construction

"This investor base is now purchasing mainly speculative meme stocks, call options, and cryptocurrencies…."

Vanda Research, March 2022

# Investments 101:

**Cash:** Safe, liquid, low-risk/low-return holding.

**Bonds:** Loans to companies, governments.

**Stocks:** Ownership in companies.

**Other Asset Classes:** Real Estate, Commodities, "Alternative Investments", Hedge Funds (Long vs. Short), Options (Puts/Calls), Structured Products

**Key to Remember: Risk and Reward are correlated.** More risk typically equals more reward over the long-term. More risk also means more <u>volatility</u>. Consider time horizon and need for liquidity.

# Major Approaches to Investing

## Direct vs. Pooled Investing

### Direct Investments

Construct a portfolio of individual investments.

Affords greatest investment control but requires expertise to select investments and can be difficult to properly diversify.

### Pooled Investments

Purchase Mutual Funds or Exchange-Traded Funds (ETFs).

# Major Approaches to Investing

## Active vs. Passive Investing

**Active Investment:**

Rely on manager expertise to select specific investments.

Try to outperform the market through wise selections.

*Try to generate "Alpha."*

**Passive Investing:**

Don't try to outperform a given market or sector, just try to replicate it. "Index investing."

Typically less expensive than active investing.

# A Simplified Trust Investment Process:

**Step 1:** Gather information about trust, beneficiaries.

**Step 2:** Establish investment goals and policy for trust, including asset allocation. ("Investment Policy Statement")

**Step 3:** Evaluate and select specific investments, managers, funds to implement asset allocation and strategy.

**Step 4:** Monitor performance, rebalance portfolio.

**Step 5:** Repeat steps 1 through 4, again and again.

# Understanding the Governing Law:

# The UPIA

# (and its friends MPT and diversification)

# Modern Portfolio Theory

- Modern trust investment law is grounded in Modern Portfolio Theory (“MPT”).
- MPT introduced by Harry Markowitz with his 1952 article "Portfolio Selection."
- Markowitz, Merton Miller and William Sharpe shared 1990 Nobel Prize in Economics for their work related to MPT.
- Other Nobel Prizes related to MPT:  Franco Modigliani (1985), Robert C. Merton (1997), and Myron S. Scholes (1997).

# THE UPIA

Adopted in nearly every U.S. jurisdiction

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.
- Manage costs.
- Diversify… "unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."

# A Deeper Dive: Diversification

- Modern portfolio theory recognizes different types of risk.
  - “market” risk
  - “industry” risk
  - “company-specific” risk

- The market doesn’t compensate those who take company-specific risk.

- A prudent investor avoids company-specific risk.

# Diversifying a Stock Portfolio:

- Assume settlor was an executive who owned a large block of ExxonMobil stock and left it in trust. Identify:
  - "market" risk
  - "industry" risk
  - "company-specific" risk ("firm" risk)

- Should the trustee diversify to avoid company-specific risk? How?

- But what about the exception: "unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying?"

# A Real World Example:

Estate of Janes ("Janes")

681 N.E.2d 332 (New York Court of Appeals 1997)

$3,500,000 estate

70%+ Kodak stock

Stock drops from $135 at date of death to $47 per share

Did the general "duty to diversify" apply?

What did Trustee do "wrong?"

# Other Oft-Cited Results

- Estate of Rowe ("Rowe")
  - 712 N.Y.S.2d 662 (N.Y.A.D. 2000) (IBM stock)
- Estate of Saxton ("Saxton")
  - 712 N.Y.S.2d 225 (N.Y.A.D. 2000) (IBM stock)
- 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)
- Wood v. U.S. Bank, N.A ("Wood")
  - 160 Ohio App.3d 831 (Ohio App. 1 Dist. 2005) (Firstar stock)

# Towards Better Results

What May Have Happened in these Cases?

- Poor fiduciary practices.
- Tension between a settlor's autonomy to trump default fiduciary law and academic support for the prudence of diversification.
- Settlors failing to explicitly address issues of trust investing.

# A New Conflict

# Default Law or Something More?

# Diversification Under the 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).

# But, Consider the 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).

# One View of the Future

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."

- In the future… I believe that the benefit-the-beneficiaries rule will set limits upon a more common form of settlor direction, the value-impairing investment instruction."

# A Second View of the Future

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):

- "Emerging rule" introduces significant confusion into the clear legal regime established by the UTC and UPIA.
- Accords too little deference to a settlor's unique vision and clear directives.
- Undermines crucial interpersonal and tax-planning elements of modern estate planning.
- Mandatory rule will encourage forum-shopping and undesirable estate planning.

# Continuing the Dialogue:

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 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."

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).

# Legislative Responses:

UTC VERSION:

“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.”

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.”

# Other New England UTC Enactments:

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.”

ME, VT: Enacted as above.

MA, CT “A trust may be created only to the extent its purposes are lawful and not contrary to public policy.”

# Implications for Drafting and Administration

# What Did the Settlor Mean?:

Settlor funds trust entirely with ABC stock. Trust document says "I authorize my trustee to retain all stock in ABC stock without any requirement of diversification."

What does this mean?

- "My trustees may invest entirely in shares of ABC."
- "My trustees must invest entirely in shares of ABC."
- Neither of the above.

# What Will/Should the Trustee Do?:

"I built this business over 35 years and it has become a great source of pride.  You clearly could make more money by liquidating the company and investing in a diversified stock portfolio.  However, keeping this business intact will honor our family name and should provide you with more than enough income."

- Analyze the above under MPT, UPIA, UTC…

- “This trust shall only hold an undiversified portfolio of life insurance.”
- “This is a GRAT.  I know I’m taking a big gamble, but that’s the whole point.”
- “The asset is important to me for social/personal reasons. Some things are more important to me than profits.”

# Parting Advice for Settlors, Their Lawyers, and Fiduciaries

# When Drafting a Trust:

- Use customized language that captures the settlor's clear intent.
- Explain and defend settlor's rationale.
- Use precise language that provides optimal guidance and/or imposes enforceable restraints.
- Understand the extent to which benefit-the-beneficiaries rule may undermine settlor's planning goals and consider alternative trust language and/or planning techniques.
- Consider all planning options, including trust language, choice of fiduciary and trust situs/governing law.

# When Administering a Trust:

- Understand UPIA and MPT
- Focus on the "process"
- Follow any investment policy statement, internal procedures or other guidelines.
- Keep good records.
- Review accounts and account officers actively and regularly.
- Be the expert you claim to be.

Understand and manage the risk-management issues relating to investments. Consider seeking court approval for investment decisions when trust document and modern portfolio theory conflict.  Account more frequently than in the past.