Maine Law Review

Volume 51 | Number 1 Article 6

January 1999

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## I. INTRODUCTION

The "prudent man" or "prudent person" rule governing trust investments is one of the oldest rules in American trust law.[1] Despite undergoing modifications over the years,[2] the fundamentals of the rule did not greatly change from its first expression in 1830[3] until 1990. Since 1990, however, trust investment law has undergone a revolution. Major criticisms of the prudent man rule in the late 1980s[4] led to the formulation and adoption of the *Restatement (Third) of Trusts: Prudent Investor Rule* in 1990.[5] In 1994, the Uniform Law Commissioners promulgated the Uniform Prudent Investor Act (UPIA)[6] for adoption by the states. Already a number of states have adopted the Act.[7] The significance of the change is symbolized by the change from "prudent man" or "prudent person" to "prudent investor."[8] The reformers advocated the use of the lessons of modern financial theory in formulating trust portfolios.[9] Many aspects of the law developed under the

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1. The rule originated in Harvard College v. Amory, 26 Mass. (9 Pick.) 446, 461 (1830).
2. *See* Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, 77 IOWA L. REV. 1151, 1151-52 (1992).
3. *See* Harvard College v. Amory, 26 Mass. (9 Pick.) at 461.
4. *See, e.g.*, BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE (1986); Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 52 (1987).
5. *See* RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE (1992) (adopted at the 1990 Annual Meeting of the American Law Institute) [hereinafter RESTATEMENT].
6. Uniform Prudent Investor Act, 7B U.L.A. 56 [hereinafter UPIA] (Supp. 1995).
7. *See infra* Section VII.A.
8. *See infra* Section VII.A.
9. *See* sources cited *supra* notes 4-6.

prudent man rule are radically changed under the prudent investor formulation.[10] Commentary is beginning to speculate on changes to investment and tax planning under the new rule and what difficulties trustees will face under the prudent investor formulation.[11]

One major impetus for the change from prudent man to prudent investor was a survey of trustee investment practices which formed the core of an extremely influential book in 1986.[12] In that book, Bevis Longstreth, a New York City attorney, surveyed 200 fiduciaries, including the fifty largest bank trust departments in the United States.[13] He found that a significant number of fiduciaries believed that trust law does not allow certain investments, such as new ventures and unconventional investment techniques.[14] Some states, in response to these criticisms of the prudent man rule, altered their statutes governing trust investments even before the publication of the new *Restatement*.[15] Some of these statutes (which I will refer to as "intermediate statutes")[16] have been in effect for several years.

The prudent investor rule, in both the *Restatement* formulation and the Uniform Act, removes many of the restrictions and limitations of the prudent man rule. As a practical matter, the crucial question concerning the prudent investor rule would appear to be whether, if the Uniform Act (or some similar form of the prudent investor rule) were adopted, trustees of personal trusts would formulate trust portfolios on the basis of modern financial theory, free of any inhibitions previously held concerning the illegality of particular investments or investment strategies. That is, if the prudent investor rule is adopted, would trustees of personal trusts invest in accordance with modern financial and economic theory (modified by beneficiary concerns and tax situations)[17] unimpeded by the restrictive law developed under the prudent man rule?[18]

This question is extremely difficult to answer, yet it is crucial for a state legislature considering adoption of the prudent investor rule. There are at present few cases involving the new statutes which provide guidance as to trustees' investment practices under modern statutes.[19]

This Article attempts to help to answer this question. Iowa is one of the states which passed an intermediate statute modifying the prudent man rule.[20] The basic statute, though amended twice,[21] has been in operation for seven years. Corporate trustees have had time to modify their investment practices to the change in the statute. Thus, the practice of Iowa corporate trustees regarding personal trusts should give some indication of whether, under a statute reflecting the prudent investor rule, trustees of personal trusts would be more likely to employ modern

10. *See infra* Section VI.
11. *See infra* Section VI.
12. *See* LONGSTRETH, *supra* note 4.
13. *See id.* at 5.
14. *See id.* at 6.
15. *See infra* Section V.
16. *See infra* Section V.
17. *See* RESTATEMENT § 227, cmts. d, e, i; UPIA § 2(c).
18. *See infra* Section II.
19. *See infra* Section VII.B-C.
20. *See* IOWA CODE ANN. § 633.123 (West 1992) (quoted *infra* Part V).
21. *See* Act of March 23, 1992, ch. 1012, § 1, 1992 Iowa Acts 13 and Act of March 20, 1996, ch. 1008, § 2, 1996 Iowa Acts 5. Neither amendment is relevant to the discussion in this article.

financial and portfolio theory in developing trust portfolios than they were under the prudent man rule.[22] Despite the fact that Iowa's intermediate statute is not as explicit as the Uniform Act in a number of respects, the practices of Iowa banks under an intermediate statute should give at least some indication as to the success of a prudent investor rule in freeing corporate trustees from the restrictions in investments under the prudent man rule.

The Author developed a survey of investment practices.[23] With the cooperation of the Iowa Trust Association, the survey was mailed to 239 trust departments in Iowa. Copies of the Iowa statute and of the Uniform Prudent Investor Act were attached to the survey.[24] The results from the survey, which form the basis of this Article, are extremely encouraging to proponents of the prudent investor rule.[25] The surveys indicate that, in regard to personal trusts, corporate trustees under the Iowa intermediate statute do use modern financial theory to formulate trust investment portfolios, but a significant percentage of the respondents remain concerned about liability for using new investment vehicles and techniques.[26] This result reveals an increased use of the tenets of modern portfolio theory from the Longstreth survey,[27] indicating that passage of a prudent investor rule would be successful in implementing the change sought by the authors of the *Restatement* and the Uniform Act: basing trust investments on the teachings of modern economic and financial theory.

Prior to discussing the survey, it is important to describe what led to the change from the prudent man rule to the prudent investor rule. Therefore, a short history of the prudent man rule begins the discussion.[28] Following this discussion is a short, and hopefully not too technical, discussion of the independent development of modern portfolio theory.[29] Next, the criticisms of the prudent man rule in the 1980s,[30] particularly those of Bevis Longstreth and Professor Jeffrey Gordon,[31] will be discussed, along with the impact of modern portfolio and economic theory on the prudent man rule.[32] A discussion of the "intermediate" statutes of the late 1980s and early 1990s will follow, to set the basis for the survey.[33] Then the prudent investor rule,[34] as formulated in the *Restatement* and the Uniform Prudent Investor Act, will be discussed. Lastly, the results of the survey and some conclusions that can be drawn from it will be presented.

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22. Some evidence of the effectiveness of a statute should be discernible from changes in practice after seven years of experience under the statute.

23. The survey is reproduced as Appendix A to this article and the results are reported in Appendix B. Caution should be employed in interpreting the survey results. For obvious reasons, only corporate trustees were surveyed. And, although the response rate was quite good (in excess of 25 percent), the total number of those responding to the survey (61) is small enough to counsel caution in extending the results too far.

24. A postage prepaid envelope was enclosed to encourage participation in the survey.

25. The results are analyzed in Part VIII, *infra*. The statistical results are presented in Appendix B, *infra*.

26. *See infra* Section VIII.

27. *See* LONGSTRETH, *supra* note 4.

28. *See infra* Section II.

29. *See infra* Section III.

30. *See infra* Section IV.

31. *See* LONGSTRETH, *supra* note 4; Gordon, *supra* note 4.

32. *See infra* Section IV.

33. *See infra* Section V.

34. *See infra* Section VI.

## II. A SHORT HISTORY OF THE PRUDENT MAN RULE[35]

At the time of the founding of the United States, the English rule was extremely conservative, allowing investment only in securities backed by the Crown.[36] The emphasis was on ensuring the safety of the corpus at all costs; the rule was extremely risk-averse.[37] When the question first arose in the United States, however, the English rule was rejected in favor of a flexible approach.[38] In dicta, the Massachusetts Supreme Judicial Court formulated the prudent man rule:

> 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.[39]

Despite the attempt of the Massachusetts court to formulate principles which would enable trustees to be flexible in exercising their discretion,[40] the prudent man rule quickly rigidified into a rule allowing only safe and conservative investments.[41] In *King v. Talbot*,[42] the influential New York Court of Appeals rejected a liberal interpretation of the rule by adding that the rule "necessarily excludes all

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35. This is intended to be a summary only. For a more extensive discussion of the history of the rule see LONGSTRETH, *supra* note 4, at 50-80; *see also* Robert J. Aalberts and Percy S. Poon, *The New Prudent Investor Rule and The Modern Portfolio Theory: A New Direction for Fiduciaries*, 34 AM. BUS. L.J. 39, 42-48 (1996); John H. Langbein, *The Uniform Prudent Investor Act and The Future of Trust Investing*, 81 IOWA L. REV. 641, 643-45 (1996); Gordon, *supra* note 4; John H. Langbein and Richard A. Posner, *Market Funds and Trust-Investment Law*, 1976 AM. BAR FOUND. RES. J. 1, 3-6 [hereinafter Langbein & Posner]; Paul G. Haskell, *The Prudent Person Rule for Trustee Investment and Modern Portfolio Theory*, 69 N.C. L. REV. 87, 88-100 (1990); Austin Fleming, *Prudent Investments: The Varying Standards of Prudence*, 12 REAL PROP., PROB. & TR. J. 243, 243-47 (1977); Mayo Adams Shattuck, *The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century*, 12 OHIO ST. L.J. 491, 491-504 (1951).

36. *See* Aalberts and Poon, *supra* note 35, at 42; Shattuck, *supra* note 35, at 492. There is speculation that this was in reaction to the collapse of the South Sea company in 1720 (the bursting of the South Sea Bubble). *See also* Langbein, *supra* note 35, at 643; Aalberts and Poon, *supra* note 35, at 42; Langbein & Posner, *supra* note 35, at 3.

37. *See* Aalberts and Poon, *supra* note 35, at 42.

38. *See* Harvard College v. Amory, 26 Mass. (9 Pick.) 446, 461 (1830). Several authors think the English rule was rejected at least partially because there were no investments available in America comparable to securities backed by the British government. *See* Shattuck, *supra* note 35, at 493; Fleming, *supra* note 35, at 243.

39. Harvard College v. Amory, 26 Mass. (9 Pick.) at 461. Some commentators believe the rule had religious origins. *See* Aalberts and Poon, *supra* note 35, at 42; J. Alan Nelson, *Note, The Prudent Person Rule: A Shield for the Professional Trustee*, 45 BAYLOR L. REV. 933, 937-38 (1993).

40. *See* LONGSTRETH, *supra* note 4, at 12; Halbach, *supra* note 2, at 1152; Thomas O. Burton, Patton G. Lochridge and David B. Young, *Risk Management for Corporate Fiduciaries* 10 (1997) (paper for presentation by members of McGinnis, Lochridge & Kilgore, L.L.P. (copy on file with author)) [hereinafter Young]; John H. Martin, *A Preface to the Prudent Investor Rule*, 132 TR. & EST. 42, 42-43 (Nov. 1993).

41. Martin, *supra* note 40, at 42-43; Langbein & Posner, *supra* note 35, at 4 ("What emerged, in short, was an emphasis on 'safe' investments, a category dominated in the minds of the judges and legislators by long-term fixed-return obligations such as mortgages and bonds.").

42. 40 N.Y. 76 (1869).

speculation, all investments for an uncertain and doubtful rise in the market."[43] A trustee could only be concerned with preservation of the corpus and obtaining a reasonable income.[44] The court rejected investments in common stocks, believing that by so investing the trustees had in effect delegated the performance of the trust to the corporate directors.[45] In the period from 1850 through the early 1900s most states adopted legal lists specifying permissible investments.[46]

However, the legacy of *King v. Talbot* was more pernicious. Common stocks were effectively held imprudent per se as investments.[47] As the case law developed, two significant limitations were developed constraining trustee investments. First, each decided case was treated as precedent, establishing an almost universally followed rule for future cases.[48] Thus, permissible investments over time became quite restricted. Second, broad categories of investment were prescribed as "speculative" and therefore per se imprudent.[49]

This system of specified "prudent" investments blessed by legal list statutes and court decisions saw little change until the late 1930s and early 1940s. Studies at this time showed that returns on trust investments in "prudent man" states were almost double the returns in legal list states.[50] From the late 1930s through the 1960s, many states replaced legal list statutes with some version of the prudent man rule.[51] Although there were occasional criticisms of the rule or the way it was applied, these criticisms engendered little change in the rule's operation.[52]

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43. *Id.* at 86.

44. *See id.*

45. *See id.* at 88.

46. *See* Shattuck, *supra* note 35, at 499; LONGSTRETH, *supra* note 4, at 12; Fleming, *supra* note 35, at 244.

47. *See* LONGSTRETH, *supra* note 4, at 12.

48. *See* Halbach, *supra* note 2, at 1152; Martin, *supra* note 40, at 42-43.

49. *See* Halbach, *supra* note 2, at 1152. Even modest speculation was forbidden; each individual investment had to be safe. *See also* Young, *supra* note 40, at 11-16. Among the investments and practices prohibited as speculative were:

1. Purchase of securities on margin.
2. Purchasing real property for resale.
3. Venture capital.

The following investments were questionable, but in most cases held speculative:

1. Precious metals
2. Collectibles
3. Deep discount bonds
4. Options
5. Futures
6. Selling securities short
7. Repurchase agreements
8. Securities lending
9. Currency hedging
10. Second mortgages.

*See* Robert A. Levy, Note, *The Prudent Investor Rule: Theories and Evidence*, 1994 GEO. MASON L. REV. 1, 3. *See also* Martin, *supra* note 40, at 42-43.

50. *See* Aalberts and Poon, *supra* note 35, at 43-44; Fleming, *supra* note 35, at 245.

51. *See* LONGSTRETH, *supra* note 4, at 12. Some of these statutes were based on a model investment statute developed by the Trust Division of the American Bankers Association. *See* Fleming, *supra* note 35, at 245; Shattuck, *supra* note 35, at 501.

52. The two most significant critiques of the rule were Shattuck, *supra* note 35 and Fleming, *supra* note 35. Mayo Shattuck, writing in 1951, was primarily concerned with encouraging the adoption of the flexible Massachusetts rule and having mutual funds and common trust funds

## III. MODERN PORTFOLIO THEORY

### A. *Risk and Return*

Entirely independent of the prudent man rule, beginning in the early 1950s, economists and financial theorists began to develop theories regarding investing. The early insights were formalized by Harry Markowitz in 1952.[53] The first significant point is that in designing a portfolio, an investor will look at the risk of the portfolio and its return.[54] Risk in this context is defined as the variance from the potential or expected outcome of an investment[55] or the amount of uncertainty involved in future outcomes.[56] But most investors are risk averse; that is, they would prefer to reduce risk to the lowest level.[57] They prefer investments with the smallest variance or deviation (lowest volatility in financial terms) from the expected return.[58] To say this in another way, for a given level of return chosen by an investor, that investor will generally choose a portfolio with the lowest level of risk (that is, the least uncertainty) possible.[59] To be convinced to invest in more volatile investments, the investor must be paid a risk premium (that is, a possibility of a greater return) to compensate the investor for the additional risk.[60] Financial analysts developed a method to measure the risk of investments[61] and to compare the risks of different investments to each other.[62]

As investors are averse to risk, they would want to reduce risk to the greatest extent possible. In examining risks, economists found that there were two different types of risk—systematic, or market risk, and nonmarket (also called firm-specific diversifiable, specific, unique, or uncompensated risk).[63] Market risk is

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recognized as permissible investments. *See* Shattuck, *supra* note 35, at 504-08. Fleming, writing in 1977, was disappointed that the flexible *Harvard College* doctrine had been rigidified by Scott's treatise and the Restatement (Second) of Trusts and advocated flexible rules permitting trustees to do their jobs. *See* Fleming, *supra* note 35, at 245-47. Fleming, however, was one of the first to urge, although not as forcefully as some of the writers in the 1980s, that the prudent man rule be modified to take account of modern financial practices. *See infra* Section IV.B.

53. Harry J. Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952).

54. *See* JONATHAN R. MACEY, AN INTRODUCTION TO MODERN FINANCIAL THEORY 17 (1991). Professor Macey's pamphlet, published by the ACTEC Foundation, is required reading for anyone interested in understanding trust investments. It presents the basic economic and financial concepts in a clear and simple way.

55. *See id.* at 17; *see also* Andrew S. Butler, *Modern Portfolio Theory and the Investment Powers of Trustees: The New Zealand Experience*, 7 BOND L. REV. 119, 122 nn.11-12 (1995).

56. *See* Stephen M. Penner, Note, *International Investment and the Prudent Investor Rule: The Trustee's Duty to Consider International Investment Vehicles*, 16 MICH. J. INT'L L. 601, 623-24 (1995).

57. *See* Macey, *supra* note 54, at 14, 16-17; Langbein & Posner, *supra* note 35, at 7.

58. *See* Macey, *supra* note 54, at 14.

59. *See* Langbein & Posner, *supra* note 35, at 7.

60. *See* Macey, *supra* note 54, at 16-17; Langbein & Posner, *supra* note 35, at 7; Penner, *supra* note 56, at 626.

61. Risk is measured by variance, which is an arithmetical expression referring to the spread of possible outcomes among various possibilities. *See* Macey, *supra* note 54, at 17, 19.

62. The standard deviation, which is the square root of the variance, compares the risks of different investments. *See id.* at 17; Butler, *supra* note 55, at 122 & n.12. Future variance is predicted by past variance. *See* Macey, *supra* note 54, at 19.

63. *See* Jerold I. Horn, *The Prudent Investor Rule—Impact on Drafting and the Administration of Trusts*, 20 ACTEC *Notes* 26, 27 (1994).

the risk that the return of the market in which the investment exists will be less than predicted.[64] It is the risk common to all securities, and reflects general economic and political conditions.[65] This risk affects all enterprises and cannot be reduced by the investor.[66] Nonmarket risk refers to the possibility that the return of a particular asset will be less than expected.[67] Experience has also revealed that all assets do not react to events in the same way. That is, to a given event, some investments may go up and others may go down.[68] To take a simplified example, if there is a strike against General Motors, the chances are that GM stock may go down, but the stock of Ford and Chrysler and others may go up. The same analysis works for industries. A tax on airline tickets may depress airline stocks, but cause a rise in automobile stocks. Holding stock in Ford and Chrysler, in the first example, and automobile stocks in the second, would help offset the losses on GM and airline stocks, respectively.[69] Thus, nonmarket risk can be diversified away.[70] By diversifying her portfolio, an investor can theoretically reduce all nonmarket risk.[71] The only risk remaining in the portfolio would be market risk.[72] Therefore, the risk of a diversified portfolio would be lower than that of a nondiversified portfolio. Since investors are risk averse, a rational investor would diversify her portfolio.[73] Moreover, since nonmarket risk can be diversified away, the market will not pay an investor a risk premium for a non-diversified portfolio.[74] Clearly, the point of diversification is to reduce firm or industry risk by investing in assets (and markets) which move in different ways so that the risk of the entire portfolio is reduced.[75]

Applying these rules to the development of a portfolio of investments, an investor would endeavor to construct a portfolio that contained assets yielding the lowest level of risk for a given rate of return or, alternatively, a portfolio yielding

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64. *See id.* at 29-30; Macey, *supra* note 54, at 23.

65. *See* Langbein, *supra* note 35, at 647-48.

66. *See* Macey, *supra* note 54, at 21; Penner, *supra* note 56, at 629.

67. *See* Horn, *supra* note 63, at 29-30; Macey, *supra* note 54, at 21. Some authors divide nonmarket risk into industry risk and firm risk. *See* Langbein, *supra* note 35, at 647-48. One author notes that market risk has been estimated to comprise thirty percent of the risk of an asset, with firm risk being twenty percent and industry risk accounting for fifty percent of total risk. *See id.*

68. *See* Macey, *supra* note 54, at 20; Lewis J. Altfest, *The New Prudent Investor Rule: Changing the Rules of the Game*, 4 J. TAX'N OF TR. AND EST., Winter 1992, at 18, 20.

69. *See* John H. Langbein and Richard H. Posner, *The Revolution in Trust Investment Law*, 68 A.B.A.J. 887, 888-89 (1976).

70. *See id.*; Macey, *supra* note 54, at 22; Langbein, *supra* note 35, at 647-48.

71. *See* Macey, *supra* note 54, at 23.

72. *See id.*

73. *Id.* at 24; Langbein & Posner, *supra* note 35, at 11.

74. Langbein & Posner, *supra* note 35, at 10; Langbein, *supra* note 35, at 648. Only market risk is compensated by a higher return in the market. *See* Langbein & Posner, *supra* note 35, at 10. Market or systematic risk of a stock is measured by its beta, which measures the riskiness of a security as compared to the risk of the entire market. *See id.* The higher the beta, the greater the risk of the stock. *See id.*

75. One author expresses it as investing in assets which complement each other as to risk. *See* Penner, *supra* note 56, at 628. The measure of the degree to which assets react to the market in the same manner is called "covariance," *see id.*, and the idea of diversification is to invest in assets which negatively covary. *See* Levy, *supra* note 49, at 12-13.

the highest rate of return for a given level of risk.[76] This is the so-called "efficient portfolio," defined as "one in which an investor would have to: (1) accept additional risk in order to obtain a higher return; and (2) give up returns in order to reduce the riskiness of the portfolio."[77] The efficient portfolio clearly must be diversified.[78] There are an infinite number of efficient portfolios, depending on the investor's choice of risk or rate of return.[79] The investor selects her optimal portfolio based on her tolerance for risk.[80]

The analysis of risk and return developed by financial theory significantly focused attention on the portfolio as a whole, rather than on the individual investments in the portfolio.[81] "The ultimate goal of modern portfolio theory is to balance portfolio risks and returns through diversification of the assets held."[82] The reason is that lowering the risk of a portfolio is accomplished by diversifying the entire portfolio by including in it assets which are negatively correlated.[83] Thus decisions as to the particular investments comprising the portfolio must be made by considering the role each plays in the whole portfolio; such decisions cannot be made in isolation.[84]

While the extent of diversification required is subject to dispute, the necessity of diversification is not.[85] Moreover, the focus on the risk and reaction of assets in relation to other assets means that an asset which is highly volatile and speculative in itself may actually reduce the risk of the total portfolio.[86] Therefore, according to modern portfolio theory, no asset is inherently good or bad or prohibited per se as speculative.[87] The judgment of the advisability of each asset must be made in the context of the entire portfolio.[88]

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76. *See* Macey, *supra* note 54, at 24.

77. *Id.*, citing Harry M. Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952).

78. *See* Macey, *supra* note 54, at 24.

79. *See id.*

80. *See id.* at 24-25.

81. *See* Butler, *supra* note 55, at 119-20.

82. *See* W. Brantly Phillips, Jr., Note, *Chasing Down The Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts*, 54 WASH. & LEE L. REV. 335, 352 (1997).

83. *See* Butler, *supra* note 55, at 119-20.

84. *See id.*

85. If portfolio theory is taken to its logical conclusion, of course, each portfolio would contain some of each type of investment, since markets and types of assets (e.g., venture capital, real estate, etc.) react differently to different events. Indeed, one author has suggested that including mutual funds investing in precious metals, foreign stocks, futures contracts and money market investments would reduce risk by 23% under his assumptions. *See* Levy, *supra* note 49, at 25. Another states that real estate, bonds, foreign securities, futures and options can be used to lower risk. *See* Gordon, *supra* note 4, at 53. Most, however, concentrate on stocks. Macey states that a well-selected 10 stock portfolio gives 88.5% of all the advantages of diversification and 20 stocks 94.2% of the advantages. *See* Macey, *supra* note 54, at 23. Another author states that to reach 98% diversification, ownership of 100 stocks is required. *See* Langbein, *supra* note 35, at 648-49 & n.50. Since almost no trust owns this many stocks, pooled investment vehicles (mutual funds or bank common trust funds) will be used. *See id. See also* Horn, *supra* note 63, at 29-30.

86. *See* Michael T. Johnson, *Speculating on the Efficacy of "Speculation": An Analysis of the Prudent Person's Slipperiest Term of Art in Light of Modern Portfolio Theory*, 48 STANFORD L. REV. 419, 421 (1996); Gordon, *supra* note 4, at 62.

87. *See supra* note 86.

88. *See* Butler, *supra* note 55, at 122-23.

To summarize, investors want to reduce risk as much as possible.[89] Modern financial theory has shown that this can be done by diversifying the portfolio.[90] The focus of the investor should be the portfolio as a whole, not the individual asset.[91] The individual asset can be evaluated only in the context of the whole portfolio because, though the asset may be highly speculative and volatile by itself, it may reduce the risk of the overall portfolio because it reacts to events differently than other assets in the portfolio.[92] As put by Professor Macey:

> Diversification not only reduces variability, it reduces variability a lot. What's more, it doesn't take a lot of diversification to generate a great reduction in the variability of a portfolio of stocks.
>
> Diversification reduces risk for one reason: all investments do not react the same way to all new information. Consequently, stock price movements are not uniform. They are imperfectly correlated. This means that if one holds a well diversified portfolio, the gains in one investment will cancel out the losses in another. Of course one cannot completely eliminate risk by holding a diversified portfolio. This is because one type of risk, called systematic risk, cannot be diversified away.[93]

Modern portfolio theory is the "most accepted conceptual framework for measuring return and risk of assets. . . ."[94] It has been accepted by financial managers and academics since the middle of the 1970s,[95] but it was not accepted by trust law until 1990.[96]

### *B. Capital Asset Pricing Model (CAPM)*

In the last section, the Author argued that since investors are risk averse, they would diversify their portfolios because to do so would reduce risk and not to do so would increase risk without reducing return.[97] While this is intuitively true, the finance theorists have demonstrated its truth by the capital asset pricing model (CAPM). Although for the purposes of this Article, it is more significant that economists have demonstrated the validity of the theory that diversification reduces firm specific risk, a short explanation of CAPM is warranted for a specific relevant insight the concept offers. CAPM holds that when investment strategies are based on risk and return, investors will diversify their portfolios to the extent that exposes them to the minimum level of risk for a given return.[98] Assume the beta coefficient (an economic term measuring the sensitivity of a security to market risk) of two portfolios is exactly the same, but the risk of every security in one portfolio (call it portfolio 1) is greater than every security in the other portfolio

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89. *See* Macey, *supra* note 54, at 14, 16-17; Langbein & Posner, *supra* note 35, at 7.
90. *See* Macey, *supra* note 54, at 24; Langbein & Posner, *supra* note 35, at 11.
91. *See* Butler, *supra* note 55, at 119-20.
92. *See* Johnson, *supra* note 86, at 421; Gordon, *supra* note 4, at 62.
93. Macey, *supra* note 54, at 20.
94. Aalberts & Poon, *supra* note 35, at 55.
95. *See* Gordon, *supra* note 4, at 74.
96. *See infra* Section VI.
97. *See supra* Section III.A.
98. *See* Jeffrey S. Glaser, *The Capital Asset Pricing Model: Risk Valuation, Judicial Interpretation, and Market Bias*, 50 Bus. Law. 687, 689-90 (1995).

(call it portfolio 2).[99] It might be assumed that investors would have a greater return (receive greater compensation from the market) for holding portfolio 1 than portfolio 2. The importance of CAPM to the present discussion is that it demonstrates that this assumption is incorrect. Investors will not receive additional compensation for holding portfolio 1.[100] The reason is that the additional risk of holding portfolio 1 is all nonmarket risk, and this risk is completely eliminated by the effects of diversification when the securities comprising portfolio 1 are chosen.[101] Like modern portfolio theory, CAPM is almost universally accepted by institutional advisers.[102]

### C. *Efficient Capital Market Hypothesis (ECMH)*

The previous sections have dealt with risk. The question remains, however, as to how the assets in the portfolio are selected. The risk-return analysis and CAPM tell us that a prudent investor will diversify the portfolio's assets to reduce nonmarket risk and will construct portfolios of stocks which are negatively covariant so that losses in some stocks will be offset by gains in others.[103] CAPM informs us that the price of the securities in the portfolio will be based on their significance to the total risk of the portfolio.[104] But should the prudent investor try to pick stocks that she thinks are undervalued by research, or attempt to "time the market"? Efficient Capital Market Hypothesis ("ECMH") says no. The theory "states that a market is efficient if the prices of goods sold in that market *fully reflects all available information about those goods*."[105] Otherwise put, a market is efficient if all information about the goods is reflected in the price of those goods instantaneously. If a market is efficient, a prudent investor would not spend the time or money necessary to research to find undervalued stocks because he could not beat the market consistently over a long period of time.[106] The reason for this is that to locate undervalued stocks, the investor must consistently discover information about companies that is not generally known.[107] The ECMH says this is impossible because by the time such information is discovered, it has already been reflected in the price of the stock.[108] Actually, there are three forms of ECMH:

1. The weak form states that information based on historic performance is reflected in a stock's current price.[109]

99. Macey, *supra* note 54, at 25. The market risk of a securities portfolio is the average of the risk of all the securities in the portfolio. *See id.* Thus, knowledge of the beta of the securities informs an investor of the riskiness of the portfolio to general events. A beta of 1.0 means that the stock moves exactly as the market moves. A stock with a beta of less than one means the investment is less risky than the market as a whole. Similarly, a stock with a beta of more than one is more risky than the market. *See id.* at 25-26. The example that follows is taken from Macey, *id.* at 31-32.

100. *See id.* at 32.

101. *Id.* This is because the beta of each portfolio is assumed to be the same.

102. *See id.*

103. *See id.* at 35-36.

104. *See id.* at 36.

105. *Id.* (emphasis in original).

106. *See id.* at 46-48.

107. *See id.*

108. *See id.* at 36.

109. *See id.* at 36-39.

2. The semi-strong form states that the market price reflects all publicly available information about a stock.[110]

3. The strong form states that a stock price reflects insider information about a stock.[111]

The efficiency of the stock market has been the subject of numerous studies. These studies have shown that the stock market is both weak form and semi-strong form efficient.[112] That is, all information publicly available and all information that can be gathered from the past values or trends of a stock is reflected in the stock's current price. The studies have shown that the portfolios of institutional investors have under-performed broad measures of the performance of markets as a whole.[113] Moreover, no one fund has outperformed its market over a long period of time.[114] Despite massive expenditures for research and trading, "professional fund managers have been unable to 'beat the market.'"[115] Professional managers did not better the law of averages in either choosing stocks or in market timing.[116]

What implications does the ECMH have for investing? First, market timing (trading based on technical analysis following stock price trends) will not work.[117] For efficient markets, a prudent investor will invest in a broad market, or index, fund.[118] However, it should be noted that the efficiency of some markets has not been studied and some markets are likely not efficient.[119] Moreover, recent work in financial theory has at least questioned the ECMH.[120] Thus, some degree of active management may be called for, at least in some circumstances.[121]

## IV. CRITICISM OF THE PRUDENT MAN RULE IN THE 1970S AND 1980S

The findings in economic and financial theory detailed in Section III developed independently of the prudent man rule. Trustees did not appear to be influenced by or apply these findings to trust investments. In the late 1970s and 1980s, however, a new group of observers began to point out the relevancy of the economic theories to trust investment practices and to call for reform in trust invest-

110. *See id.* at 40-41.

111. *See id.* at 41-42.

112. *See id.* at 38-41. Studies have been done for the New York Stock Exchange, the American Stock Exchange, and over-the-counter stocks. *See id.* at 37. The evidence, however, indicates that the securities markets are not strong form efficient. *See id.* at 41.

113. *See* Langbein & Posner, *supra* note 69, at 887; Macey, *supra* note 54, at 38.

114. *See* Langbein & Posner, *supra* note 69, at 887.

115. *Id.*

116. *See* Langbein, *supra* note 35, at 655-56. Macey points out that the stock market became efficient because of competition between market professionals (such as brokers and portfolio managers). Since these professionals are compensated for finding and understanding information about securities, it is in their best interests to uncover such information. The key reason why even professionals cannot beat the market is the cost of discovering information about stocks. *See also* Macey, *supra* note 54, at 44-46.

117. *See* Macey, *supra* note 54, at 46-48.

118. *See id.* at 55; Horn, *supra* note 63, at 30; Langbein, *supra* note 35, at 656-57.

119. *See* Macey, *supra* note 54, at 50-51. *See also* Section VI *infra*.

120. *See* Macey, *supra* note 54, at 56-58. The validity of the ECMH is beyond the scope of this article. However, whether markets other than the equity markets are efficient is clearly important in evaluating whether a trustee has performed its duty prudently. *See* Section VI, *infra*. I hope to examine this question in more detail in a subsequent article.

121. *See infra* Section VI.

ing. These criticisms, from academicians, a practicing lawyer, and a trust officer, set the stage for the evolution from the prudent man to the prudent investor.

### A. *Langbein and Posner*

In 1976, two young law professors, then at the University of Chicago, published an article inaugurating a new law journal.[122] John Langbein[123] and Richard Posner[124] took on the task of discussing the impact of the developments in financial theory on the prudent man rule. While focusing on whether index funds were permissible trust investments, the authors reviewed the developments in financial theory previously traced in this article.[125] Although the authors conclude that index funds are permissible trust investments,[126] the major importance of the article lies elsewhere. Perhaps its greatest significance is that it was the first attempt by recognized legal scholars to bring to the attention of practicing attorneys and law academicians the learning of economic and financial theorists.[127] Thus, Langbein and Posner are to be given credit for beginning the integration of economic and financial theory into the law of fiduciary investments and for being the "founding fathers" of the impending revolution of the prudent man rule.

The article also contained other significant observations. In its focus on the overall portfolio rather than the individual investments comprising the portfolio, the article began the attack which would culminate in victory.[128] The article also strongly criticized the rule prohibiting delegation by the trustee of all but ministerial tasks, particularly as to choosing investments.[129] Langbein and Posner laid the groundwork for a revision of this duty fifteen years later.[130]

### B. *Austin Fleming*

At about the same time as the Langbein and Posner article,[131] Austin Fleming, an attorney with a major Chicago bank, published an article based on his remarks at the Annual Meeting of the Section of Real Property, Probate and Trust Law of the American Bar Association.[132] Fleming's mission differed from that of Langbein

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122. *See* Langbein & Posner, *supra* note 35.

123. Now Chancellor Kent Professor of Law and Legal History at Yale Law School, Co-Reporter of the Restatement (Third) of Property, Donative Transfers, and Reporter of the Uniform Prudent Investor Act.

124. Now Chief Judge of the United States Court of Appeals for the Seventh Circuit.

125. *See* Langbein & Posner, *supra* note 35, at 6-18.

126. *See id.* at 30.

127. In listing previous discussions of whether a trustee can invest in an index fund, the authors cite three student notes and a book by now Judge Posner. *See id.* at 2 n.2. While Posner's book *Economic Analysis of Law* is now well known, it was published only three years prior to the article and had at that time perhaps not been widely read by practicing lawyers or law school academicians outside of the "law and economics" school. At any rate, the article is recognized as the initial important attempt to introduce economic and financial theory into the discussion of trust investments. *See* Gordon, *supra* note 4, at 54 n.6.

128. *See* Langbein & Posner, *supra* note 35, at 6-7, 24-26.

129. *See id.* at 18-24.

130. *See infra* Section VI.

131. *See* Langbein & Posner, *supra* note 35.

132. *See* Fleming, *supra* note 35, at n.*. Given the date of the presentation (August 10, 1976), I assume that the presentation was given to the Section at the 1976 American Bar Association Annual Meeting.

and Posner; Fleming advocated a return to the flexible *Harvard College v. Amory*[133] formulation of the prudent man rule.[134] Fleming believed that the original adaptability of the prudent man rule as formulated and the Model Investment Statute developed in the 1940s was constrained by the *Restatement (Second) of Trusts* and *Scott on Trusts*.[135] Fleming criticized these treatises as primarily responsible for altering the rule from a prudent man managing his own portfolio to one managing another's property.[136] This change in emphasis led courts to emphasize conservation, rule that the primary duty was to safeguard corpus, and distinguish between speculation and investment.[137] Fleming viewed the gloss of the treatises as a static concept, emphasizing the preservation of corpus and total risk avoidance, which would not adapt to changing investment theory.[138] The result of these limits is to "deter conscientious trustees from doing the best investment job they are capable of . . . ."[139]

Fleming's article emphasized a number of other deficiencies in the prudent man rule. The emphasis on the individual investment compels trustees to retain losing investments well beyond when a normal investor would sell them.[140] This results in very conservative investments and under-diversified trust portfolios holding a few "safe" stocks.[141] The prudent man rule ignores any duty to preserve the purchasing power of the principal.[142] The failure of the rule to allow new investment techniques results in corporate trustees ignoring will or trust provisions allowing such investments for fear that despite the language of the governing instrument, a court will brand the investment speculative.[143]

Perhaps the greatest significance of Mr. Fleming's presentation and article is that they brought the problem to the attention of the practicing bar. The presentation was given to a meeting of the largest organization of trust and estate attorneys, and it was published in that organization's journal. The author was associated with a major bank in a large city. Such a presentation alerted practicing lawyers to the problem in a number and a way perhaps the Langbein and Posner article could not.

### *C. Bevis Longstreth*

After Fleming's article, there were several other scholarly works criticizing the prudent man rule.[144] However, the next major step in reform came in 1986.

133. 26 Mass. (9 Pick.) 446 (1830).

134. *See* Fleming, *supra* note 35, at 255.

135. *See id.* at 245-46.

136. *See id.* at 246.

137. *See id.*

138. *See id.*

139. *See id.* at 247.

140. *See id.* at 248-49. A normal investor, knowing that some losses are inevitable, would sell them based on their poor performance. A trustee, concerned about being surcharged regardless of the overall performance of the portfolio, retains such investments hoping for a recovery. *See id.* at 249.

141. *See id.* at 249.

142. *See id.*

143. *See id.* at 251, 254-55.

144. *See, e.g.*, Kenneth L. Hirsch, *Inflation and the Law of Trusts*, 18 REAL PROP., PROBATE & TR. J. 601, 603 (1983) (stating that the rule was inappropriate in inflationary periods, since investing for high income or to protect the purchasing power of the remainder may expose a

Bevis Longstreth, a partner in the New York law firm of Debevoise & Plimpton, authored a book entitled *Modern Investment Management and the Prudent Man Rule*.[145] It is, of course, not only impossible but well beyond the scope of this article to summarize Longstreth's book. All that can be done is to make some comments which can only begin to describe its importance.

First, the author was, and still is, a practicing lawyer and a partner at a leading New York City law firm. The impact of criticism of the prudent man rule from such an attorney is enormous. Second, because of the position of the author, it is likely that the information contained in the book was more widely read than previous criticisms of the rule. Third, Longstreth combined a description of modern financial theory[146] with descriptions of the history and current status of the prudent man rule[147] and criticisms of the rule. He was able to collect in one place aspects of the rule which had previously been separately treated. Longstreth noted the rigidity of the rule, its ignorance of modern financial theory,[148] and the responsibility of Scott's *Law of Trusts* and the *Restatement (Second) of Trusts* for much of that rigidity.[149] In greater detail and with more certainty than any of the previous treatments, Longstreth called for major changes in the prudent man rule, which he termed the "modern paradigm of prudence" and which he described in some detail.[150] He also recommended that the ALI formulate a new restatement of the prudent man rule.[151]

Perhaps of even greater significance, however, is that Longstreth provided empirical evidence for his conclusions. He undertook to survey 200 fiduciaries, including the fifty largest bank trust departments, on their investment practices.[152] The survey resulted in one finding of enormous importance for our purposes. It showed that a significant number of fiduciaries, particularly corporate trustees of personal trusts, believed that the prudent man rule prohibits or renders questionable certain techniques in investing trust assets.[153] This finding and the details of the survey[154] gave great weight to Longstreth's conclusion that the rules govern-

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trustee to liability); Leslie Joyner Bobo, Comment, *Nontraditional Investments of Fiduciaries: Re-Examining the Prudent Investor Rule*, 33 EMORY L.J. 1067, 1093-94 (1984) (noting that investments permitted by the rule had neither kept pace with inflation nor protected the purchasing power of the remainder interests, that on a total return basis, inflation has been far ahead of traditional investments and that a conscientious fiduciary who saw his duty as protecting the beneficiaries against inflation was forced to risk liability by investing in risky and possibly imprudent investments).

145. LONGSTRETH, *supra* note 4.

146. *See id.* Chapters 3-4, apps. A, B.

147. *See id.* Chapters 1-2.

148. *See id.* at 13.

149. *See id.* at 13-16.

150. *See id.* at 156-57.

151. *See id.* at 158. Longstreth terms it a "restatement of the law of fund management by fiduciaries...." *Id.*

152. The survey recipients also included corporate pension funds, foundations, and private universities. *See id.* at 5.

153. *See id.* at 6.

154. The survey also revealed a number of other significant matters. *See id.* at 153-54, 232-66.

ing trust investments and delegation needed modernization.[155] The publication of Longstreth's book led directly to the changes described in the next two sections.

### *D. Jeffrey Gordon*

On the heels of Longstreth's book, Professor Gordon, who collaborated with Longstreth and wrote one of the appendices to the book,[156] published an influential article expanding on that appendix.[157] Gordon's article offered an explanation of why the "constrained" prudent man rule retained vitality and predicted change in the rule.[158] Professor Gordon expanded on Fleming's criticism of Scott and the *Restatement*,[159] explaining the importance and influence of authoritative commentary on judges and the development of the common law.[160] More importantly, however, Gordon's article represents the most extensive attempt to reconcile modern portfolio theory and the prudent man rule. Gordon partially excuses Scott for constraining the rule on the ground that Scott lacked the theoretical framework to distinguish between some risk, which Scott believed was acceptable, and too much risk, which was not.[161] Moreover, Gordon emphasized that it was not necessary to overrule the cases relied on by Scott to make the prudent man rule consistent with financial theory.[162] The cases need only be interpreted in light of the newer learning on market operation and investor behavior.[163] Professor Gordon also offered an explanation for the paucity of cases challenging the prudent man rule,[164] and the barriers to acceptance of the rule, including principally the complexity of the rule and the difficulty judges could have in understanding it.[165] Lastly, Gordon discussed in detail those portions of the rule which would require change to accommodate modern portfolio theory and then discussed some of those changes.[166]

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155. *See id.* at 158.
156. *See id.* at ix, app. B at 195-231.
157. *See* Gordon, *supra* note 4.
158. *See id.* at 55-56, 113-14.
159. *See* Fleming, *supra* note 35, at 245-46. *See also* Section IV.B, *supra.*
160. *See* Gordon, *supra* note 4, at 62-64.
161. *See id.* at 69.
162. *See id.* at 67.
163. *See id.*.
164. *See id.* at 75-88.
165. *See id.* at 90-94.
166. *See id.* at 94-112. Briefly, the changes suggested by Gordon are:

1. The trustee's duty of caution would require the trustee to use reasonable care, but would permit her to employ any investment vehicle or technique reasonably expected to achieve maximum return at the appropriate level of risk. *See id.* at 96.

2. The anti-netting rule, prohibiting the offsetting of gains on some securities against losses on others, would be dropped. *See id.* at 97.

3. Diversification would become mandatory except in special circumstances, rather than only to reduce the risk of large losses. *See id.* at 97-99.

4. The rules on allocations of receipts between principal and income would require changes. *See id.* at 99-112.

## V. THE INTERMEDIATE STATUTES

In the period between 1986 and 1991,[167] several states modified their "prudent man" statutes in response to the criticisms described above. During this period, twelve states amended their statutes, at least in part, to incorporate the lessons of modern financial theory into the prudent man standard. California, in

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167. This period is chosen because Bevis Longstreth's book was published in 1986, *see* LONGSTRETH, *supra* note 4, and the RESTATEMENT (THIRD) OF TRUSTS (PRUDENT INVESTOR RULE) was adopted by the American Law Institute at its 1990 Annual Meeting and became available in published form in 1992. *See* RESTATEMENT (THIRD) OF TRUSTS (PRUDENT INVESTOR RULE) (1992). Statutes drafted during this period might have worked from drafts of the *Restatement*, but states were not as likely to enact lengthy statutes incorporating elements of the comments into the statute. Such statutes were enacted in 1992 or later. *See, e.g.*, 760 ILL. COMP. STAT. ANN., 5/5 (West 1992). The Illinois statute was really the first of the more elaborate statutes incorporating aspects of the *Restatement* comments. Illinois worked from the "Proposed Final Draft" of the *Restatement*. *See* Uniform Prudent Investor Act, Prefatory Note. Virginia, which amended its statutes in 1992, is not included in the group of "intermediate" statutes, because although the Virginia statute bears a good deal of resemblance to the statutes discussed in this section, its changes were enacted after 1991.

The Virginia statute provides in part:

Standard of judgment and care required; authorized investments.

A. Except with respect to the securities described in § 26-40.01 and for those investments authorized by § 26-40, in acquiring, investing, reinvesting, exchanging, retaining, selling and managing property for the benefit of another, a fiduciary, whether individual or corporate, shall exercise the judgment of care, skill, prudence and diligence under the circumstances prevailing from time to time, (including, but not limited to, general economic conditions, anticipated tax consequences, the duties of the fiduciary and the interests of all beneficiaries) that a prudent person familiar with such matters and acting in his own behalf would exercise under the circumstances in order to accomplish the purposes set forth in the controlling document. *In investing pursuant to this standard, a fiduciary shall consider individual investments in the context of the investment portfolio as a whole and as part of the fiduciary's overall investment plan and shall have a duty to diversify investments unless, under the circumstances, it is prudent not to do so. Any determination of liability for investment performance shall consider not only the performance of a particular investment, but also the performance of the portfolio as a whole.*

Within the limitations of the foregoing standard, a fiduciary is authorized to acquire and retain every kind of property, real, personal or mixed, and every kind of investment which persons of prudence, discretion and intelligence might acquire or retain for their own account under the circumstances. Also, within the limitations of the foregoing standard, a corporate fiduciary is authorized to retain as received its own stock or securities or the stock or securities of a corporation owning eighty percent or more of its common stock, or any stock or securities received in exchange for any such investments.

B. Nothing contained in this section shall be construed as authorizing any departure from, or variation of, the express terms or limitations set forth in the controlling document creating or defining a fiduciary's duties and powers, but the terms "legal investment," "authorized investment," "prudent man (or prudent investor) investment" or words of similar import, as used in any such instrument, shall be taken to mean any investment that is permitted by the terms of subsection A . . . .

E. A controlling document may waive the rule of subjection A. A general authorization in a controlling document authorizing a fiduciary to invest in such assets as the fiduciary, in his sole discretion, may deem best, or other language purporting to expand the fiduciary's investment powers, shall not be construed to waive the rule of subsection A unless the controlling document expressly manifests an intention that it be waived (i) by reference to the "prudent man" or "prudent investor" rule, (ii) by

1986, was the first state to amend its statute in response to the criticisms of the prudent man rule. The 1986 California legislation provided:

§ 16040. Standard of care; modification by trust instrument

(a) The trustees shall administer the trust with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims to accomplish the purposes of the trust as determined from the trust instrument.

(b) When investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing trust property, the trustee shall act with the care, skill, prudence, and diligence under the circumstances then prevailing, including but not limited to the general economic conditions and the anticipated needs of the trust and its beneficiaries, that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims to accomplish the purposes of the trust as determined from the trust instrument. In the course of administering the trust pursuant to this standard, individual investments shall be considered as part of an overall investment strategy.

(c) The settlor may expand or restrict the standards provided in subdivisions (a) and (b) by express provisions in the trust instrument. A trustee is not liable to a beneficiary for the trustee's good faith reliance on these express provisions.[168]

The Iowa statute is perhaps more typical. Altered in 1991, the amended statute provides in part:

633.123. Model prudent person investment Act

1. Investments by fiduciaries.

When investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing property for the benefit of another, a fiduciary shall exercise the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use to attain the purposes of the account.*This standard requires that when making investment decisions, a fiduciary shall consider the role that the investment plays within the account's portfolio of assets and may consider the general economic conditions, the anticipated tax consequences of the investment, the anticipated duration of the account, and the needs of all beneficiaries of the account.*

*The propriety of an investment decision is to be determined by what the fiduciary knew or should have known at the time of the decision about the inherent nature and expected performance of the investment, the attributes of the account portfolio, the general economy, and the needs and objectives of the beneficiaries of the account as they existed at the time of the investment decision.*

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reference to the power of the fiduciary to make "speculative" investments, (iii) by an express authorization to acquire or retain a specific asset or type of asset such as a closely held business, or (iv) by other language synonymous with (i), (ii), or (iii). A fiduciary shall not be liable to a beneficiary for the fiduciary's good faith reliance on a waiver of the rule of subsection A.

VA. CODE § 26-45.1 (1997) (emphasis added).

168. CAL. PROB. CODE § 16040 (West 1991). California has since amended its statute to enact the UPIA. CAL. PROB. CODE, §§ 16045-16054 (West Supp. 1998).

2. Actions pursuant to governing instrument.

A fiduciary acting under a governing instrument is not liable to anyone whose interests arise from the instrument for the fiduciary's good faith reliance on the express provisions of the instrument. In the absence of an express provision to the contrary in the governing instrument, a fiduciary shall not be deemed to have breached the person's fiduciary duties for continuing to hold property received into an account at the account's inception or subsequently added to the account or acquired pursuant to proper authority if the fiduciary, in good faith and with reasonable prudence, considers that retention is in the best interest of the trust or estate or in furtherance of the goals of the governing instrument.[169]

In fact, the legislation of nine of the other eleven states that altered their statutes during this period greatly resembles the Iowa statute quoted above.[170] This

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169. IOWA CODE ANN. § 633.123 (1992) (emphasis added).

170. In addition to California, *see supra* text at note 168, and Iowa, *see supra* text at note 169, the statutes of the remaining 8 states provide:

*Alabama*

§ 19-3-120.2. Standard of care—Considerations by fiduciary.

(a) When investing, reinvesting, purchasing, acquiring, exchanging, selling and managing property for the benefit of another, a trustee, executor, administrator, guardian, conservator or other fiduciary shall act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use to attain the purposes of the account. In making investment decisions, a fiduciary shall consider the role that the investment plays within the account's overall portfolio of assets and may consider the general economic conditions, the anticipated tax consequences of the investment, the anticipated duration of the account and the needs of the beneficiaries of the account.

(b) The propriety of an investment decision is to be determined by what a fiduciary knew or should have known at the time of the decision about the inherent nature and expected performance of the investment, the attributes of the account portfolio, the general economy, and the needs and objectives of the beneficiaries of the account as they existed at the time of the investment decision.

(c) Any fiduciary acting under a governing instrument shall not be liable to anyone whose interests arise from such instrument for the fiduciary's good faith reliance on the express provisions of such instrument. The standards set forth in this section may be expanded, restricted or eliminated by express provisions in a governing instrument.

(d) In the absence of an express provision to the contrary in a governing instrument, a fiduciary may without liability continue to hold property received into an account at its inception or subsequently added to it or acquired pursuant to proper authority if and as long as the fiduciary, in the exercise of good faith and of reasonable prudence, may consider that retention to be in the best interest of the account or in furtherance of the goals of the governing instrument. Such property may include, among other things, stock in the fiduciary if a corporation, and stock in any corporation controlling, controlled by or under common control with the fiduciary.

ALA. CODE § 19-3-120.2 (1996) (enacted in 1989).

*Delaware*

§ 3302. Degree of care; authorized investments.

(a) When investing, reinvesting, purchasing, acquiring, exchanging, retaining, selling and managing property for the benefit of another, a fiduciary shall act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use to attain the purposes of the account. In making investment decisions, a fiduciary may consider the general economic conditions, the anticipated tax consequences of the investment and the anticipated duration of the account and the needs of its beneficiaries.

(b) Within the limitations of the foregoing standard and considering individual investments as part of an overall investment strategy, a fiduciary is authorized to acquire every kind of property, real, personal or mixed, and every kind of investment, wherever located, whether within or without the United States, including, but not by way of limitation, bonds, debentures and other corporate obligations, stocks, preferred or common, shares or interests in common funds or common trust funds, securities of any open-end or closed-end management type investment company or investment trust registered under the Federal Investment Company Act of 1940 (15 U.S.C. § 80A-1 et seq.), options, futures, warrants, limited partnership interests and life insurance. No investment made by a fiduciary shall be deemed imprudent solely because the investment is not specifically mentioned in this subsection.

(c) The propriety of an investment decision is to be determined by what the fiduciary knew or should have known at the time of the decision about the inherent nature and expected performance of the investment, the attributes of the portfolio, the general economy, and the needs and objectives of the beneficiaries of the account as they existed at the time of the decision. Any determination of liability for investment performance shall consider not only the performance of a particular investment, but also the performance of the portfolio as a whole.

(d) Any fiduciary acting under a governing instrument shall not be liable to anyone whose interests arise from that instrument for the fiduciary's good faith reliance on the express provisions of such instrument. The standards set forth in this section may be expanded, restricted or eliminated by express provisions in a governing instrument.

12 DEL. CODE ANN. § 3302 (1995) (enacted in 1986).

*Georgia*

Investments by executors and trustees—Standard for handling property; authorized acquisitions and investments; retention of property; conversion of nonproductive property qualifying for marital deduction into productive property.

(a) As used in this Code section, the terms "property" and "investment" shall be deemed to include life insurance, endowment, and annuity contracts issued by any insurer authorized to do business in this state.

(b) In acquiring, investing, reinvesting, exchanging, retaining, selling, and managing property for the benefit of another, an executor or trustee shall exercise the judgment and care, under the circumstances then prevailing, that a prudent person acting in a like capacity and familiar with such matters would use to attain the purposes of the account. In making investment decisions, an executor or trustee may consider the general economic conditions, the anticipated tax consequences of the investment, the anticipated duration of the account, and the needs of its beneficiaries.

(c) Within the limitations of the standard provided in subsection (b) of this Code section and considering individual investments as part of an overall investment strategy, an executor or trustee is authorized to acquire and retain every kind of property (real, personal, or mixed) and every kind of investment, specifically including, but not by way of limitation, bonds, debentures, and other corporate obligations, and stocks, preferred or common, including the securities of or other interests in any open-end or closed-end management investment company or investment trust registered under the Investment Company Act of 1940, as from time to time amended. The propriety of an investment decision is to be determined by what the executor or trustee knew or should have known at the time of the decision about the inherent nature and expected performance of the investment (including probable yield), the attributes of the portfolio, the general economy, and the needs and objectives of the beneficiaries of the account as they existed at the time of the decision. Any determination of liability for investment performance shall consider not only the performance of a particular investment, but also the performance of the individual's portfolio as a whole. Within the limitations of such standard, an executor or trustee may retain property properly acquired, without limitation as to time and without regard to its suitability for original purchase.

GA. CODE ANN. § 53-8-2 (1997) (enacted in 1988).

*Montana*

72-34-114. Duty to use ordinary skill and prudence.

(1) The trustee shall administer the trust with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would use to accomplish the purposes of the trust as determined from the trust instrument.

(2) When investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing trust property, the trustee shall act with the care, skill, prudence, and diligence under the circumstances then prevailing, including but not limited to the general economic conditions and the anticipated needs of the trust and its beneficiaries, that a prudent person would use to accomplish the purposes of the trust as determined from the trust instrument. In the course of administering the trust pursuant to this standard, individual investments shall be considered as part of an overall investment strategy.

(3) The trustor may expand or restrict the standards provided in subsections (1) and (2) by express provisions in the trust instrument. A trustee is not liable to a beneficiary for the trustee's reliance on these express provisions.

MONT. CODE ANN. § 72-34-114 (1997) (enacted in 1989).

*Nevada*

164.050. Standard of care in investing and managing property.

1. In acquiring, investing, reinvesting, exchanging, retaining, selling and managing property for the benefit of another, a fiduciary shall exercise the judgment and care under the circumstances then prevailing, which men of prudence, discretion and intelligence exercise in the management of their own affairs, not in regard to speculation, but in regard to the permanent disposition of their money, considering the probable income as well as the probable safety of their capital. Within the limitations of the foregoing standard, and subject to any express provision or limitation contained in any particular trust instrument or will, a fiduciary is authorized to acquire and retain every kind of property, real, personal or mixed, and every kind of investment, specifically including, but not by way of limitation, bonds, debentures, and other corporate obligations, and stocks, preferred or common, which men of prudence, discretion and intelligence acquire or retain for their own account.

2. The propriety of an investment decision is to be determined by what the fiduciary knew or should have known at the time of the decision about the inherent nature and expected performance of the investment, the attributes of the portfolio, the general economy and the needs and objectives of the beneficiaries of the account as they existed at the time of the decision. Any determination of the liability of the fiduciary for the performance of his investments must be made giving consideration not only to the performance of a particular investment, but also to the performance of the portfolio as a whole.

3. Nothing contained in this section authorizes any departure from, or variation of, the express terms or limitations set forth in any will, agreement, court order or other instrument creating or defining the fiduciary's duties and powers, but the terms "legal investment," or "authorized investment," or words of similar import, as used in any such instrument, shall be taken to mean any investment which is permitted by the terms of subsection 1.

4. The provisions of this section govern fiduciaries acting under wills, agreements, court orders and other instruments now existing or hereafter made.

NEV. REV. STAT. ANN. § 164.050 (Michie 1993) (effective 1989).

*South Carolina*

§ 62-7-302. Trustee's standard of care.

(a) Except as otherwise provided by the terms or limitations set forth in any will, agreement, court order, or other instrument creating or defining the fiduciary's duties and powers (the terms "legal investment" or "authorized investment" or words of similar import, as used in any such instrument being taken, however, to mean any investment which is permitted by the terms of this section), in acquiring, investing, reinvesting, exchanging, retaining, selling, and managing property for the benefit of another, a fiduciary shall exercise the judgment and care under the circumstances then prevailing, that a prudent person acting in a like capacity and familiar with such matters would use to attain the purposes of the fiduciary account. In making investment decisions, a fiduciary may consider the general economic conditions, the anticipated tax consequences of the investment, the anticipated duration of the fiduciary account, the needs and objectives of its beneficiaries, and other prevailing circumstances. Within the limitations of the foregoing standard and considering individual investments as part of an overall investment strategy, a fiduciary is authorized to:

(1) acquire and retain every kind of property and every kind of investment, specifically including, but not by way of limitation, bonds, debentures, and other corporate obligations, and stocks, preferred or common, and securities of any open-end or closed-end management-type investment company or investment trust registered under the Federal Investment Company Act of 1940, as amended;

(2) retain property properly acquired, without limitation as to time and without regard to its suitability for original purchase;

(3) retain the property received by such fiduciary on the creation of the estate, guardianship, trust, or other fiduciary account (including, in the case of a corporate fiduciary, stock or other securities of its own issue or of its parent corporation's issue) without regard to its suitability for original purchase;

(4) retain the securities into which corporate securities owned by the fiduciary may be converted or which may be derived therefrom as a result of merger, consolidation, stock dividends, splits, liquidations, and similar procedures (and may exercise by purchase or otherwise any rights, warrants, or conversion features attaching to any such securities);

(5) purchase or otherwise acquire and retain any security underwritten by a syndicate, even if the fiduciary or its affiliate (defined as any entity which owns or is owned by, in whole or in part, the fiduciary or is owned by the same entity that owns the fiduciary) participates or has participated as a member of the syndicate, provided the fiduciary does not purchase the security from itself, its affiliate, or from another member of the underwriting syndicate or its affiliate pursuant to an implied or express reciprocal agreement between the fiduciary or its affiliate, and such other member or its affiliate, to purchase all or part of each other's underwriting participation commitment within the syndicate. The propriety of an investment decision is to be determined by what the fiduciary knew or should have known at the time of the decision about the inherent nature and expected performance of the investment, the attributes of the portfolio, the general economic conditions, the anticipated tax consequences of the investment, the anticipated duration of the fiduciary account, the needs and objectives of the beneficiaries of the account, and other pertinent circumstances as they existed at the time of the decision. Any determination of liability for investment performance shall consider not only the performance of a particular investment but also the performance of the portfolio as a whole. Any fiduciary acting under a governing instrument shall not be liable to anyone whose interests arise from that instrument for the fiduciary's good faith reliance on the express provisions of such instrument. The standards set forth in this section may be expanded, restricted, or eliminated by express provisions in a governing instrument; and

(6) invest and reinvest in the securities of an open-end or closed-end management investment company or of an investment trust registered under the Investment Company Act of 1940, as amended. A bank or trust company may invest in these securities even if the bank or trust company, or an affiliate of the bank or trust company, provides services to the investment company or investment trust such as that of an investment advisor, custodian, transfer agent, registrar, sponsor, distributor, manager, or otherwise, and receives reasonable remuneration for those services.

(b) The provisions of this section shall not be construed as restricting the power of a court of proper jurisdiction to permit a fiduciary to deviate from the terms of any will, agreement, or other instrument relating to the acquisition, investment, reinvestment, exchange, retention, sale, or management of fiduciary property.

S.C. CODE ANN. § 62-7-302 (Law. Co-op. 1987 & Supp. 1997) (enacted in 1990).

*Tennessee*

35-3-117. Additional methods of investment under prudent man rule.

(a) All trustees, guardians and other fiduciaries in this state (herein collectively called "fiduciary"), unless prohibited by the will, deed, agency agreement or trust instrument (herein collectively called "governing instrument") of the person (herein collectively called "trustor") creating the trust, agency account or other fiduciary relationship, or unless by any such governing instrument another mode of investment is prescribed, may, in addition to other methods of investment authorized by law, invest all funds held in the trust or agency account or for investment as provided in this section.

(b) When investing, reinvesting, purchasing, acquiring, exchanging, selling and managing property, a fiduciary shall act not in regard to speculation but with the care, skill, prudence and diligence under the circumstances then prevailing, specifically including, but not by way of limitation, the general economic conditions, the anticipated tax consequences of an investment, the anticipated duration of the trust, and the anticipated needs of the trust and its beneficiaries, that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims to attain the goals of the trustor as determined from the governing instrument. Within the foregoing limitations and considering individual investments as part of an overall investment strategy, a fiduciary is authorized to acquire and retain every kind of property (real, personal or mixed, and including life insurance, endowment and annuity contracts) and every kind of investment. The trustor may expand or restrict the standards set forth in this section by express provisions in the governing instrument. Any fiduciary under a governing instrument shall not be liable to anyone whose interests arise from that instrument for the fiduciary's good faith reliance on those express provisions. Any determination of liability for investment performance shall consider the performance of the portfolio as a whole and shall not be confined to the performance of a particular investment.

(c) In the absence of express provisions to the contrary in the governing instrument, a fiduciary may without liability continue to hold property received into a trust at its inception or subsequently added to it or acquired pursuant to proper authority if and as long as the fiduciary, in the exercise of good faith and reasonable prudence, discretion and intelligence, may consider that retention is in the best interest of the trust and its beneficiaries or in furtherance of the goals of the trustor as determined from that instrument. Such property may include capital stock in the corporate fiduciary and stock in any corporation controlling, controlled by or under common control with such fiduciary. . . .

TENN. CODE ANN. § 35-3-117 (1996) (enacted in 1989).

*Texas*

§ 113.056. Standard for Trust Management and Investment.

(a) Unless the terms of the trust instrument provide otherwise, in acquiring, investing, reinvesting, exchanging, retaining, selling, supervising, and managing trust property, including an investment vehicle authorized for the collective investment of trust funds pursuant to Part 9, Title 12, of the Code of Federal Regulations, a trustee shall exercise the judgment and care under the circumstances then prevailing that persons of ordinary prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income from as well as the probable increase in value and the safety of their capital. In determining whether a trustee has exercised prudence with respect to an investment decision, such determination shall be made taking into consideration the investment of all the assets of the trust, or the assets of the collective investment vehicle, as the case may be, over which the trustee had management and control, rather than a consideration as to the prudence of the single investment of the trust, or the single investment of the collective investment vehicle, as the case may be.

(b) Within the limitations of Subsection (a) of this section, a trustee may acquire and retain every kind of property and every kind of investment that persons of ordinary prudence, discretion, and intelligence acquire or retain for their own account.

(c) Within the limitations of Subsection (a) of this section, a trustee may indefinitely retain property acquired under this section without regard to its suitability for original purchase.

type of statute expanded the traditional prudent man rule in four ways:

1. It made clear that the propriety of any individual investment was to be judged by the investment's relation to the portfolio as a whole.[171]

2. It made explicit that in designing the portfolio, the fiduciary could take account of factors such as economic conditions, the needs of the beneficiaries, the expected length of the trust, and the tax aspects of the investment.[172]

3. It recognized that the governing instrument could authorize or permit investments beyond the stated standard.[173]

4. A decision as to prudence would be based on the fiduciary's knowledge (or what the fiduciary should have known) at the time the decision was made.[174]

Two states took a slightly more expansive approach. In 1986, Minnesota adopted a statute which, although having many similarities to the statutes cited above, contained some significant differences. This statute lists additional factors to be used in considering prudence and appears to attempt to authorize a broader range of investments and techniques than previously allowed under the traditional prudent man rule.[175]

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> (d) Within the limitations of Subsection (a) of this section, whenever the instrument directs, requires, authorizes, or permits investment in obligations of the United States government, the trustee may invest in and hold such obligations either directly or in the form of interests in an open-end management type investment company or investment trust registered under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq., or in an investment vehicle authorized for the collective investment of trust funds pursuant to Part 9, Title 12 of the Code of Federal Regulations, so long as the portfolio of such investment company, investment trust, or collective investment vehicle is limited to such obligations and to repurchase agreements fully collateralized by such obligations.

TEX. PROB. CODE ANN. § 113.056 (West 1995) (enacted in 1991).

171. *See* statutes *supra* at notes 168-70 and accompanying text.

172. *See id.*

173. *See id.*

174. *See id.*

175. *See* MINN. STAT. ANN. § 501.125 (West 1996) (repealed 1989) (quoted in RESTATEMENT (THIRD) OF TRUSTS, PRUDENT INVESTOR RULE § 227, Reporter's General Notes at 74-75 (Proposed Final Draft 1990)), which provided:

> (a) A trustee is authorized to invest in every kind of real or personal property and every kind of investment, specifically including, but not by way of limitation, bonds, debentures and other individual or corporate obligations, mutual funds, and corporate stocks that a prudent person would invest in having in mind the preservation of the trust estate and the amount and regularity of the income derived. In considering an investment, a trustee shall exercise the care, skill, and judgment under the circumstances then prevailing that a person of ordinary prudence would exercise in the management of the person's own property; and shall consider the role that the investment plays within the trust's overall portfolio of assets. If the trustee has greater skills than a person of ordinary prudence or is named trustee by representing that the trustee has greater skills than a person of ordinary prudence, the trustee is under a duty to use those skills.
>
> (b) Among the factors to be considered by a trustee in determining the prudence of a particular investment are the following:
>
> (1) the probable income of the trust as well as the probable safety of the capital of the trust;
>
> (2) the composition of the portfolio of the trust with regard to diversification;
>
> (3) the length of the term of investments of the trust;
>
> (4) the duration of the trust;
>
> (5) the liquidity needs and current return of the trust's portfolio relative to the anticipated cash requirements of the trust;
>
> (6) other assets of the beneficiary or beneficiaries known to the trustee, in

A series of statutes enacted by the state of Washington in 1984 adopted a "total asset" (portfolio) approach, listed seven factors that a fiduciary should consider in applying that approach, and authorized nontraditional investments, including, for example, new and unproven enterprises (including investing as a limited partner), with a limit of ten percent of the trust.[176]

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(7) the relative interests of income and remainder beneficiaries; and

(8) the tax consequences.

(c) If a trustee is a national banking association or holds a certificate under section 48.37 or if a trustee retains or employs an investment advisor registered under the Investment Advisors Act of 1940, an investment which is otherwise prudent is not imprudent solely because it is in new, unproven, untried or other enterprises with a potential for a significant growth or in a limited partnership or commingled fund investing in these enterprises.

Minnesota has since enacted the UPIA. MINN. STAT. ANN. § 501B.151 (1997).

176. *See* WASH. REV. CODE ANN. §§ 11.100.020, 11.100.023 (West 1996), which provide as follows:

§ 11.100.020. Management of Trust Assets by Fiduciary.

(1) A fiduciary is authorized to acquire and retain every kind of property. In acquiring, investing, reinvesting, exchanging, selling and managing property for the benefit of another, a fiduciary, in determining the prudence of a particular investment, shall give due consideration to the role that the proposed investment or investment course of action plays within the overall portfolio of assets. In applying such total asset management approach, a fiduciary shall exercise the judgment and care under the circumstances then prevailing, which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, and if the fiduciary has special skills or is named trustee on the basis of representations of special skills or expertise, the fiduciary is under a duty to use those skills.

(2) Except as may be provided to the contrary in the instrument, the following are among the factors that should be considered by a fiduciary in applying this total asset management approach:

(a) The probable income as well as the probable safety of their capital;
(b) Marketability of investments;
(c) General economic conditions;
(d) Length of the term of the investments;
(e) Duration of the trust;
(f) Liquidity needs;
(g) Requirements of the beneficiary or beneficiaries;
(h) Other assets of the beneficiary or beneficiaries, including earning capacity; and
(i) Effect of investments in increasing or diminishing liability for taxes.

(3) Within the limitations of the foregoing standard, and subject to any express provisions or limitations contained in any particular trust instrument, a fiduciary is authorized to acquire and retain every kind of property, real, personal, or mixed, and every kind of investment specifically including but not by way of limitation, debentures and other corporate obligations, and stocks, preferred or common, which persons of prudence, discretion, and intelligence acquire for their own account.

§ 11.100.023. Authority of Fiduciary to Invest in Certain Enterprises.

Subject to the standards of RCW 11.100.020, a fiduciary is authorized to invest in new, unproven, untried, or other enterprises with a potential for significant growth whether producing a current return, either by investing directly therein or by investing as a limited partner or otherwise in one or more commingled funds which in turn invest primarily in such enterprises. The aggregate amount of investments held by a fiduciary under the authority of this section valued at cost shall not exceed ten percent of the net fair market value of the trust corpus, including investments made under the authority of this section valued at fair market value, immediately after any such investment is made. Any investment which would have been authorized by this section if in force at the time the investment was made is hereby authorized.

We would be in a better position to analyze whether the courts would employ these "intermediate statutes" to import modern portfolio theory into the evaluation of trust investment decisions if these statutes had produced a body of case law indicating how they would be interpreted. Unfortunately, to date only a single case has involved a significant interpretation of these statutes. *Estate of Cooper*[177] was an estate accounting proceeding challenging the investments of a co-executor and co-trustee (who was also the income beneficiary) over a period of eleven years.[178] Decedent bequeathed one-half of her community property in trust with the income from the trust payable to her husband for his life, and on his death the trust property became payable to decedent's two children.[179] Following the sale of the community's share of a closely held corporation at a one-million dollar profit,[180] the estate was invested thirteen percent in common stocks and eighty-seven percent in bonds and bond equivalents.[181] In addition, the estate inventory listed an unsecured note of $1.2 million and interests in two partnerships.[182] The court evaluated the propriety of the investments as if they were held by a trust.[183]

The court viewed the question of whether the fact that the return of the trust as a whole exceeded the co-trustee bank's Trust Department returns exonerated the trustees, or whether the court could consider the performance of specific assets in determining trustee liability.[184] The court ruled that it could consider specific assets and groups of assets, correctly ruling that the performance of the trust as a whole is not measured by the overall net gain or loss of the trust.[185]

Although the court reached the correct result, its reasoning was flawed. The court apparently did not understand the total portfolio concept of the statute. An evaluation of the total portfolio would have analyzed whether the executors and trustees formulated a rational plan for the investment of the estate and trust, evaluating the role of each investment in the overall corporation of the portfolio. There is no indication that the court undertook this sort of evaluation.[186] The question is not whether specific assets or groups of assets could be scrutinized. The relevant question is whether the trustee formulated a plan for the trust, evaluating risk and return, and chose the trust investments with a view as to their role in the overall

177. 913 P.2d 393 (Wash. Ct. App. 1996).

178. *See id.* at 393-96. The decedent died in 1978, but no inventory and accounting of the estate assets was filed until 1989.

179. *See id.* at 395.

180. *See id.* at 396.

181. *See id.* at 397.

182. *See id.* at 396.

183. *See id.* at 397.

184. *See id.* at 395.

185. *See id.* at 398.

186. There is one subtle hint that perhaps the court had an inkling of what it should be doing. The court stated:

> Likewise, Mr. Cooper did not weigh his investment in income-producing securities against his investment in [the closely held corporation]. The overall trust performance was boosted dramatically by the sale of the [closely held] stock in 1983. But Mr. Cooper's investment strategy could not have anticipated the gain from the sale of the stock before it occurred.

*Id.* at 399.

portfolio.[187] There is no indication that the court understood that its role was to determine if the trustees performed this kind of analysis.[188]

In addition to deciding the case on the trustee's failure to formulate a rational investment plan, the court could have decided the case on the ground that the husband, as trustee and income beneficiary, had a conflict of interest. By investing in assets weighted toward producing income, the trustee violated the duty of impartiality between the income beneficiary and remaindermen.[189] While the duty of impartiality is influenced by modern portfolio theory,[190] there is no indication that this case represents the balancing of interests called for by the *Restatement*.[191] Moreover, the conflict of interest in this case makes the trustee's conduct wrongful on grounds entirely independent of the propriety of the investments.

The only other case to discuss the intermediate statutes does not significantly aid in their interpretation because it involved a trust instrument containing special provisions which controlled the question at issue.[192] For our purposes, the court noted that while the Minnesota statute required that diversification be considered with regard to the initial making of an investment, the sale or disposition of investments is in the trustee's discretion.[193] While this may indicate a strict interpretation of the statute, the importance of the statement is unclear. The import of the court's observation is unclear, first, because it is dictum (since the special provision in the instrument controlled the investments in this case); and second, because the court devotes only three sentences in its opinion to the issue.

## VI. THE RESTATEMENT (THIRD) OF TRUSTS AND THE UNIFORM PRUDENT INVESTOR ACT—MODERN PORTFOLIO THEORY ADOPTED

### A. *Introduction*

The traditional prudent man rule prohibited trustees from investing trust funds in accordance with modern portfolio theory. Trustees were prevented from pursuing promising investment opportunities[194] and using newer investment tools such

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187. *See supra* at Section III.

188. The court did recognize that the prudent investor test was one of conduct and that the performance of the trust, while a factor, is not controlling. *See* Estate of Cooper, 913 P.2d at 398.

189. *See* RESTATEMENT (SECOND) TRUSTS § 232. This duty, like the other aspects of trust investing, applies not to each individual investment, but to the trust portfolio as a whole. *See* RESTATEMENT, *supra* note 5 § 227 cmt. i, § 232 cmt. c. The court noted the overweighting of the investments towards income and recognized the conflict of interest the husband faced between his duty as trustee and his position as income beneficiary. *See* Estate of Cooper, 913 P.2d at 399.

190. *See* RESTATEMENT, *supra* note 5, § 232, cmt. c.

191. *See id.*

192. In the Matter of Trusts Created by Hormel, 504 N.W.2d 505 (Minn. App. 1993). The trust instruments involved provided that the trusts and the grantor's foundation maintain a controlling interest in Geo. A. Hormel & Co. *See id.* at 507. The main issue in the case was whether the trustees should be surcharged for failure to sufficiently diversify the assets of the trusts. *See id.* at 508-09.

193. *See id.* at 512.

194. *See* Diane Del Guercio, *The Distorting Effect of the Prudent-Man Laws on Institutional Equity Investment*, 40 J. FIN. ECO. 31, 35 (1996).

as futures and options.[195] This caused trustees to tilt trust accounts toward high quality stocks.[196] Thus, the performance of trust funds tended to mirror the performance of large capitalization companies.[197] Mutual funds outperformed bank funds from 1968 to 1983, while the reverse was true from 1983 to 1989.[198] The significant point is that the fear of liability under the old prudent man rule distorted trustees' investment decisions and did not permit trustees to invest in accordance with modern economic theory.

Summarizing the deficiencies of the common law prudent man rule, the rule:

1. focused on individual assets rather than on the overall portfolio;
2. focused on the preservation of the nominal value of the corpus rather than on maintenance of its purchasing power;
3. completely prohibited certain investments and classes of investments;
4. prohibited delegation of all but ministerial duties;
5. encouraged the avoidance of acquiring new investment products and employing new investment techniques; and
6. approved certain investments without inquiry.[199]

The intended flexibility of the prudent man rule as first enunciated rigidified with subsequent elaboration by the courts.[201] The investment rules became rigid and frozen.[200] Such arbitrary restrictions cause unjustified liability for trustees and conservatism in adopting new and promising products and techniques. The restrictions were unwise and "often counterproductive."[202] While there were isolated reports of trust departments at certain banks using modern portfolio theory,[203] such instances were few. It was said that courts were unable to comprehend the teachings of modern portfolio theory.[204]

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195. *See id.* (reporting a 1988 study by Stanley Block & Timothy Gallagher, *How Much Do Bank Trust Departments Use Derivatives?*, 15 J. PORTFOLIO MGMT. Fall 1988 at §§ 12-15, showing only 11.3 percent of bank trust managers used futures and options for trust funds, with 95 of 204 managers responding citing legal obstacles to explain the failure to use these vehicles).

196. *See id.* at 32, 58-59. High quality stocks tend to be those of companies with larger capitalization and low book-to-market ratios. *See id.* at 60.

197. *See id.* at 58-59.

198. *See id.*

199. *See* Horn, *supra* note 63, at 27. *See also* Aalberts and Poon, *supra* note 35, at 53; Johnson, *supra* note 86, at 420-21; Young, *supra* note 40, at 11; Richard A. Sages, *The Prudent Investor Rule and the Duty Not to Delegate*, TR. & EST. May, 1995, at 22.

200. *See* RESTATEMENT, *supra* note 5, Introduction.

201. *See id.*

202. *See id.*

203. It was reported in 1990 that, at least for trust accounts of individual investors, United States Trust Company of New York was using modern portfolio theory, including focusing on total return, index funds, international investments, and a long-term perspective. Frederick B. Taylor, *Overcoming the Short-Term Short-Sighted Approach*, TR. & EST., March 1990, at 16-17. It was also reported that the Worthen Bank and Trust Company in Little Rock invested in no load mutual funds (in place of common trust funds) for trusts, allocating these funds based on the clients' return objectives and risk tolerances, subscribed to services rather than using analysts, established asset allocation models and a computer program for purchases and sales, and evaluated investment companies and mutual funds instead of individual stocks. *See* Aubrey L. Avants, *Investing the Multi-Manager Multi-Style Way*, TR. & EST., March 1990, at 20, 21-24.

204. *See* Young, *supra* note 40, at 10.

The American Law Institute investigated the topic of trust investments and, in 1990, reformulated the prudent man rule.[205] The Institute reformulated the prudent man rule as the prudent investor rule in the new *Restatement*.[206] The National Conference of Commissioners on Uniform State Law in 1994 reformulated the *Restatement* principles into a uniform act.[207] The *Restatement*'s prudent investor rule was based on certain "principles of prudence":[208]

1. No investment or technique is imprudent per se.[209]

2. "[S]ound diversification is fundamental to risk management and is therefore ordinarily required of trustees."[210]

3. Trustees must analyze risk and return for each trust and consciously determine the level of each appropriate to the trust, considering the purposes, beneficiaries, required distributions, tax factors and other circumstances of the trust.[211]

4. Trustees must avoid expenses (including fees and transaction costs) that cannot be justified by the requirements and objectives of the trust.[212]

5. The trustee's duty of impartiality among beneficiaries includes, as relating to future beneficiaries, protecting the purchasing power of the remainder interests.[213]

6. All functions of the trust may be delegated, and the trustee has authority (and may in some cases have a duty) to delegate as a prudent investor would.[214]

The remainder of this section proceeds to discuss briefly each of these principles as reflected in the *Restatement* and the UPIA.

### *B. Formulation of the Rule*

The *Restatement* actually made minimal changes in the formulation of the rule, but the changes it did make are crucial. The *Restatement*'s formulation is:

> § 227. General Standard of Prudent Investment.
>
> The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements and other circumstances of the trust.[215]

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205. *See* RESTATEMENT, *supra* note 5. The reformulation was passed at the ALI annual meeting in 1990.

206. *See id.*

207. This Act was called the Uniform Prudent Investor Act (1994).

208. *See* RESTATEMENT, *supra* note 5, Introduction.

209. *See id.*

210. *See id.*

211. *See id.*

212. *See id.*

213. *See id.*

214. *See id.*

215. RESTATEMENT, *supra* note 5, § 227. The remaining portions of § 227 will be quoted in succeeding subsections of this section as appropriate. The UPIA formulation is similar: "A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust." *Id. supra* note 6, § 2(a). The corresponding portion of the RESTATEMENT (SECOND) OF TRUSTS § 227 (1959) was:

> Investments Which a Trustee Can Properly Make
> In making investments of trust funds, the trustee is under a duty to the beneficiary
> (a) in the absence of provisions in the terms of the trust or of a statute otherwise providing, to make such investments and only 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.

First, the change in the title from the *Restatement (Second)* is significant. The new standard is general and avoids any reference to proper investments. The new provision was intended to preserve the flexibility of the original rule and extend it.[216] Symbolically significant is the change from "prudent man" to "prudent investor," indicating an intention to cleanse the rule of its prior rigidity and to embrace modern investment theory.[217] In addition, by omitting any reference to "his own property," the *Restatement* does away with the controversy over whether the standard was the management of the prudent man's own funds or the funds of others.[218] Of great significance also is the deletion of the reference to "preservation of the estate and amount and regularity of income."[219] This will be discussed in a later subsection.[220] It should be noted that the rule is a default rule which can be overridden by a provision in the governing instrument.[221]

The provision in the *Restatement* concerning the "purposes, distribution requirements, and other circumstances of the trust" is new and is intended to emphasize that the investment strategy of the trust should be formulated with many factors taken into account. Such factors include the terms of the trust,[222] the economic circumstances and needs of the beneficiaries,[223] the cash needs of the trust,[224] the distribution requirements (both regular and unusual),[225] the tax brackets of the beneficiaries,[226] the tax effects of the timing of capital gains, and fees.[227]

216. *See* RESTATEMENT, *supra* note 5, § 227, cmt. a, reporter's notes, general notes at 59. The new title omits any reference to investments being proper. For § 227 of RESTATEMENT (SECOND) OF TRUSTS see *supra* note 215.

217. *See* RESTATEMENT, *supra* note 5, cmts. e, h.

218. *See id.*, reporter's notes, general notes at 59.

219. *See* RESTATEMENT (SECOND) OF TRUSTS § 227 (1959).

220. *See* discussion *infra* Section VI.E.

221. RESTATEMENT, *supra* note 5, § 227(d).

222. *See* Halbach, *supra* note 2, at 1167-68, n.57.

223. *See id.*

224. *See id.*

225. *See id.*

226. *See* Altfest, *supra* note 68, at 21.

227. *See id.* at 21-22. UPIA provides:

> Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:
> (1) general economic conditions;
> (2) the possible effect of inflation or deflation;
> (3) the expected tax consequences of investment decisions or strategies;
> (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;
> (5) the expected total return from income and the appreciation of capital;
> (6) other resources of the beneficiaries;
> (7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and
> (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

UPIA, *supra* note 6, § 2(c).

### *C. Adoption of Modern Portfolio Theory*

Both the *Restatement*[228] and the UPIA[229] specifically accept modern portfolio theory in the sense that a portfolio should be constructed by ascertaining the risk tolerance and return objectives of the trust.[230] Both require the trustee to be sensitive to risk and return, and both recognize that risk tolerance varies greatly in each trust.[231] The comments to the *Restatement*[232] and the Reporter's Notes[233] contain an extensive discussion of the elements of modern portfolio theory, including the relationship of risk and return. While the *Restatement* does note that "[t]here are no universally accepted and enduring theories of financial markets or prescriptions for investment that can provide clear and specific guidance to trustees and courts,"[234] and that varied investment approaches to investing trust funds are permitted,[235] the prudent investor rule is clearly designed with modern portfolio theory in mind.[236] However, the Reporter for the *Restatement* has said:

> The prudent investor project was undertaken with a clear recognition that trust investment law should reflect and accommodate current knowledge and concepts in the financial community. While seeking to incorporate the lessons of modern experience and research, a scrupulous effort was made to avoid either endorsing or excluding particular theories of economics or investment. In addition, an important objective in drafting the prudent investor rule was to preserve the flexibility necessary for the incorporation of future learning and developments. . . .
>
> The rules are designed to be general and flexible enough to adapt to the changes that may occur over time in the financial world.[237]

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228. RESTATEMENT provides:

> This [prudent investor] standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.

RESTATEMENT, *supra* note 5, § 227(a).

229. UPIA provides:

> A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

UPIA, *supra* note 6, § 2(b). It is interesting that the UPIA replaces the Restatement's "should" with "must," mandating the trustee to use a risk and return analysis.

230. Modern portfolio theory and the relationship of risk and return were discussed *supra* in Section III. *See also* Robert Cooter and Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1062-63 (1991).

231. *See* UPIA, *supra* note 6, § 2 cmt.; RESTATEMENT, *supra* note 5, § 227 cmts. e-h.

232. *See* RESTATEMENT, *supra* note 5, § 227 cmts. e-i.

233. *See* RESTATEMENT, supra note 5, § 227 reporter's notes on cmts. e-h at 74-79.

234. RESTATEMENT, *supra* note 5, § 227 cmt. f.

235. *See id.*

236. *See* Horn, *supra* note 63, at 28; Aalberts & Poon, *supra* note 35, at 54.

237. Halbach, *supra* note 2, at 1154. *See also* RESTATEMENT, *supra* note 5, Introduction, at 5; Lyman W. Welch, *How the Prudent Investor Rule May Affect Trustees*, TR. & EST. Dec. 1991, 15, 16.

### *D. Total Portfolio Approach*

Under the prudent man rule, assets were evaluated individually with no consideration of the role of the asset in the total trust portfolio.[238] Modern portfolio theory teaches that the proper focus is on the total portfolio, and each asset must be evaluated in light of its effects on the total portfolio.[239] Indeed, this is one of the prime tenets of modern portfolio theory.[240] In accordance with modern economic theory, both the *Restatement*[241] and the UPIA[242] require that each investment be viewed as a part of the overall trust portfolio. The significance of this approach, which has been previously discussed,[243] is summarized in the UPIA comment to section 2:

> Portfolio standard. Subsection (b) emphasizes the consolidated portfolio standard for evaluating investment decisions. An investment that might be imprudent standing alone can become prudent if undertaken in sensible relation to other trust assets, or to other nontrust assets. In the trust setting the term "portfolio" embraces the entire trust estate.[244]

### *E. Preservation of Purchasing Power*

Under the traditional prudent man rule, the trustee's duty was to preserve the estate.[245] This was meant to avoid losses to the estate; it did not encompass protection of the remainder interest against inflation.[246] Both the *Restatement*[247] and the UPIA[248] have recognized that modern portfolio theory requires that the purchasing power of the trust corpus be preserved.[249] It has been predicted that under

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238. *See* sources cited *supra* note 199.

239. *See* William S. Hershberger, *Fiduciary Investing in the 90's—Restatement Third of Trusts: Panacea or Placebo*, 27 PHILIP E. HECKERLING INST. ON EST. PLAN. ¶ 500, ¶ 503.4(B) at 5-23 (1993). *See also* Aalberts & Poon, *supra* note 35, at 63.

240. *See* Aalberts and Poon, *supra* note 35, at 63. *See also* Langbein & Posner, *supra* note 69, at 890. *See supra* Section III.

241. *See* RESTATEMENT, *supra* note 5, § 227(a), also quoted in *supra* note 228.

242. UPIA, *supra* note 6, § 2(b), quoted in note 229.

243. *See supra* Sections III and V.

244. UPIA, *supra* note 6, § 2 cmt.

245. *See* RESTATEMENT (SECOND) OF TRUSTS § 227 (1957).

246. *See id.*

247. *See* RESTATEMENT, *supra* note 5, § 227, cmt. e, which discusses the necessity of preserving the purchasing power of the trust property as a part of the requirement of caution, and states:

> [T]his requirement of caution requires the trustee to invest with a view both to safety of the capital and to securing a reasonable return.
>
> "Safety" of capital includes not only the objective of protecting the trust property from the risk of loss of nominal value but, ordinarily, also a goal of preserving its real value—that is, seeking to avoid or reduce loss of the trust estate's purchasing power as a result of inflation.

248. *See* UPIA, *supra* note 6, § 2(c)(2), which directs the trustee to consider "the possible effect of inflation or deflation" in investing.

249. *See* Aalberts & Poon, *supra* note 35, at 62-63; Herschberger, *supra* note 239, at ¶ 503.5(C) 5-28 to 29; Altfest, *supra* note 68, at 20; John A. Taylor, *Massachusetts' Influence in Shaping the Prudent Investor Rule for Trusts*, 78 MASS. L. REV. 51, 59 (1993); Phillips, *supra* note 82, at 360; Sages, *supra* note 199, at 26.

the *Restatement* and the UPIA sacrificing return for low risk by selection of a conservative portfolio composed of traditional conservative investments (such as bonds, treasury bills, certificates of deposit and savings accounts, and even some equities that emphasize dividends over appreciation) that permit inflation to erode the purchasing power of the corpus would constitute a breach of the duty of caution, and create liability to the trust beneficiaries.[250]

The second part of this change is that "return" in modern portfolio theory means total return, including both income and appreciation.[251] In modern portfolio theory, the type of return is irrelevant; maximizing total return at a given level of risk is the objective.[252] Several authors have noted that in the trust investment context such a definition of return could create a conflict between the income beneficiaries and remaindermen.[253] This could occur, for example, when the strategy adopted by the trustee to maximize return at the risk tolerance of the trust required heavy investment in low dividend, high growth stocks or, inversely, in high yield, low growth stocks.[254] The *Restatement* recognizes this problem[255] and, while not suggesting an allocation formula to balance income and growth assets for any particular trust,[256] it recommends that the trustee use its best judgment to balance the interests of all beneficiaries in light of all the circumstances of the trust.[257] The *Restatement* recognizes that preservation of the purchasing power of the corpus may be impossible in certain circumstances.[258] Further discussion of the solution to the potential conflict between the duty of impartiality and the total return concept of modern portfolio theory is beyond the scope of this article.[259]

250. *See* Horn, *supra* note 63, at 30; Taylor, *supra* note 249, at 51-52.

251. *See* RESTATEMENT, *supra* note 5, § 227, cmt. e; UPIA, *supra* note 5, § 2(c)(5); Macey, *supra* note 54, at 60-61; Butler, *supra* note 55, at 132; Gordon, *supra* note 4, at 99-101.

252. *See* Macey, *supra* note 54, at 62.

253. *See* Gordon, *supra* note 4, at 100-01; Macey, *supra* note 54, at 60-62; Butler, *supra* note 55, at 132-33; Joel C. Dobris, *New Forms of Private Trusts for the Twenty-First Century—Principal and Income*, 31 REAL PROP., PROB. & TR. J. 1, 3 (1996).

254. *See* Halbach, *supra* note 2, at 1171-72.

255. *See* RESTATEMENT, *supra* note 5, § 232, cmt. c.

256. *See* Taylor, *supra* note 249, at 59.

257. *See* RESTATEMENT, *supra* note 5, § 227, cmt. e.

258. *See id.*, *supra* note 5.

259. This problem has been recognized by commentators with differing suggestions. One author suggests that the trustee may have to forego investing in some of its preferred selections to satisfy the duty of impartiality. *See* Dobris, *supra* note 253, at 3. Several authors have suggested the increased use of fully discretionary trusts, with a payment of a percentage of the total return to the current beneficiary mandated by the governing instrument or allocated in the trustee's discretion. *See also* Butler, *supra* note 55, at 133-34; Macey, *supra* note 54, at 60-61; Halbach, *supra* note 2, at 1171; RESTATEMENT, *supra* note 5, § 227, cmt. i; Martin, *supra* note 40, at 46; Joel C. Dobris, *Real Return, Modern Portfolio Theory, and College, University and Foundation Decisions on Annual Spending from Endowments: A Visit to the World of Spending Rules*, 28 REAL PROP., PROB. & TR. J. 49, 80 (1993). Giving the trustee power to invade principal for the current beneficiary has also been suggested. *See id.* at 79; Halbach, *supra* note 2, at 1171. Prior to the *Restatement*, it was suggested that the payout be geared to the actual long-term yield of the trust, with a separate account to reflect surpluses and shortfalls. *See* Gordon, *supra* note 4, at 102-07.

### *F. No Investment Is Imprudent Per Se*

In conformity with modern portfolio theory, both the *Restatement*[260] and the UPIA[261] permit a trustee to hold any investment as part of a trust and to use any investment technique. No investment is imprudent in and of itself.[262] The basis of this rule is the finding of modern portfolio theory that an investment which is risky in itself can actually reduce the overall volatility of a trust portfolio because it moves inversely to the other investments.[263] Moreover, to generate a higher rate of return, higher risk is required, which may be appropriate for some trusts.[264] The rejection of the rule that speculative investments are imprudent in all circumstances increases the flexibility of trustees in designing the trust portfolio and the adaptability of the rule to approve new investment vehicles and techniques.[265] Trustees are now allowed to evaluate and include in trust portfolios, where appropriate, risky investments such as venture capital and junk bonds,[266] mortgages and other asset-backed securities and real estate,[267] stripped securities, currency and interest rate swaps, Eurobonds, financial futures, options,[268] various equity derivatives,[269] and foreign stocks.[270] It should be noted that these assets may be inappropriate for many, if not most, trust portfolios and for those in which they may be appropriate, they will probably only be includable in small amounts.[271] The important point is that trustees may consider the use of these investments and techniques in constructing the trust portfolio.[272]

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260. RESTATEMENT, *supra* note 5, § 227, cmt. f.

261. *See* UPIA, *supra* note 6, § 2(e), which provides: "A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act]." *Id.*

262. *See* RESTATEMENT, *supra* note 5, § 227, cmt. f; Halbach, *supra* note 2, at 1155, 1166; Langbein, *supra* note 35, at 649-50; Bevis Longstreth, *Tailoring Prudence: Using Circumstances, Not Absolutes, to Judge Fiduciaries*, TR. & EST. Sept. 1986 at 14, 16 [hereinafter Longstreth, *Tailoring Prudence*]; Levy, *supra* note 49, at 7.

263. *See* RESTATEMENT, *supra* note 5, § 227, cmt. e; Levy, *supra* note 49, at 7.

264. *See* Longstreth, *Tailoring Prudence*, *supra* note 262, at 16; Young, *supra* note 40, at 10-11.

265. *See* RESTATEMENT, *supra* note 5, § 227 reporter's notes to cmt. k; Halbach, *supra* note 2, at 1155.

266. *See* Halbach, *supra* note 2, at 1166.

267. *See* Taylor, *supra* note 249, at 62.

268. *See* Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEXAS L. REV. 1369, 1370 (1991). *See generally* Henry T. C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEXAS L. REV. 273 (1991).

269. *See* Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 TEXAS L. REV. 1319, 1323 (1991).

270. *See* Penner, *supra* note 56, at 638, 641-43; Langbein, *supra* note 35, at 659.

271. One author has stated that to use non-traditional investments, such as many of those mentioned above, a $10,000,000 portfolio is required. These investments are highly volatile and under-diversified, generally produce little income, are highly illiquid, and require expertise because the markets in which they exist are not efficient. *See* Nancy L. Jacob, *Portfolio Management and Non-Traditional Investing*, TR. & EST. June, 1995 at 14, 14.

272. For the steps involved in constructing a portfolio, see Aalberts & Poon, *supra* note 35, at 67-69.

### *G. Diversification*

Under the prior prudent man rule, diversification was generally required, but only to minimize the risk of large losses.[273] In modern portfolio theory, however, diversification assumes far greater importance. Diversification is required to reduce as far as possible the risk of a portfolio that is not compensated for by the market by way of greater return.[274] A major finding of modern portfolio theory is that, since different investments react differently to events effecting the economy, an investment can reduce risk if it reacts differently to events than do the other investments in the portfolio.[275] Therefore, unless "the objectives of both prudent risk management and impartiality can be satisfied" without diversification, or unless circumstances peculiar to the trust (such as the continuation of a family business) are involved, diversification is required for all trusts.[276]

The problem then becomes how much and what types of diversification are required. Various "optimum" numbers of securities necessary for diversification[277] and various types of investments which should be held have been suggested.[278] Wisely, both the *Restatement*[279] and the UPIA[280] avoid any specification as to the exact number or type of investments to be held by a particular trust.

### *H. Duty To Limit Costs*

A new portion of the prudent investor rule—one which has engendered some controversy—is the duty to limit costs.[281] This duty is at least partially derived from both the increased requirement of diversification, discussed previously,[282]

273. *See* RESTATEMENT (SECOND) TRUSTS § 228, cmt. a, which states in part: "The trustee is under a duty to the beneficiary to exercise prudence in diversifying the investments so as to minimize the risk of large losses, and therefore he should not invest a disproportionately large part of the trust estate in a particular security or type of security." *Id.*

274. *See* RESTATEMENT, *supra* note 5, § 227, cmt. e.; *see also supra* Section III.

275. *See* RESTATEMENT, *supra* note 5, § 227, cmt. g.

276. *Id.*; *see also* UPIA *supra* note 6, § 3. Among the special circumstances mentioned are the capital gains cost of selling low basis securities in a tax sensitive trust and the desire to retain a family business. *See id.*, cmt.; RESTATEMENT, *supra* note 5, § 228, cmt. c. It should be noted that preservation of a family farm should constitute a special situation which might relieve the trustee (at least partially) of the duty to diversify. *See* RESTATEMENT, *supra* note 6, § 228, cmt. e, Illus. 5; Langbein, *supra* note 35, at 665; Gordon, *supra* note 4, at 98.

277. *See, e.g.*, Penner, *supra* note 56, at 633-34 (50 assets); Aalberts & Poon, *supra* note 35, at 69 (40-50 securities in the portion of the portfolio devoted to equities); Langbein & Posner, *supra* note 69, at 889 (about 200 stocks necessary in order to reduce the risk to a one percent gain or loss).

278. *See, e.g.*, Penner, *supra* note 56, at 642-43 (stating that ignoring international investments is a breach of duty); Stephen P. Johnson, *Trustee Investments: The Prudent Person Rule or Modern Portfolio Theory, You Make The Choice*, 44 SYRACUSE L. REV. 1175, 1183 (1993) (suggesting inclusion of nontraditional investments). RESTATEMENT, *supra* note 5, § 227, reporter's note, general note on cmts. e to h at 77 (significant diversification achievable with small number of securities).

279. *See id. See also* RESTATEMENT, *supra* note 5, § 227, cmt. g.

280. *See* UPIA, *supra* note 6, § 4, cmt.

281. *See* RESTATEMENT, *supra* note 5, § 227(c)(3), which provides "(c) In addition, the trustee must: . . . (3) incur only costs that are reasonable in amount and appropriate to the investment responsibility of the trusteeship." *Id.* The UPIA is similar. Section 7, entitled "Investment Costs," provides: "In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee." UPIA, *supra* note 6, § 7.

282. *See supra* Section VI.G.

and the efficient market hypothesis which is part of modern portfolio theory.[283] The efficient market hypothesis broadly teachès that in efficient markets, all information is reflected in a stock's price within an extremely short time after the information becomes available.[284] Thus, it is extremely difficult to "beat the market," despite the expertise of fiduciaries, their employees, brokers, or others.[285] Therefore, at least as to the major securities markets, which are efficient, paying large expenses, especially broker's commissions, is wasteful because empirical research has revealed that such effort rarely yields returns in excess of market returns.[286] Therefore, incurring costs in an attempt to outperform the market in an efficient market would be wasteful. While scrupulously avoiding any condemnation of active strategies,[287] the overall tone of the *Restatement* comments leaves a firm impression that a primarily passive strategy which holds down costs is preferred. The *Restatement*, as a beginning, clearly authorizes mutual funds as a trust investment which does not violate the delegation rules.[288] Indeed, for a relatively small trust, mutual funds are almost a necessity, since reasonable diversification is otherwise extremely difficult to achieve without high transaction costs.[289] The *Restatement* concludes: "Therefore, given the fiduciary duty to avoid excessive administration expense . . . purchasing suitable mutual fund shares may be more inviting to the trustee because it offers a means of obtaining much greater diversification for what will usually be a lower cost."[290] The *Restatement* then compares passive and active strategies. A program of passive strategies, primarily investing in index funds,[291] is termed "a practical investment alternative to be considered by trustees,"[292] offering the advantages of economy, price security, and diversification.[293] A suggestion is made that debt instruments, such as short-term federal obligations, be used to lower the risk of a portfolio composed mainly of index funds, and borrowing be used to raise return.[294] In contrast, while active management strategies are allowed, and admitted to be necessary in certain situations, the *Restatement* notes the normal high transaction costs of such strategies and requires, if these costs are substantial, that they be justified by "realistically evaluated return expectations."[295]

The general tone of the comments to the *Restatement*, and the emphasis on cost containment, have led commentators to state that a trustee's only rational strategy is to buy a market index fund and borrow if a higher return is desired, or buy

283. *See supra* Section III.
284. *See* RESTATEMENT, *supra* note 5, § 227, reporter's note, general note on cmts. e through h, at 75.
285. *See id.*; *see also* Young, *supra* note 40, at 11.
286. *See* RESTATEMENT, *supra* note 5, § 227, reporter's note, general note on cmts. e through h, at 75.
287. *See id.* § 227, cmt. h.
288. *See id.*, cmt. m.
289. *See id.*, cmt. h.
290. *Id.* The *Restatement* does caution that such an approach requires knowledge of different types of funds, and the fees and dangers of each type. *See id.*
291. *See infra* notes 296-301, discussing index funds.
292. RESTATEMENT, *supra* note 5, § 227, cmt. h.
293. *See id.*
294. *See id.*
295. *Id.*

riskless assets, such as Treasury notes, to reduce portfolio risk.[296] Others predict that the *Restatement*'s emphasis on cost control might be read as mandating a passive strategy and requiring considerable justification for an active strategy.[297]

An index fund is a fund that buys securities in proportion to their value on an exchange or listing of all or of a particular type of stock, bond or other investment.[298] Because the fund only buys or sells a security when a significant change in the price of the security occurs or when an investment is added to or dropped from the index measuring the fund, index funds have a "buy and hold" strategy which insures low transaction costs.[299] Indeed, one author has suggested that trustees should prefer no-load funds over funds having a sales charge because of lower costs.[300] In fact, given the growth of index funds in recent years, a trustee can get an index fund which invests in almost any type of asset desired.[301] Therefore, there would appear to be limited need or justification for investing in other than index funds.

Where are active strategies useful? Such strategies are primarily useful in markets that are less efficient than the major securities markets.[302] The major areas where the markets are less efficient and active management may be justified include real estate,[303] venture capital,[304] foreign securities,[305] financial derivatives, such as distressed debt and managed futures,[306] arbitrage,[307] private equity partnerships,[308] and hedged funds.[309]

While active strategies are expressly permitted, current views on market efficiency indicate the advisability of serious consideration of index funds.[310] But trustees should note the warning from the Reporter of the *Restatement* when considering active investment strategies:

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296. *See* Langbein & Posner, *supra* note 35, at 18.

297. *See* Hershberger, *supra* note 239, at ¶ 503.6(D) 5-33-34. *See also* Halbach, *supra* note 2, at 1164-66; Altfest, *supra* note 68, at 20-21; Langbein & Posner, *supra* note 69, at 888; Butler, *supra* note 55, at 125-28.

298. *See* RESTATEMENT, *supra* note 5, § 227, cmt. h.

299. *See* Langbein & Posner, *supra* note 69, at 888.

300. *See* Altfest, *supra* note 68, at 20-21.

301. The first index fund was offered on June 7, 1973. *See* Robert Frick, *Reality Check: A Diary of a Bear Market*, KIPLINGER'S PERSONAL FINANCE MAGAZINE, Oct. 1997, at 91, 94. As of late 1996, 133 index funds existed, and many more were expected. *See* Ken Sheets, *The Agony and the Index*, KIPLINGER'S PERSONAL FINANCE MAGAZINE, Oct. 1996, at 77. Among existing types of index funds were international funds, funds indexed to the Dow Jones 30, the Standard & Poor 500, the STPI BARRA Growth Index, the Russell 2000 Index of Small Company Stocks, and many others. *See id.* at 77-81.

302. *See* RESTATEMENT, *supra* note 5, § 227, cmt. h; Martin, *supra* note 40, at 45; Aalberts & Poon, *supra* note 35, at 70.

303. *See* Butler, *supra* note 55, at 126-27; Halbach, *supra* note 2, at 1163; Jacob, *supra* note 271, at 14.

304. *See* Butler, *supra* note 55, at 126-27; Halbach, *supra* note 2, at 1163; Jacob, *supra* note 271, at 24-29.

305. *See* Langbein, *supra* note 35, at 659-60; Penner, *supra* note 56, at 638-43.

306. *See* Jacob, *supra* note 271, at 21-24, 29-32.

307. *See id.* at 21.

308. *See id.*

309. *See id.*

310. *See* Halbach, *supra* note 2, at 1162.

Cost and risk concerns should be taken carefully into account in deciding whether to undertake a particular active investment strategy and also in implementing that strategy. In particular, prudent fund managers should cautiously and realistically evaluate increased return expectations before concluding that these expectations justify the extra costs that typically result from active investment programs. . . . The greater the departure from sound passive strategies, the greater the manager's burden becomes, not only of justification but also of continuous monitoring.[311]

*I. Delegation*

Historically, a trustee was permitted to delegate only ministerial tasks; discretionary duties (including the choice of investments) were not delegable and were required to be performed by the trustee personally.[312] Dissatisfaction with the rule became widespread, partly due to the complexity of investment alternatives available[313] and partly because the vagueness of the rule gave little guidance to trustees as to what was ministerial and what was discretionary.[314] Both the *Restatement*[315] and the UPIA[316] reverse the delegation rule and permit such delegation as a prudent investor would exercise in the circumstances.

Delegation is not limited to ministerial acts.[317] The *Restatement* does not permit full delegation of the duties of the trustee; the trustee must at least define the trustee's investment objectives and must approve the investment plan and strategy of the trust.[318] While the UPIA is more detailed, calling for the exercise of "reasonable care, skill and caution" in delegation of powers and duties,[319] it is

311. *Id.* at 1165-66.

312. *See* John H. Langbein, *Reversing the Nondelegation Rule of Trust-Investment Law*, 59 Mo. L. Rev. 105, 108-09 (1994); Langbein, *supra* note 35, at 650-51; Young, *supra* note 40, at 28-29.

313. *See* Langbein, *supra* note 35, at 650-52.

314. *See* Langbein, *supra* note 312, at 108-09.

315. *See* Restatement, *supra* note 5, § 171; § 227, cmt. j.

316. *See* UPIA, *supra* note 6, § 9(a).

317. *See* Restatement, *supra* note 5, § 171, cmt. f.

318. *See id*, § 227, cmt. j.

319. Section 9 of the UPIA provides:

§ 9. Delegation of Investment and Management Functions.

(a)A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:

(1) selecting an agent;

(2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and

(3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

(b) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

(c) A trustee who complies with the requirements of subsection (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.

(d) By accepting the delegation of a trust function from the trustee of a trust that is subject to the law of this State, an agent submits to the jurisdiction of the courts of this State.

UPIA, *supra* note 6, at § 9.

doubtful if the difference in wording between the UPIA and the *Restatement* is intended to indicate a difference in philosophy or standards. The intention of liberalizing the delegation rule was to enable trustees to take advantage of expert advice in investment decisions,[320] and most commentators agree that the hiring of an investment manager or an advisor to consult periodically about the trust's portfolio is permitted under the new rules.[321] The trustee must use prudence, care, and skill in hiring the advisor or investment manager, supervising his performance, and monitoring his activities.[322]

The reversal of the delegation rules has generated significant comment. One author proposes the use of a special trustee for investments or for a particular asset if desired by the grantor.[323] The new rule has been commended for increasing the possibility of family members (and other individuals) being able to act as trustees because of their ability to procure outside investment advice.[324] Another commentator views the rule as contrary to a grantor's expectations, arguing that the grantor chose the trustee because of the grantor's reliance on the trustee's skill and abilities.[325] The grantor intended the trustee to perform discretionary duties personally, whereas the new rule allows the trustee to delegate those duties.[326] The commentators have also debated over whether, and in what circumstances, there may be a duty to delegate investment functions.[327]

## VII. THE RESTATEMENT AND UPIA IN STATE LEGISLATURES AND THE COURTS

### A. *Adoption of the Uniform Prudent Investor Act*

As of January 1, 1998, the UPIA has been adopted in full or with minor modifications in 19 states.[328] Seven other states have adopted statutes which incorpo-

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320. *See* RESTATEMENT, *supra* note 5, Introduction at 7.

321. *See* Altfest, *supra* note 68, at 21, 22-23; Young, *supra* note 40, at 31; Halbach, *supra* note 2, at 1173-74.

322. *See* RESTATEMENT, *supra* note 5, Introduction at 7; Langbein, *supra* note 312, at 110; Altfest, *supra* note 68, at 22-23.

323. *See* Horn, *supra* note 63, at 33.

324. *See* Taylor, *supra* note 249, at 52. Grantors and testators may often believe that family members are more sensitive to a beneficiary's circumstances and need for trust funds than banks. For such grantors, the new delegation rule offers the best of both worlds. The family member can act as trustee, bringing his knowledge and skill in family relations to the trust, while obtaining investment advice from a bank or other financial manager. One author has noted that acting as an investment manager, advisor or as consultant on risk, return, and asset allocation for trustees may represent a new opportunity for banks. *See* Sager, *supra* note 199, at 27.

325. *See* Jerome J. Curtis, Jr., *The Transmogrification of the American Trust*, 31 REAL PROP., PROB. & TR. J. 251, 273 (1996).

326. *See id.* at 273-75.

327. *See* Young, *supra* note 40, at 28-29; Langbein, *supra* note 312, at 109-10; Hershberger, *supra* note 239, ¶ 503.5, at 5-28. *See also* RESTATEMENT, *supra* note 5, § 227, cmt. j. This question is beyond the scope of this article.

328. *See* ARIZ. REV. STAT. ANN. § 14-7601 (West Supp. 1997); ARK. CODE ANN. §§ 24-3-417-426 (Michie Supp. 1997); CAL. PROB. CODE § 16045 (West Supp. 1998); COLO. REV. STAT. ANN. § 15-1.1-101 (Bradford 1997); 1997 CONN. LEGIS. SERV. P.A. 97-140; HAWAII REV. STAT. §§ 554 B-1-B-12 (1995); IDAHO CODE § 68-501 (Michie Supp. 1998); ME. REV. STAT. ANN. tit. 18-A, § 7-302 (West 1998); MINN. STAT. ANN. § 501B.151 (West 1990); MO. ANN. STAT. § 456.900 (West Supp. 1998); Neb. Laws L.B. 102; N.J. STAT. ANN. § 3B: 20-11.1 (West Supp. 1998); N.M. STAT. ANN. § 45-7-601 (Michie 1995); N.D. CENT. CODE § 59-02-08.1 (Michie Supp. 1997); OKLA. STAT. ANN. tit. 60, § 175.60 (West Supp. 1998); OR. REV. STAT. § 128.192

rate many of the concepts of the UPIA, but do not adopt its language.[329] This represents quick and widespread adoption for a four-year-old statute, indicating that state legislatures approve of the principles of modern portfolio theory as applied to trust investments.

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(Oreg. Leg. Coun. Com. 1997); R.I. GEN. LAWS § 18-15-1 (Michie 1996); UTAH CODE ANN. § 75-7-302 (Lexis Supp. 1998); W. VA. CODE § 44-6C-1 (Michie 1997). Although N.Y. Est. Powers & Trusts § 11-2.3 is often added to this list, the New York statute, though having the same objectives and purposes as the UPIA, differs from it substantially in form. N.Y. Est. Powers & Trusts § 11-2.3 is quoted in note 329, *infra.*

329. The first of these statutes was adopted by Illinois in 1992 and was based on a draft of the RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE (Proposed Final Draft 1990). The statute, currently 760 ILL. COMP. STAT. ANN. 5/5 (West 1992) provides:

> Sec. 5. Investments. (a) Prudent Investor Rule. A trustee administering a trust has a duty to invest and manage the trust assets as follows:
>
> (1) The trustee has a duty to invest and manage trust assets as a prudent investor would considering the purposes, terms, distribution requirements, and other circumstances of the trust. This standard requires the exercise of reasonable care, skill, and caution and is to be applied to investments not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy that should incorporate risk and return objectives reasonably suitable to the trust.
>
> (2) No specific investment or course of action is, taken alone, prudent or imprudent. The trustee may invest in every kind of property and type of investment, subject to this Section. The trustee's investment decisions and actions are to be judged in terms of the trustee's reasonable business judgment regarding the anticipated effect on the trust portfolio as a whole under the facts and circumstances prevailing at the time of the decision or action. The prudent investor rule is a test of conduct and not of resulting performance.
>
> (3) The trustee has a duty to diversify the investments of the trust unless, under the circumstances, the trustee reasonably believes it is in the interests of the beneficiaries and furthers the purposes of the trust not to diversify.
>
> (4) The trustee has a duty, within a reasonable time after the acceptance of the trusteeship, to review trust assets and to make and implement decisions concerning the retention and disposition of original pre-existing investments in order to conform to the provisions of this Section. The trustee's decision to retain or dispose of an asset may properly be influenced by the asset's special relationship or value to the purposes of the trust or to some or all of the beneficiaries, consistent with the trustee's duty of impartiality.
>
> (5) The trustee has a duty to pursue an investment strategy that considers both the reasonable production of income and safety of capital, consistent with the trustee's duty of impartiality and the purposes of the trust. Whether investments are underproductive or overproductive of income shall be judged by the portfolio as a whole and not as to any particular asset.
>
> (6) The circumstances that the trustee may consider in making investment decisions include, without limitation, the general economic conditions, the possible effect of inflation, the expected tax consequences of investment decisions or strategies, the role each investment or course of action plays within the overall portfolio, the expected total return (including both income yield and appreciation of capital), and the duty to incur only reasonable and appropriate costs. The trustee may but need not consider related trusts and the assets of beneficiaries when making investment decisions.
>
> (b) The provisions of this Section may be expanded, restricted, eliminated, or otherwise altered by express provisions of the trust instrument. The trustee is not liable to a beneficiary for the trustee's reasonable and good faith reliance on those express provisions.
>
> (c) Nothing in this Section abrogates or restricts the power of an appropriate court in proper cases (i) to direct or permit the trustee to deviate from the terms of the trust instrument or (ii) to direct or permit the trustee to take, or to restrain the trustee from taking, any action regarding the making or retention of investments.

(d) The following terms or comparable language in the investment powers and related provisions of a trust instrument, unless otherwise limited or modified by that instrument, shall be construed as authorizing any investment or strategy permitted under this Section: "investments permissible by law for investment of trust funds," "legal investments," "authorized investments," "using the judgment and care under the circumstances then prevailing that men of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to the speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital," "prudent man rule," and "prudent person rule."

(e) On and after the effective date of this amendatory Act of 1991, this Section applies to all existing and future trusts, but only as to actions or inactions occurring after that effective date.

*Id.* Four states have enacted statutes which were modeled on the Illinois statute. *See* FLA. STAT. ANN. § 518.11 (West 1997) (enacted in 1993); KAN. STAT. ANN. § 17-5004 (1995) (enacted in 1993); MD. CODE ANN., EST. & TRUSTS § 15-114 (Michie Supp. 1996) (enacted in 1994); VA. CODE ANN. § 26-45.1 (Michie 1997) (enacted in 1992). Washington in 1995 enacted a statute blending the UPIA and Illinois approaches. *See* WASH. REV. CODE ANN. § 11.100.020 (West 1998). In 1994 New York enacted perhaps the most comprehensive statute not modeled after the UPIA. N.Y. EST. POWERS & TRUSTS § 11-2.3 (West Supp. 1998) provides:

§ 11-2.3 Prudent investor act

(a)Prudent investor rule.

A trustee has a duty to invest and manage property held in a fiduciary capacity in accordance with the prudent investor standard defined by this section, except as otherwise provided by the express terms and provisions of a governing instrument within the limitations set forth by section 11-1.7 of this chapter. This section shall apply to any investment made or held on or after January first, nineteen hundred ninety-five by a trustee.

(b)Prudent investor standard.

(1)The prudent investor rule requires a standard of conduct, not outcome or performance. Compliance with the prudent investor rule is determined in light of facts and circumstances prevailing at the time of the decision or action of a trustee. A trustee is not liable to a beneficiary to the extent that the trustee acted in substantial compliance with the prudent investor standard or in reasonable reliance on the express terms and provisions of the governing instrument.

(2)A trustee shall exercise reasonable care, skill and caution to make and implement investment and management decisions as a prudent investor would for the entire portfolio, taking into account the purposes and terms and provisions of the governing instrument.

(3)The prudent investor standard requires a trustee:

(A) to pursue an overall investment strategy to enable the trustee to make appropriate present and future distributions to or for the benefit of the beneficiaries under the governing instrument, in accordance with risk and return objectives reasonably suited to the entire portfolio;

(B) to consider, to the extent relevant to the decision or action, the size of the portfolio, the nature and estimated duration of the fiduciary relationship, the liquidity and distribution requirements of the governing instrument, general economic conditions, the possible effect of inflation or deflation, the expected tax consequences of investment decisions or strategies and of distributions of income and principal, the role that each investment or course of action plays within the overall portfolio, the expected total return of the portfolio (including both income and appreciation of capital), and the needs of beneficiaries (to the extent reasonably known to the trustee) for present and future distributions authorized or required by the governing instrument;

(C) to diversify assets unless the trustee reasonably determines that it is in the interests of the beneficiaries not to diversify, taking into account the purposes and terms and provisions of the governing instrument; and

(D) within a reasonable time after the creation of the fiduciary relationship, to determine whether to retain or dispose of initial assets.

(4)The prudent investor standard authorizes a trustee:

(A) to invest in any type of investment consistent with the requirements of this paragraph, since no particular investment is inherently prudent or imprudent for purposes of the prudent investor standard;

(B) to consider related trusts, the income and resources of beneficiaries to the extent reasonably known to the trustee, and also an asset's special relationship or value to some or all of the beneficiaries if consistent with the trustee's duty of impartiality;

(C)to delegate investment and management functions if consistent with the duty to exercise skill, including special investment skills; and

(D) to incur costs only to the extent they are appropriate and reasonable in relation to the purposes of the governing instrument, the assets held by the trustee and the skills of the trustee.

(5)Special investment skills.

For a bank, trust company or paid professional investment advisor (whether or not registered under any federal securities or investment law) which serves as a trustee, and any other trustee representing that such trustee has special investment skills, the exercise of skill contemplated by the prudent investor standard shall require the trustee to exercise such diligence in investing and managing assets as would customarily be exercised by prudent investors of discretion and intelligence having special investment skills.

(c)Delegation of investment or management functions.

(1)Delegation of an investment or management function requires a trustee to exercise care, skill and caution in:

(A) selecting a delegee suitable to exercise the delegated function, taking into account the nature and value of the assets subject to such delegation and the expertise of the delegee;

(B) establishing the scope and terms of the delegation consistent with the purposes of the governing instrument;

(C) periodically reviewing the delegee's exercise of the delegated function and compliance with the scope and terms of the delegation; and

(D) controlling the overall cost by reason of the delegation.

(2)The delegee has a duty to the trustee and to the trust to comply with the scope and terms of the delegation and to exercise the delegated function with reasonable care, skill and caution. An attempted exoneration of the delegee from liability for failure to meet such duty is contrary to public policy and void.

(3)By accepting the delegation of a trustee's function from the trustee of a trust that is subject to the law of New York, the delegee submits to the jurisdiction of the courts of New York even if a delegation agreement provides otherwise, and the delegee may be made a party to any proceeding in such courts that places in issue the decisions or actions of the delegee.

(d)Investment in securities of related investment companies.

A trustee holding funds for investment may invest the same in securities of any management type investment company or trust registered pursuant to the federal investment company act of nineteen hundred forty, as amended, notwithstanding that the trustee or an affiliate of the trustee acts as investment advisor, custodian, transfer agent, registrar, sponsor, distributor, manager or provides other services to the investment company or trust. Unless the will, lifetime trust or order appointing the trustee provides otherwise, the trustee shall elect annually either (i) to receive or have its affiliate receive compensation for providing such services to such investment company or trust for the portion of the trust invested in such investment company or trust or (ii) to take annual corporate trustees' commissions with respect to such portion.

(e)As used in this section:

(1) the term "trustee" includes a personal representative, trustee, guardian, donee of a power during minority, guardian under article eighty-one of the mental hygiene law, committee of the property of an incompetent person, and conservator of the property of a conservatee;

(2) the term "trust" includes any fiduciary entity with property owned by a trustee as defined in this section;

(3) the term "governing instrument" includes a court order; and

(4) the term "portfolio" includes all property of every kind and character held by a trustee as defined in this section.

*Id.* In passing, it might be noted that South Dakota enacted a provision similar to the "intermediate" statutes discussed in Section V, *supra*, although South Dakota did not enact its statute

*B. Case Law Under the UPIA and Similar Statutes*

Since the UPIA was promulgated only four years ago, it is not surprising that only two cases have been found construing the UPIA and similar statutes. None of the cases arose in a UPIA state. Both were decided under the New York statute previously cited.[330] The first held only that the test under the statute is prudence rather than performance and that poor performance cannot be the basis for holding a trustee imprudent.[331] The other involved the authority of a corporate trustee of testamentary trusts to delegate investment powers to a family financial advisor, thus becoming a directed trustee.[332] Under the new New York statute, such delegation is permitted if the trustee uses care, skill, and caution in selecting the person, establishing the scope and terms of the delegation, monitoring the delegee's activities, and controlling the cost.[333] Since the will authorized the employment of agents by the trustees to advise on investments and permitted the trustees to delegate discretionary powers, the court held that the new statute did not prohibit the delegation and that the delegation in this case would be "consistent with the spirit of the statute."[334] The court noted in dicta that ordinarily a corporate fiduciary would not delegate investment powers because it would reduce compensation, but that delegation would be appropriate in some instances (i.e., when investing in foreign securities and venture capital).[335]

*C. The Effect of the Restatement and the UPIA on Cases Not Governed by the New Statute*

If there have not been many cases yet in those states which have adopted the UPIA or similar statutes, the *Restatement* and the new statutes may have an unanticipated effect on the analysis of cases not governed by the revised statutes.

The test of prudence under the prudent man rule looked at the propriety of the individual assets chosen for the portfolio, the performance of discretionary tasks by the fiduciary without delegation, and the preservation of the nominal value of the corpus.[336] While a few early cases indicated that preserving the corpus might include keeping up with inflation,[337] and occasional dicta, primarily in pension cases, slightly broadened the prudent man rule,[338] rarely were these traditional trust rules challenged. It was hoped that the *Restatement's* expansive approach would encourage a gradual move by courts to embrace modern portfolio theory and to require trustees to become and stay informed about investment vehicles and

330. *See supra* note 329.

331. *See In re* Fleet Trust Co., 662 N.Y.S.2d 360, 362 (Sur. Ct. 1997).

332. *See* Estate of Younker, 663 N.Y.S.2d 946, 947 (Sur. Ct. 1997).

333. *See id.* at 948.

334. *See id.*

335. *See id.*

336. *See supra* Section II for a brief discussion of these rules. *See also* LONGSTRETH, *supra* note 4, at 11-22, 39-41.

337. *See, e.g.*, Carlick v. Keiler, 375 S.W.2d 397 (Ky. 1964); *In re* Mayo, 105 N.W.2d 900 (Minn. 1960) (decided under a deviation theory); Davison v. Duke University, 194 S.E.2d 761 (N.C. 1973); *In re* Carlisle's Will, 278 N.Y.S.2d 1011 (Sur. Ct. 1967). *See also* Kenneth L. Hirsch, *Inflation and the Law of Trusts*, 18 REAL PROP., PROB. & TR. J. 601, 627, 640 (1983).

338. *See, e.g.*, Leigh v. Engle, 858 F.2d 361, 367-68 (7th Cir. 1988).

strategies.[339] There is some evidence that these hopes may be realized. An important case arose in New York in 1995.[340] The proceeding was an accounting of executors covering a twenty-year period. The will created a marital deduction trust and two other trusts.[341] Among the assets in the estate were marketable securities worth over three million dollars, with almost $1.8 million of that consisting of stock of Eastman Kodak Company.[342] The value of Eastman Kodak had dropped substantially between the decedent's death, in 1973, and the filing of the accounting, in 1981.[343] The charitable remaindermen alleged that the executors acted imprudently in failing to sell at least some of the Kodak stock.[344] The case was decided under New York's former prudent man rule stated in the prior version of its trusts investment statute.[345] The court held the executors had acted imprudently and surcharged the executors.[346] What is interesting is that language rarely seen in previous cases was prominent in the opinion. In discussing the prudent man rule, the Surrogate's Court stated: "A fiduciary needs to analyze the risks of a portfolio, the marketability of the holdings, its volatility, and the market conditions then and there prevailing."[347] Although some Kodak stock was sold to pay expenses, Kodak stock comprised more than 60 percent of the portfolio.[348] The court analyzed the executor's reasons for retaining Kodak stock and its allegation that it conducted periodic reviews, consultations, and monitoring of the portfolio. To this allegation, the court noted:

> Notwithstanding turbulent worldwide economic conditions including an OPEC oil embargo, all of which resulted in a monumental and precipitous decline in the stock market during the 1973-74 period, the bank's position continued to be one to retain the Eastman Kodak stock in its concentrated form. In that one year the EK stock dropped from approximately $115 a share to about $60 a share. In summary, the bank's position in demonstrating prudence is that the retention of the EK was part of a conscious and studied investment plan. In reality, the bank's responsiveness to the admittedly turbulent and precipitous tenor of the times (1973) was to do nothing. To assert that mere review, analysis, and monitoring satisfies the standard of due care by a prudent person where action and activity are indicated, tests the Court's sense of reason and logic . . . .[349]

On appeal, the Appellate Division also wrote differently from previous cases. While recognizing the rule that the focus was on the individual investment, the court gave equal weight to the following quotation from a previous case:

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339. *See* Taylor, *supra* note 249, at 62.

340. *See* Estate of Janes, 630 N.Y.S.2d 472 (Sur. Ct. 1995), *modified as to damages*, 643 N.Y.S.2d 972 (App. Div. 1996), *aff'd*, 681 N.E.2d 332 (N.Y. 1997).

341. *See* Estate of Janes, 630 N.Y.S.2d at 473.

342. *See id.* This represented 71 percent of the value of the estate's securities portfolio. *See id.*

343. *See id.* at 474.

344. *See id.* Charities were also income beneficiaries of one of the trusts, which received 25 percent of the estate. *See id.* at 475.

345. *See* N.Y. EST. POWERS & TRUSTS Former § 11-2.2(a)(1) (McKinney 1967). The new Prudent Investor Act, N.Y. EST. POWERS & TRUSTS § 11- 2.3(a), did not apply since all investments in this case were made prior to January 1, 1995, the new section's effective date. *See* Estate of Janes, 681 N.E.2d 332, 336 n.* (N.Y. 1997).

346. *See* Estate of Janes, 630 N.Y.S.2d 472, 479, 481 (Sur. Ct. 1995).

347. *Id.* at 474-75.

348. *See id.* at 476.

349. *Id.* at 477.

> The record of any individual investment is not to be viewed exclusively, of course, as though it were in its own watertight compartment, since to some extent individual investment decisions may properly be affected by considerations of the performance of the fund as an entity, as in the instance, for example, of individual security decisions based in part on considerations of diversification of the fund or of capital transactions [intended] to achieve sound tax planning for the fund as a whole.[350]

The significance is that the language from *Bank of New York* is dicta, because the case was decided by reference to the individual holdings. Moreover, it was the first case (and perhaps the only New York case prior to this one) advancing the total portfolio approach. On the other hand, the individual asset rule was well established in New York. To give the two approaches equal weight is a sharp departure from prior cases.

The court then took up the well established rule in New York that there is no absolute duty to diversify and a failure to do so is not imprudent.[351] This rule had an impressive list of New York authorities.[352] The court rejected the rule in favor of the following "fairer and more persuasive reading of the cases:"[353]

> [A]lthough there is no absolute duty to diversify in all circumstances, and although a failure to diversify will not automatically result in liability, neither is a fiduciary automatically insulated from liability based on a "mere" failure to diversify where the lack of diversification itself presents an unreasonable risk to the assets of the estate or trust.[354]

This sounds very much like a presumption that a lack of diversification must be satisfactorily explained by the fiduciary. If so, it marks a clear departure from the previous rule surcharging for diversity only in compelling cases. Moreover, it is much closer to the *Restatement (Third)* rule.[355]

Lastly, the court noted that the Bank "never made a formal analysis of estate assets, implemented any formalized investment plan, or established any investment goals for the benefit of either the income beneficiaries or the remaindermen."[356] Such an analysis is the basis of developing a plan under modern portfolio theory.[357] However, such a statement was absent from prior case law.

The New York Court of Appeals affirmed the decision of the Appellate Division.[358] The court quoted Professor Scott as approving the court's consideration of each asset in relation to the trust portfolio as a whole,[359] which is exactly the view of modern portfolio theory.[360] The court then used this concept in supporting the surcharge:

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350. Estate of Janes, 643 N.Y.S.2d at 976 (quoting *In re* Bank of New York, 323 N.E.2d 700 (N.Y. 1974)).
351. *See* Estate of Janes, 643 N.Y.S.2d at 977.
352. *See id.* (citing cases).
353. *Id.* at 978.
354. *Id.*
355. RESTATEMENT, *supra* note 5, § 228.
356. Estate of Janes, 643 N.Y.S.2d at 979.
357. *See supra* Section III.
358. Estate of Janes, 681 N.E.2d 332 (N.Y. 1997).
359. *See id.* at 337.
360. *See supra* Section III.

> A second deficiency in petitioner's elements of hazard list is that all of the factors relied on by petitioner go to the propriety of an individual investment "exclusively . . . as though it were in its own watertight compartment" which would encourage a fiduciary to treat each investment as an isolated transaction rather than "in its relation to the whole of the trust estate."... This ignores the market reality that, with respect to some investment vehicles, concentration itself may create or add to risk, and essentially takes lack of diversification out of the prudent person equation altogether.
>
> ....
>
> ... Notably, there was proof that [the bank] (1) failed initially to undertake a formal analysis of the estate and establish an investment plan consistent with the testator's primary objectives; (2) failed to follow petitioner's own internal trustee review protocol during the administration of the estate, ... and (3) failed to conduct more than routine reviews of the Kodak holdings in this estate, without considering alternate investment choices, over a seven-year period of steady decline in the value of the stock.[361]

The major focus of the opinion of the Court of Appeals is the relation of the asset to the total portfolio and the failure of the executor to develop, implement, and monitor an investment plan for the estate. The opinion is consistent with the *Restatement* and modern portfolio theory and represents a sharp departure from prior analysis. Although the case does not explicitly mention the *Restatement (Third) of Trusts* and refers to the New York statute only in a footnote,[362] it appears unmistakable that the court was influenced by these sources. Although this is only one case, it was decided by a most influential court. It is highly probable that additional changes in analysis of the prudent person rule will be forthcoming.

## VIII. THE SURVEY

### *A. The Design and Distribution of the Survey*

The survey was designed to test whether a so-called "intermediate" statute, which mandates evaluating a portfolio by looking at total return, but that neither specifically validates every investment and technique nor spells out in detail the tenets of modern portfolio theory, changed the practices and opinions on prohibited investment techniques of corporate trustees. As the objective of the survey differs to some extent from that of Longstreth's survey,[363] some of the questions in this survey were somewhat different, although some were similar. The contents of the survey are shown in Appendix A. The survey was mailed to 239 banking institutions in Iowa having trust functions from a list made available to the author by The Iowa Trust Association.[364] Twelve institutions had either moved, had by their own evaluation trust assets too small to be involved in the survey, or chose

361. Estate of Janes, 681 N.E.2d at 338-39 (citations omitted).

362. *See id.* at 336 n.*.

363. *See* LONGSTRETH, *supra* note 4, Appendix C.

364. The Author again conveys his gratitude to The Iowa Trust Association and to J. Michael Deege, its Executive Director, for their cooperation in the distribution of the survey and encouraging the members of the organization to respond. Without this aid, the survey could not have been conducted.

not to participate. Of the remaining 227 trust companies, responses were received from sixty-one, a 26.8 percent rate. Given the rural nature, small size, and relatively few personnel of many of the institutions involved, the Author considers this an excellent response and a valid response on which to draw conclusions.[365]

One point should be noted about the survey. Two trust companies having several branches throughout Iowa combined their responses and submitted one survey covering all their branches.[366] Other trust companies allowed each branch to send a separate response. The Author, after much consideration, decided to count the combined responses as separate banks on the ground that failure to do so would underweigh the combined responses in comparison to those trust companies which allowed each branch to send in a separate response. Thus, some caution should be used in viewing the statistics on this ground.

Second, a comparison with Bevis Longstreth's pioneering survey in 1985[367] should be done cautiously. Mr. Longstreth surveyed the banks having the fifty largest trust departments in the United States.[368] This Author's survey covered trust companies in Iowa. With one possible exception (and then only by combining its branches in several states), none of the trust companies in the Author's survey would have been included in Mr. Longstreth's survey. Given the size of the trusts held by the fifty largest bank trust departments, it is far more likely that those trust departments would hold unusual types of assets and engage in the sophisticated techniques asked about in the surveys. Thus, one should be cautious in comparing the surveys. Nevertheless, some conclusions of the effect of the "intermediate statutes" can be stated.

### *B. Analysis of the Survey Results*

The statistical results of the survey (in percentages) are given in Appendix B.

Overall, the results are not really surprising. In those areas of the survey asking about factors involving total return, the statute appears to have resulted in improvement, in the sense that more trust departments have adopted modern theory

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365. The Author thanks the personnel of those trust companies who responded for the time and effort expended on the survey.

366. One such combined response covered eight banks; the other covered two banks.

367. LONGSTRETH, *supra* note 4.

368. *See id.* at 5.

369. Recall that Iowa Code § 633.123, provides that in

> making investment decisions, a fiduciary shall consider the role that the investment plays within the account's portfolio of assets and may consider the general economic conditions, the anticipated tax consequences of the investment, the anticipated duration of the account, and the needs of all beneficiaries of the account.

IOWA CODE ANN. § 633.123(1) (West 1992).

370. The methods reported in answer to question three by those corporate trustees stating that they do not use risk-return analysis included the trustee's opinion, committee selection after contacting other financial institutions in the area to compare rates, discussion with the grantor or attorney for the trust to determine investment objectives and goals, work with the client, what will best fit the client, use a conservative style of investment, and hold the assets with which the grantor funds the trust.

371. These included investment desires of the beneficiaries, age and time horizon of the beneficiaries, comfort of the beneficiaries or grantor with certain types of assets, and how and to whom the remainder was given.

372. Among the factors mentioned were economic conditions, inflation, concentration, risk aversion and return expectations of beneficiaries, and market trends and projections. There is some overlap between this category and the first category.

in these areas.[369] This is particularly shown by the first two questions of the survey. Eighty-five percent of the respondents use the risk-return analysis mandated by modern portfolio theory. Of those using the analysis, almost all take account of the factors listed in question two (the income requirements and tax circumstances of the beneficiaries and the need for and timing of distributions). If there is any surprise, it is that fifteen percent of the respondents still do not use risk-return analysis.[370] In response to the question concerning other factors taken into account, the factors listed fell generally into three groups. Twenty-three percent discussed beneficiaries' concerns,[371] forty percent cited investment characteristics,[372] (with twenty-three percent specifically mentioning risk tolerance), and twenty-nine percent mentioned trust characteristics, with almost all of this category (twenty-six percent) composed of length of the trust.

When attention is turned to whether the respondents believe that the Iowa prudent person rule prohibits certain investments or techniques, the findings became more problematic. First, only one-quarter of the respondents believed that the prudent person rule prohibited taking advantage of investment opportunities they would otherwise pursue.[373] The most often mentioned was use of small-cap stocks in an overall portfolio, mentioned by more than half of those answering yes to the question.

In a most interesting answer, seventy-two percent of the respondents said they held non-dividend paying stocks in their trust portfolios, a clear indication that most respondents had few qualms about the prudent person rule permitting these investments.[374]

When discussing specific assets and techniques, to get a true picture one must combine the answers to questions four, six, eight, and ten. Combining the answers yields the following conclusions: Although three-quarters of the respondents do not believe they are prevented by the prudent person rule from pursuing opportunities they believe appropriate (question four), a major reason for this is that most do not invest at all in many of the types of assets listed in question six or, if they hold such assets, it is in a very small percentage of the trusts they manage. Moreover, the trustees holding these assets often have specific authorization in the trust instrument to hold these assets (question eight), which, according to the written comments, gives the trustee protection from liability for poor performance. The respondents also give heavy weight to the grantor's intentions as to asset types expressed in the instrument. Moreover, a significant segment of those answering "no" to question six held only "safe" investments, e.g., mutual funds, domestic fixed income investments, mortgages and real estate, for which they believe no

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373. *See* Question 4, Appendix B. It might be noted that of the 25 percent answering yes, two-thirds said this happened often. However, it should also be noted that in Longstreth's survey, while no respondent said the rule often prohibited investment opportunities, 63 percent of respondents said it did "sometimes." LONGSTRETH, *supra* note 4, at 247.

374. *See* Question 5, Appendix B. This represents an advance over Longstreth's survey. Longstreth reports that one of the investments most frequently mentioned as precluded under the prudent man rule by bank trust departments was non-dividend paying stocks. *See* LONGSTRETH, *supra* note 4, at 234. One respondent who answered yes to this question stated these holdings were typically through mutual funds. If this is true (though not stated) for other respondents, the advance evidenced by the response to this question is somewhat tempered. Those answering no to this question generally cited the need for current income, although one respondent considered such stocks imprudent.

governing instrument permission is necessary. Moreover, as discussed below, "riskier" assets are usually held in a fairly small number of trusts in those trust companies holding these assets. In short, the picture that emerges is that most respondents hold very few "risky" assets, do not practice "risky" techniques, usually have specific authority in the governing instruments to hold the "risky" assets they do hold, and do not consider the prudent person rule an impediment to taking advantage of investment opportunities in the assets and techniques listed in questions six and ten. In general, these trustees consider such assets and techniques inappropriate for personal trusts. If this is a correct interpretation of the data, the one-quarter of the respondents answering "yes" to question four and the fifty-four percent stating that some of the techniques listed in question ten are prohibited or questionable indicate that the "intermediate" type of statute does not significantly expand the types of assets or techniques trust officers believe are prudent.

As to assets held (question six), none of the respondents had trust assets invested in options or commodity or non-commodity futures. Only two percent invested in commodities (crops where the trust held farmland) and three percent in venture capital (less than two percent of trusts at these institutions held venture capital). On the other end of the scale, ninety-two percent of the respondents held mutual funds and real estate, eighty-nine percent held domestic fixed income investments and seventy-one percent held preferred stock. The holdings for the latter group are not surprising, since these investments are generally safe from any attack under the prudent person rule. More surprising was that fifty-six percent of the respondents held index funds,[375] thirty-nine percent held foreign equities[376] and fifty-two percent held foreign mutual funds.[377] This indicates a commitment to diversification consistent with modern portfolio theory. The percentage of respondents holding gold and gold stocks was larger than anticipated, although a very small percentage of trusts held these assets.[378] Not only was the fact that thirty-nine percent of the respondents held real estate investment trusts (REITs) higher than expected, the percentage of trusts holding REITs in those institutions was significant.[379] Given Iowa's investment in agriculture, the number of respondents holding real estate and mortgages is easy to understand.[380]

Given these results, the response to the other part of question six, asking if the Iowa prudent person rule prohibits investment in any of the assets, offers significant food for thought. Forty-one percent of the respondents believed at least some

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375. This is a significantly higher percentage than reported by the Longstreth survey (33 percent). *See* LONGSTRETH, *supra* note 4, at 249. However, the percentage of trusts holding index funds was usually small, almost always below 15 percent.

376. The number of trusts holding foreign equities, as in the case of index funds, was generally small (usually below five percent), although two respondents said 20 percent of their trusts held foreign equities and one stated 50 percent of its funds held them.

377. The percentage of funds holding foreign mutual funds was a bit greater than index funds or foreign equities, with 10 respondents reporting over 10 percent of their funds held these, two of which reported 50 percent holding foreign mutual funds.

378. Most respondents reported that less than one percent of their trusts held either gold or gold stocks.

379. While many reported less than one percent of the trusts held REITs, one respondent reported 71 percent of its trusts held REITs, another reported 45 percent and another 20 percent.

380. The percentages of trusts holding real estate is interesting. Seventy-two percent of respondents reporting trusts holding real estate and reporting the percentage of their trusts holding it, reported that 10 percent or more of the trusts they managed held the asset.

of the investments were prohibited, while thirty-one percent said none were prohibited. Options (thirty-four percent), commodity futures (thirty-three percent), and commodities and non-commodity futures (thirty percent) were the most mentioned.

At first glance, question seven appears to say that enactment of the UPIA will make little difference in the practice of trust investing in Iowa. This may in fact be true because, as mentioned above, a significant number of trust companies hold few if any questionable assets, generally have specific authority for these investments in the trusts that contain them, and frankly think "riskier" investments are inappropriate to their trusts. If this view is not influenced by the prudent person rule, a change in the law will not make a significant difference in their investing practices. However, for the more than one-fifth of the respondents who answered "more likely," the change will be significant. Respondents giving this answer liked the specificity and more complete language of the UPIA and the allowance and encouragement of a greater degree of diversification.

Perhaps the greatest limit of the prudent person rule is revealed in question ten. More than half of the respondents believe some or all of these techniques are prohibited by the rule, with naked puts and calls, margin purchases, short selling and straddles mentioned as prohibited or questionable by more than forty percent of those responding. One respondent commented that the UPIA is more permissive of such techniques, although the respondent would consider many of these techniques inappropriate for personal trusts it manages under any version of a "prudent man" or "prudent investor" statute.

The last question was inserted to obtain information concerning delegation of investment powers, which is permitted by the UPIA.[381] The percentage already delegating (approximately one-third of those responding) is fairly high. However, it should be taken cautiously. Two respondents specifically stated that their response was based on defining investing in mutual funds as being a delegation.[382] Others may have also answered "yes" to this question based on investment in mutual funds without specifically so stating. Because the question was intended to determine whether the trustee actually delegated the choosing of investments to an outside manager beyond investing in mutual funds, and the question was apparently to some extent ambiguous, care should be used in drawing any conclusions from this question.

### *C. Conclusion*

The survey results appear to confirm that "intermediate" statutes (such as Iowa's statute), mandating that investment performance be evaluated by looking at the investments in relation to their impact on the total portfolio, has encouraged corporate trustees in some areas. Most report they use a risk-return analysis and appear to generally consider the factors mentioned by the *Restatement* and the UPIA. A surprising number of corporate trustees hold "non-traditional" assets, including assets that some might have formerly labeled "questionable" or "imprudent," in at least some of the trusts they manage. Also, many of the respondents hold stocks

381. UPIA, *supra* note 6, at § 9.
382. These were counted as a "no" answer.

which do not regularly pay a dividend in their trusts. Even if these holdings are in mutual funds (a question not asked in the survey), this represents an advance toward modern portfolio theory. On the other hand, approximately one-quarter of the respondents feel constrained not to hold certain classes of assets and many believe certain investment techniques are limited by the prudent person rule. And a number of respondents mentioned the flexibility and specificity in the UPIA, believing adoption of that act would allow the greater use of non-traditional assets and techniques.

## IX. CONCLUSION

In the 1980s, writers began to realize that the prudent person rule then generally in force in the United States was preventing trust assets from being invested in the manner modern economic theory predicted would maximize the return on these assets. Modern portfolio theory, which by then had been developing for more than thirty years, focused on a risk-return analysis for each portfolio. It taught that the proper focus was on the portfolio as a whole and the role that each investment played in the overall portfolio, emphasized the role that diversification played in reducing uncompensated risk, and revealed that because of the differing role that each asset or technique could play in a portfolio, no asset or technique should be prohibited. These developments led to the passage of "intermediate" statutes by a number of states, altering the focus of any inquiry into a trustee's investment performance from the individual asset to the total portfolio and the role of the questioned asset in the portfolio.

Beginning in 1989, the American Law Institute undertook a major examination into trust investing which resulted in the reformation of the prudent man rule. The formulation of the prudent investor rule in the *Restatement (Third) of Trusts* and the later promulgation of the Uniform Prudent Investor Act (UPIA) adopted modern economic theory as the basis of trust investing and proposed a major alteration in the development of a trust portfolio.

In an attempt to determine the effect of the "intermediate" statutes, the Author undertook to survey Iowa trust companies on their investment practices. The survey revealed some movement toward adopting the practices of modern portfolio theory under an "intermediate" statute, but also the feeling that even such statutes do not remove major impediments to investing in a manner consistent with modern theory. The data also lead to an inference that many respondents believe that trusts should be invested quite conservatively and the importance of the income needs of a trust would render certain asset classes and techniques inappropriate to trust investing, even under the UPIA. This inference, if true, would indicate that while adoption of the UPIA would result in some change in trust investments, many if not most trusts would not alter their investment structure greatly.[383] The question of whether such a philosophy is correct remains for future experience and research.

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383. This is also the view of at least one commentator who did not believe the *Restatement* would have a major impact due to the need for income and the purposes of most trusts. Welch, *supra* note 237, at 20-21. The commentator believed the greatest impact of the adoption of the prudent investor rule would be on larger trusts and professional trustees, which would become more growth oriented and choose somewhat less conservative investments. *See id.*

The survey also clearly revealed that even under an "intermediate" statute, a significant percentage of trust companies believe there are investment opportunities prohibited by the prudent person rule which they could use to their advantage in trusts they manage. Moreover, these respondents believe the UPIA is much more certain and permissive in allowing these assets and techniques. It would appear that legislatures should be encouraged to adopt the UPIA or some version of it to alleviate these concerns and spell out clearly that all classes of assets and techniques are permitted if evaluated with care, skill, and caution.

Some commentators also believed that there would be great resistance to the adoption of a prudent investor rule.[384] In any event, the few cases decided under the "intermediate" or modern statutes reveal that these statutes and modern portfolio theory have already influenced the analysis of cases not expressly governed by the statutes. It is likely that this trend will continue. It is also likely that as cases arise in jurisdictions adopting the UPIA, the basis of determining a trustee's liability for improper investments will undergo fundamental changes. Adoption of the UPIA and the principles of the *Restatement* will remove the impediments to investment opportunities caused by the old prudent person rule. It will also bring trust investment law into conformity with modern investment theory. It will probably cause some alteration in the practices of trustees.[385] Today's economic challenges require that trustees have the ability to invest freely and flexibly, recognizing the needs of both those holding the income interest and the remainder beneficiaries. The "intermediate" statutes were a good first step, but more is now necessary. The rules of the *Restatement* and the UPIA have the potential to bring trust investment practices into the modern era. The prudent investor needs the specificity and certainty of the UPIA and the *Restatement*.

384. *See also* Gordon, *supra* note 4, at 88-91; Johnson, *supra* note 86, at 421.

385. Though a discussion of these changes is beyond the scope of this article, a number of commentators suggest that the documenting of decisions will greatly increase and more factors may need consideration. *See* Welch, *supra* note 237, at 24-25; Taylor, *supra* note 249, at 62-63; Herschberger, *supra* note 239, at 5-39. On other recommendations, *see generally* Altfest, *supra* note 68. The most extensive discussions of the potential changes of trust practices to date have been written by John H. Langbein, the Reporter for the UPIA. *See generally* Langbein, *supra* note 312, and Langbein, *supra* note 35.

## APPENDIX A

## PERSONAL TRUST INVESTMENTS SURVEY

1. In determining the investments of personal trusts managed by your institution, do you employ the risk-return alaysis suggested by modern portfolio theory?

   Yes _____No _____

2. If you answered "Yes" to question 1, do you take into account any of the following factors (check all that apply)?

   _____ The income requirements of the beneficiaries.

   _____ The tax circumstances of the beneficiaries.

   _____The possible need for and timing of significant distributions from the trust (for example, attendance of college by beneficiaries).

   _____ Other factors.

   If "Other Factors" is checked, please briefly describe examples of such factors.

3. If you answered "No" to question 1, what process do you use to develop an investment portfolio for your trust accounts?

4. Does the prudent person rule governing investments prohibit taking advantage of investment opportunities you would otherwise pursue in portfolios of personal trusts (inter vivos or testamentary) managed by your institution? For your convenience, sections 633.123 and 633.123A of the Iowa Code are attached to this survey as Attachment 1.

   Yes _____No _____

   If so, how often:
   Often _____ Sometimes _____ Rarely _____

   Please list the types of investments or investment techniques that you believe are prohibited.

5. Do you hold in personal trusts managed by your institution any common stocks which do not regularly pay a dividend?

   Yes _____No _____

   If you answered no, why, in your opinion, do personal trusts managed by your institution not own any such stocks?

6. Please indicate whether any of the personal trusts of which your institution is trustee contains any of the following and, if so, the percentage of trusts containing each asset:

| | Yes | No | Percentage |
|---|---|---|---|
| (a) Options | | | |
| (b) Commodities | | | |
| (c) Commodity Futures | | | |
| (d) Non-Commodity Futures | | | |
| (e) Mutual Funds (other than your bank's common trust funds or your bank's proprietary mutual funds). | | | |
| (f) Venture Capital | | | |
| (g) Index Funds | | | |
| (h) Foreign Equities | | | |
| (i) Foreign Mutual Funds | | | |
| (j) Gold | | | |
| (k) Gold Stocks | | | |
| (l) Collectibles | | | |
| (m) Domestic Fixed Income Investments | | | |
| (n) Foreign Fixed Income Investments | | | |
| (o) REITs | | | |
| (p) Mortgages | | | |
| (q) Real Estate | | | |
| (r) Preferred Stocks | | | |

Do you believe that the prudent person rule in force in Iowa precludes investment of personal trusts in any of the above? If so, please list the assets you believe are precluded.

7. Included with this survey as Attachment 2 is the Uniform Prudent Investor Act as proposed by the National Conference of Commissioners on Uniform State Laws. If this act was enacted by the state (or states) in which your institution does business, would you be more likely, less likely, or equally likely to invest in the assets listed in question 6 for the personal trusts managed by your institution.

More Likely _____ Less Likely _____ Equally Likely _____

If you answered More Likely or Less Likely, which assets would you be more or less likely to invest in under the Uniform Act?

Please briefly explain why you would be more or less likely to invest in these assets under the Uniform Act.

8. With respect to any asset listed in question 6 to which you state <u>ARE</u> held in personal trusts managed by your institution, did the governing trust instrument or will specifically authorize the investment in the category isted?

Yes _____ No _____

9. With respect to any asset listed in question 6 to which you state are <u>NOT</u> held in personal trusts managed by your institution, would your answer change if the governing trust instrument or will specifically authorized the investment in the specific category listed?

Yes _____ No _____

If "Yes," please explain briefly why your answer would change.

10. Do you believe the prudent person rule precludes or renders questionable with regard to personal trusts any investment techniques, such as short selling, margin purchases, hedging, market timing, arbitrage, covered calls, puts, naked puts and calls, or straddles?

    Yes _____ No _____

    If you answered "Yes," please state which techniques are rendered questionable or are prohibited.

| Technique | Prohibited | Questionable |
| --- | --- | --- |

11. Do you delegate investment authority to any outside managers?

12. Please state the amount of managed assets of personal trusts managed by your institution.

    $ ________________________

## APPENDIX B

## PERSONAL TRUST INVESTMENTS SURVEY

## ALL FIGURES ARE PERCENTAGES[386]

1. In determining the investments of personal trusts managed by your institution, do you employ the risk-return analysis suggested by modern portfolio theory?

   Yes 85 No 15

2. If you answered "Yes" to question 1, do you take into account any of the following factors (check all that apply)?

   100 The income requirements of the beneficiaries.

   98 The tax circumstances of the beneficiaries.

   100 The possible need for and timing of significant distributions from the trust (for example, attendance of college by beneficiaries).

   ___ Other factors.

   If "Other Factors" is checked, please briefly describe examples of such factors.

3. If you answered "No" to question 1, what process do you use to develop an investment portfolio for your trust accounts?

4. Does the prudent person rule governing investments prohibit taking advantage of investment opportunities you would otherwise pursue in portfolios of personal trusts (inter vivos or testamentary) managed by your institution? For your convenience, sections 633.123 and 633.123A of the Iowa Code are attached to this survey as Attachment 1.

   Yes 25 No 75

   If so, how often:

   Often 67% Sometimes 27% Rarely 7%

   Please list the types of investments or investment techniques that you believe are prohibited.

5. Do you hold in personal trusts managed by your institution any common stocks which do not regularly pay a dividend?

   Yes 72% No 28%

   If you answered no, why, in your opinion, do personal trusts managed by your institution not own any such stocks?

386. In some questions, the answers add to more or less than 100 percent due to rounding.

6. Please indicate whether any of the personal trusts of which your institution is trustee contains any of the following and, if so, the percentage of trusts containing each asset (in percentages):

| | Yes | No |
|---|---|---|
| (a) Options | 0 | 100 |
| (b) Commodities | 2 | 98 |
| (c) Commodity Futures | 0 | 100 |
| (d) Non-Commodity Futures | 0 | 100 |
| (e) Mutual Funds (other than your bank's common trust funds or your bank's proprietary mutual funds). | 92 | 8 |
| (f) Venture Capital | 3 | 97 |
| (g) Index Funds | 56 | 44 |
| (h) Foreign Equities | 39 | 61 |
| (i) Foreign Mutual Funds | 52 | 48 |
| (j) Gold | 20 | 80 |
| (k) Gold Stocks | 30 | 70 |
| (l) Collectibles | 13 | 87 |
| (m) Domestic Fixed Income Investments | 89 | 11 |
| (n) Foreign Fixed Income Investments | 13 | 87 |
| (o) REITs | 39 | 61 |
| (p) Mortgages | 57 | 43 |
| (q) Real Estate | 92 | 8 |
| (r) Preferred Stocks | 70 | 30 |

Do you believe that the prudent person rule in force in Iowa precludes investment of personal trusts in any of the above? If so, please list the assets you believe are precluded.

| Asset | Percentage Believing Investment Precluded By Iowa's Prudent Person Rule |
|---|---|
| (a) Options | 34 |
| (b) Commodities | 30 |
| (c) Commodity Futures | 33 |
| (d) Non-Commodity Futures | 30 |
| (e) Mutual Funds | 0 |
| (f) Venture Capital | 26 |
| (g) Index Funds | 3 |
| (h) Foreign Equities | 16 |
| (i) Foreign Mutual Funds | 15 |
| (j) Gold | 23 |
| (k) Gold Stocks | 15 |
| (l) Collectibles | 26 |
| (m) Domestic Fixed Income Investments | 0 |
| (n) Foreign Fixed Income Investments | 15 |
| (o) REITs | 3 |
| (p) Mortgages | 2 |
| (q) Real Estate | 2 |
| (r) Preferred Stock | 0 |

| | |
|---|---|
| Respondents Saying Some of Assets Listed Are Prohibited By Prudent Man Rule | 41% |
| Respondents Saying None of Assets Listed Are Prohibited By Prudent Man Rule | 31% |
| Respondents Not Sure | 2% |
| Respondents Not Answering Question | 26% |

7. Included with this survey as Attachment 2 is the Uniform Prudent Investor Act as proposed by the National Conference of Commissioners on Uniform State Laws. If this act was enacted by the state (or states) in which your institution does business, would you be more likely, less likely, or equally likely to invest in the assets listed in question 6 for the personal trusts managed by your institution?

   More Likely 21 Less Likely 0

   Equally Likely 77 No Answer 3

   If you answered "More Likely" or "Less Likely," which assets would you be more or less likely to invest in under the Uniform Act?

   Please briefly explain why you would be more or less likely to invest in these assets under the Uniform Act.

8. With respect to any asset listed in question 6 to which you stated ARE held in personal trusts managed by your institution, did the governing trust instrument or will specifically authorize the investment in the category listed?

   Yes 54 No 43 Some 3

9. With respect to any asset listed in question 6 to which you stated are NOT held in personal trusts managed by your institution, would your answer change if the governing trust instrument or will specifically authorized the investment in the specific category listed?

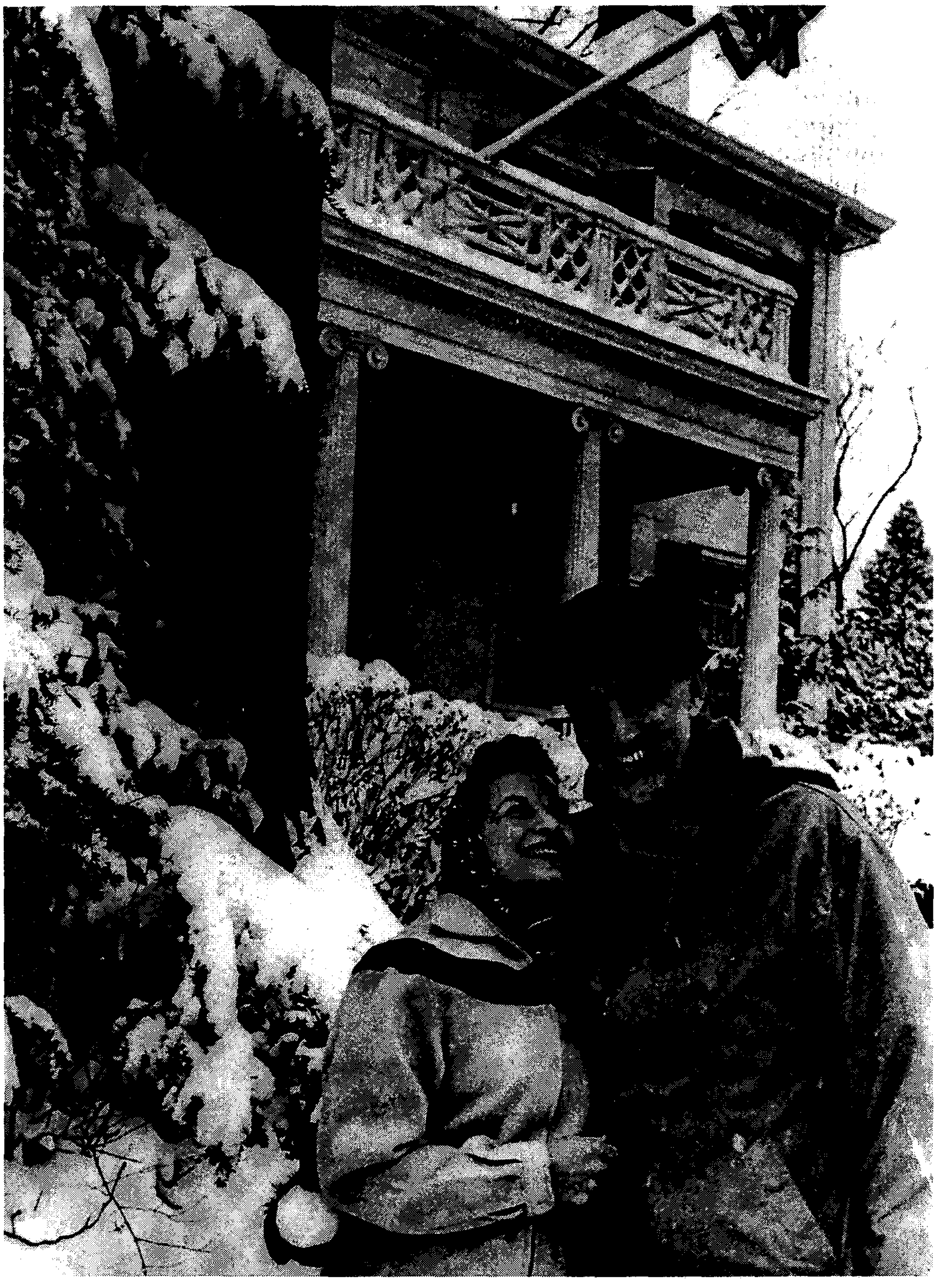
   Yes 18 No 80 No Answer 2

   If "Yes," please explain briefly why your answer would change.

10. Do you believe the prudent person rule precludes or renders questionable with regard to personal trusts any investment techniques, such as short selling, margin purchases, hedging, market timing, arbitrage, covered calls, puts, naked puts and calls, or straddles?

    Yes 54 No 41 No Answer or Don't Know 5

    If you answered "Yes," please state which techniques are rendered questionable or are prohibited.



| Technique | Prohibited | | Questionable | |
|---|---|---|---|---|
| | All Answers | Yes Answers | All Answers | Yes Answers |
| Short Selling | 24 | 44 | 18 | 33 |
| Margin Purchases | 36 | 67 | 10 | 18 |
| Hedging | 15 | 26 | 20 | 36 |
| Market Timing | 11 | 21 | 23 | 42 |
| Arbitrage | 18 | 32 | 5 | 9 |
| Covered Calls | 15 | 26 | 11 | 21 |
| Puts | 15 | 26 | 11 | 21 |
| Naked Puts and Calls | 38 | 70 | 8 | 15 |
| Straddles | 18 | 32 | 23 | 42 |

11. Do you delegate investment authority to any outside managers?

Yes 31 No 69

12. Please state the amount of managed assets of personal trusts managed by your institution.

$ ____________________