Alaska State Legislature
House of Representatives

COMMITTEE ASSIGNMENTS:

LABOR & COMMERCE
MILITARY & VETERANS AFFAIRS
COMMUNITY & REGIONAL AFFAIRS
OIL & GAS

INTERIM:
716 W. 4TH AVE.
ANCHORAGE, AK 99501
PHONE (907) 258-8161

SESSION:
STATE CAPITOL
ROOM 420
JUNEAU, AK 99801-1182
PHONE (907) 465-3875

Representative Joe Ryan
1 800-922-3875 http://www.akrepublicans.org

SPONSOR STATEMENT for House Bill 321

The Uniform Prudent Investor Act reverses common law rules that restrict the investment powers of trustees. The new act requires a trustee to invest as a prudent investor would, using reasonable care, skill and caution in light of the objectives and risk tolerance of the individual trust. Diversification of assets is an obligation. Trustees can delegate investment responsibilities to experts. Within the scope of these powers and duties, trustees can choose to invest in any kind of asset that meets the objective of the specific trust.

What are the specific advantages of the Uniform Prudent Investor Act?

1. Trusts are likely to achieve a better return for beneficiaries than is the case under the common law rules.
2. Trustees can protect the trust corpus better through diversification of assets than is the case under the common law rules
3. Trustees can invest to counter the effects of inflation, something that the common rules do not allow.
4. A trustee no longer is forced to relay upon his or her own knowledge and expertise, but can acquire investment services to enhance his or her own knowledge and skill.
5. Trustees can take into account the changing character and kinds of assets available for investment, free from archaic restrictions.

6. Trustees are judged on overall performance of the assets in a trust, rather than on the performance of specific assets.
7. The specific needs of each trust can be taken into account in devising investment strategy, rather than be subordinate to generic investment rules treating all trusts as the same.
8. The Act will provide uniformity of law, necessary in an interstate investment enviroment.

LEGAL SERVICES

DIVISION OF LEGAL AND RESEARCH SERVICES
LEGISLATIVE AFFAIRS AGENCY
STATE OF ALASKA

(907) 465-3867 or 465-2450
FAX (907) 465-2029
Mail Stop 3101

130 Seward Street, Suite 409
Juneau, Alaska 99801-2105

MEMORANDUM

February 9, 1998

SUBJECT: Sectional Summary (HB 321)

TO: Representative Joe Ryan

FROM: Tamara Brandt Cook
Director TBC

Here is the sectional summary you requested for a bill dealing with trusts based on the Uniform Prudent Investor Act of the National Conference of Commissions on Uniform State Laws.

Secs. 1 and 2. Correct a cross-reference to a statute repealed in this bill.

Sec. 3. Adds a new article -- the Uniform Prudent Investor Act.

Sec. 13.36.200. Requires a trustee to comply with the prudent investor rule and permits the rule to be expanded, restricted, eliminated, or altered by the provisions of a trust.

Sec. 13.36.205. Requires a trustee to manage assets by considering the purposes, terms, distribution requirements, and other circumstances of the trust. Lists specific circumstances that a trustee must consider. Requires a trustee to make a reasonable effort to verify facts relevant to management of trust assets. A trustee with special skills has a duty to use those skills.

Sec. 13.36.210. Requires diversification of investments, unless the purposes of the trust are better served without diversifying.

Sec. 13.36.215. Requires a trustee to review a trust and make decisions regarding assets within a reasonable time after accepting a trusteeship or receiving the assets.

Sec. 13.36.220. Requires a trustee to manage assets solely in the interest of the beneficiaries.

Sec. 13.36.225. Requires a trustee to act impartially if a trust has two or more beneficiaries.

Sec. 13.36.230. A trustee may only incur costs that are reasonable in managing a trust.

Sec. 13.36.235. Compliance with the prudent investor rule is determined in light of the facts existing at the time of the trustee's decision or action.

Sec. 13.36.240. A trustee may delegate investment and management functions, but the trustee must exercise care, skill and caution in selecting an agent, establishing the terms of the delegation, and reviewing the agent's actions.

Sec. 13.36.260. Certain general phrases that may appear in a trust invoke the standards of this article.

Sec. 13.36.265. The new article applies to trusts existing on and created after the effective date of those sections, but, as applied to existing trusts, the article governs only decisions or actions that occur after the effective date.

Sec. 13.36.270. The new article is to construed to make uniform the law among the states that adopt a Uniform Prudent Investor Act.

Sec. 13.36.275. The short title is the Uniform Prudent Investor Act.

Sec. 4. The existing statute dealing with a trustee's standard of care is repealed.

Sec. 5. Immediate effective date.

TBC:glc
98-070.glc

Alaska State Legislature

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M E M O R A N D U M

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Sec. 13.36.275. The short title is the Uniform Prudent Investor Act.

Sec. 4. The existing statute dealing with a trustee's standard of care is repealed.

Sec. 5. Immediate effective date.

TBC:glc
98-070.glc

STATE OF ALASKA

DEPARTMENT OF LAW

OFFICE OF THE ATTORNEY GENERAL

TONY KNOWLES, GOVERNOR

P.O. BOX 110300
JUNEAU, ALASKA 99811-0300
PHONE: (907) 465-3600
FAX: (907) 465-2075

February 12, 1998

The Honorable Joe Ryan
House of Representatives
Alaska State Legislature
State Capitol, Room 420
Juneau, Alaska 99811

Re: HB 321: Uniform Prudent Investor Act

Dear Rep. Ryan:

The Department of Law has reviewed HB 321, which proposes enactment of the Uniform Prudent Investor Act. We find no legal problems. The bill is an important vehicle to keep our law current on modern portfolio theory and trust management principles.

Sincerely,

BRUCE M. BOTELHO
ATTORNEY GENERAL

Deborah E. Behr

By: Deborah E. Behr
Assistant Attorney General

DEB:ng
H:\LEGIS98\BILL\321_HB.LTR

cc: Pat Pourchot, Legislative Director
Office of the Governor

Chrystal Smith, Legal Administrator
Dept. of Law

Mary Ellen Beardsley
Assistant Attorney General
Anchorage

Vince Usera
Assistant Attorney General
Juneau

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Facsimile (907) 586-3777

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Caroline Crenna
Paul L. Dillon
Thomas W. Findley
Devon P. Grover
Richard D. Monkman
Arthur H. Peterson
Peter K. Putzier
<u>Paralegal</u>
Teri Heuscher
<u>Firm Administrator</u>
Melanie E. Mickelson

ANCHORAGE
Ray R. Brown
Mauri Long
Kristen D. Pettersen
<u>Paralegal</u>
M. Benita Raymond

510 L Street, Suite 6[illegible]
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Telephone (907) 277-54[illegible]
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January 30, 1998

The Honorable Joe Ryan
House of Representatives
Alaska State Legislature
State Capitol, Room 420
Juneau, Alaska 99811

<u>**HAND DELIVERED**</u>

Re: House Bill 321, Uniform Prudent Investor Act

Dear Representative Ryan:

You have asked for my comments on HB 321, which proposes enactment of the Uniform Prudent Investor Act. It very closely tracks the "official" version promulgated by the National Conference of Commissioners on Uniform State Laws. I strongly support it, and urge its passage.

The only significant modifications from the official version are the following:

1. sec.1's amendment of AS 13.16.350(a) merely picks up, with regard to the standards applicable to the personal representative of an estate, the standards in the new statutes, for consistency;

2. sec. 2's amendment of AS 13.26.245 does the same thing for the duties of a conservator;

3. proposed AS 13.36.265(b) (on page 5 of the bill) merely makes the "application" section specifically applicable to the decisions and actions of personal representatives and conservators, as dealt with in secs. 1 and 2 of the bill;

4. sec. 4 of the bill repeals AS 13.36.075, the current section that sets out a trustee's standard of care and performance, again to be consistent with the amendments made in secs. 1 and 2; the substance of existing AS 13.36.075 is set out and expanded upon in proposed AS 13.36.205 (at pages 2 and 3 of the bill).

This bill was promulgated by the National Conference in 1994, has already been enacted in 19 states, and is pending in at least seven others. (The latest figures that I have are dated July 1, 1997. I will try to get you an update.)

I will slightly paraphrase a purpose statement from the National Conference: This Act removes much of the common-law restriction upon the investment authority of trustees and similar fiduciaries. It allows them to use modern portfolio theory to guide investment decisions. A fiduciary's performance is measured on the performance of the whole portfolio, not upon the performance of each single investment. This Act allows the fiduciary to delegate investment decisions to qualified and supervised agents. It requires sophisticated risk-return analysis to guide investment decisions. Thus, this Act expedites trust management, while assuring both the person creating the trust and the beneficiary of a trust of a sound set of standards for that management.

I hope that these comments are helpful to you in getting this bill enacted this year. You might also want to consider the Uniform Principal and Income Act as a companion bill, or as part of this one. Let me know if you have any questions; however, this is another subject on which Commissioner Jerry Kurtz is more well-versed than I.

Yours truly,

Art Peterson

Arthur H. Peterson
Uniform Law Commissioner
for Alaska

cc: Rest of Alaska's ULC Delegation:
Deborah E. Behr
W. Grant Callow
Tamara Brandt Cook
L.S. (Jerry) Kurtz, Jr.
Jay A. Rabinowitz

AHP/ph

ALASKA TRUST COMPANY

Wealth Management Specialists

February 9, 1998

Representative, Joe Ryan
2011 Farmer Place, #4
Anchorage, Alaska 99508

Re: The Prudent Investor Act

Dear Joe:

I have been advised that you would like a brief summary of what the new Prudent Investor act accomplishes. The Prudent Investor Act is designed to replace the antiquated "Prudent Person Rule".

The Prudent Investor Act requires that the trustee, or other fiduciaries, incorporate a modern portfolio theory in to its investment approach. This requires the trustee, or other fiduciary, to consider all appropriate factors in implementing a portfolio of investments.

The major points of the new legislation are to clarify, or allow for, the following:

(1) The standard of prudence applies to the trust as a whole instead of individual investments.

(2) The overall investment strategy should be based upon the risk and reward objectives suitable for the trust.

(3) The duty to diversify must be part of the investment strategy, unless the trustee reasonably determines that it is in the interest of the beneficiaries not to diversify, taking in to account the purposes, terms, and provisions of the governing document.

(4) No particular investment is inherently prudent or imprudent.

(5) No special status is given to original investments and the trustee must review them within a reasonable time.

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Anchorage, Alaska 99501
Phone: 907-278-6775 Fax: 907-258-1649
aktrust@pobox.alaska.net

(6) A corporate trustee, or paid professional advisor acting as trustee, is accountable under a special investment skills standard.

(7) Delegation of investment authority is permitted but the trustee retains liability for the investment performance of the delegee.

This new statute is designed to raise the level of the trustees responsibility and duties to the beneficiaries. The overall investment strategy needs to be designed to enable the trustee to make appropriate present, and future, distributions to the beneficiaries.

When structuring a portfolio the trustee needs to consider the following:

- The size of the portfolio.
- The expected duration of the trust.
- Liquidity and distribution requirements.
- General economic conditions.
- The effect of inflation-or deflation.
- The tax consequences of investment decisions or strategies, and of distributions of principal or income to the beneficiaries.
- The role that each investment plays within the overall portfolio.
- The expected total return of the portfolio from both income, and appreciation from capitol.
- The distribution needs of the beneficiaries.

A version of the Prudent Investor Rule has been approved by over (20) states and it is anticipated that over the next few years, all states will incorporate the Prudent Investor Rule standards and requirements.

Please le' me know if the above explanation is sufficient. I would be happy to discuss any further clarification that you may need on this matter.

Sincerely,

Douglas J. Blattmachr
President & CEO

DJB/ss

UNIFORM PRUDENT INVESTOR ACT

-A SUMMARY-

Trustees of trusts and like fiduciaries have been subject to rules severely restricting the types of investment modalities in which they can invest the assets of the trusts that they administer and manage. Interest-bearing instruments – safe income – of limited kinds (no junk bonds) are the limit of risk permitted or thought to be permitted under the traditional rules. Protect the paper value of the principal at all costs is the mandate for trustees. In addition, a trustee's performance is rated by the performance of each and every investment, singly, and not on the performance of the whole of the portfolio. And trustees have been precluded from obtaining professional investment help.

The result for trusts is modest income production at best without regard for the erosion of a trust's assets by inflation. Can it be that these rules miscalculate the real risk and actually jeopardize the assets of a trust rather than provide for their protection?

The answer is yes. And a remedy is now at hand in the Uniform Prudent Investor Act (UPIA), promulgated by the Uniform Law Commissioners in 1994. The adoption of this act by the state legislatures will correct the rules, based on false and damaging premises, that now govern the actions of trustees.

By no means does UPIA turn trustees into unrestrained speculators. It provides rules governing investment that, in fact, result in greater protection for the trust's assets while providing a prospect of better income. UPIA does not encourage irresponsible, speculative behavior, but requires careful assessment of investment goals, careful analysis of risk versus return, and diversification of assets to protect them. It gives the trustee the tools to accomplish these ends. UPIA requires trustees to become devotees of "modern portfolio theory" and to invest as a prudent investor would invest "considering the purposes, terms, distribution requirements, and other circumstances of the trust" using "reasonable care, skill, and caution."

The trustee has a list of factors which must be considered in making investment decisions, including "general economic conditions," "possible effect of inflation or deflation," "the expected total return from income and the appreciation of capital," and "other resources of the beneficiaries." The trustee must take tax consequences of investment decisions into account. There is a positive obligation to diversify assets "unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." The trustee's obligations are significant, requiring sophisticated approaches to investment that really take into account the right risk-to-return ratio for the particular trust.

In addition, a trustee's performance in UPIA is measured by the performance of all the assets together. A loss with respect to a single asset does not mean that the trustee has violated his or her fiduciary responsibilities. The act takes the truly holistic approach to investment practices.

In return for these obligations, UPIA removes any restrictions upon the types of investment modalities which may be chosen in a trust's portfolio. It is quite possible, for example, to hold positions in high-interest bonds (junk bonds) or mutual funds investing in such bonds, in a diversified portfolio, if such an investment meets the needs of the particular trust in light of the risk/return analysis specific to that trust.

One of the boons to trustees of smaller trusts is the ability to invest in mutual funds. Mutual funds reduce investment risk by diversifying their portfolios. By using mutual funds, a trustee of a trust that does not have a large enough corpus to effectively diversify its assets can enhance diversification of the trust's portfolio to limit the trust's risk of loss.

UPIA also permits the trustee to delegate investment and management functions "that a prudent trustee of comparable skills could properly delegate under the circumstances." Careful selection of the agent and careful, periodic review of the agent's actions are part of the trustee's responsibility when delegating authority. An agent has a responsibility of reasonable care in conducting the delegated business of the trust.

Why is it that the prudent man rule of prior law may, in fact, jeopardize the assets in a trust? Some of the instruments in which trustees have been able to invest have become more volatile in price. Treasury bonds, for example, long thought to be safe investments, now fluctuate considerably in value with the fluctuation of interest rates. The former so-called safe investment may not be so safe anymore. In contrast, common stocks have shown consistently better returns over the years than bonds – yet trustees have been prevented from investing in common stocks. Stocks have been historically safer investments, therefore, in diversified portfolios than bonds have been. Trusts have been deprived of return at some greater risk by the antiquated rules that govern investment of their assets.

By far the most insidious damage to trust assets comes from inflation. If trustees cannot invest in modalities that exceed the rate of inflation in return, the inevitable result is diminution of the corpus of the trusts they manage. The beneficiaries of trusts so restricted lose in all ways, both with respect to income and principal.

The UPIA provides rules that can be modified or waived in the trust agreement. Any person who wishes to put property in trust and who wants to provide different standards of conduct for the trustee is permitted to do so under UPIA.

UPIA provides a reasonable approach to the investment of trust assets that better meets the needs of beneficiaries while preserving trust assets. It should become the law in every state as soon as possible.

A Few Facts About
THE UNIFORM PRUDENT INVESTOR ACT

PURPOSE: This act removes much of the common law restriction upon the investment authority of trustees of trusts and like fiduciaries. It allows such fiduciaries to utilize modern portfolio theory to guide investment decisions. A fiduciary's performance is measured on the performance of the whole portfolio, not upon the performance of each investment singly. The act allows the fiduciary to delegate investment decisions to qualified and supervised agents. It requires sophisticated risk-return analysis to guide investment decisions.

ORIGIN: Completed by the Uniform Law Commissioners in 1994.

ENDORSED BY: American Bar Association
American Bankers Association

STATE ADOPTIONS:

Arizona
Arkansas *
California
Colorado
Connecticut *
Idaho *
Maine
Minnesota
Missouri
Nebraska
New Jersey *
New Mexico
North Dakota *
Oklahoma
Oregon
Rhode Island
Utah
Washington
West Virginia

1997 INTRODUCTIONS:

District of Columbia
Hawaii
Indiana
Iowa
Massachusetts
Mississippi
Vermont

For any further information regarding the Uniform Prudent Investor Act, please contact John McCabe or Katie Robinson at 312-915-0195.

ORGANIZATION

The National Conference of Commissioners on Uniform State Laws has worked for the uniformity of state laws since 1892. It is a non-profit unincorporated association, comprised of state commissions on uniform laws from each state, the District of Columbia, the Commonwealth of Puerto Rico and the U.S. Virgin Islands. Each jurisdiction determines the method of appointment and the number of commissioners actually appointed. Most jurisdictions provide for their commission by statute.

There is only one fundamental requirement for the more than 300 uniform law commissioners: that they be members of the bar in the jurisdiction they represent. While some commissioners serve as state legislators, most are practitioners, judges and law professors. They serve for specific terms, and receive no salaries or fees for their work with the Conference.

The state uniform law commissions come together as the National Conference for one purpose — to study and review the law of the states to determine which areas of law should be uniform. The commissioners promote the principle of uniformity by drafting and proposing specific statutes in areas of the law where uniformity between the states is desirable. It must be emphasized that the Conference can only propose — no uniform law is effective until a state legislature adopts it.

The Conference is a working organization. The uniform law commissioners participate in drafting specific acts; they discuss, consider and amend drafts of other commissioners; they decide whether to recommend an act as a uniform or a model act; and they work toward enactment of Conference acts in their home jurisdictions.

HISTORY

The uniform law movement began in the latter half of the 19th century. The Alabama State Bar Association recognized as early as 1881 the legal tangles created by wide variations in state laws. But it was not until 1889 that the American Bar Association decided, at its 12th Annual Meeting, to work for "uniformity of the laws" in the then 44 states.

Within a year, the New York Legislature authorized the governor to appoint three commissioners to explore the best way to effect uniformity of law between increasingly interdependent states. The ABA endorsed New York's action. The result was the first meeting of the *Conference of State Boards of Commissioners on Promoting Uniformity of Law in the U.S.*

Seven states sent commissioners to that first meeting of the Conference in Saratoga Springs, New York in 1892. By 1912, every state had appointed uniform law commissioners. The U.S. Virgin Islands is the last jurisdiction to join, appointing its first commission in 1988.

Since its organization, the Conference has drafted more than 200 uniform laws on numerous subjects and in various fields of law, setting patterns for uniformity across the nation. Uniform acts include the Uniform Probate Code, the Uniform Child Custody Jurisdiction Act, the Uniform Partnership Act, the Uniform Anatomical Gift Act and the Uniform Limited Partnership Act.

Most significant was the 1940 Conference decision to attack major commercial problems with comprehensive legal solutions — a decision that set in motion the project to produce the Uniform Commercial Code. The Code took ten years to complete and another 14 years before it was enacted across the country. It remains the signature product of the Conference.

Today the Conference is recognized primarily for its work in commercial law, family law, probate and estates, law of business organizations, health law, and conflicts of law. It rarely drafts law that is regulatory in character.

FINANCIAL SUPPORT

The major portion of financial support for the Conference comes from state appropriations. Expenses are apportioned among the states by means of an assessment based on population.

The Conference gets maximum results from minimum budgets because its major asset, drafting expertise, is donated. The only compensation for commissioners is the satisfaction derived from solving important legal problems. Commissioners devote hundreds and even thousands of hours — amounting in some cases to millions of dollars worth of time — to the development of uniform and model acts. No state could afford the bills for the legal expertise that is donated to the drafting of uniform state laws.

PROCEDURES

Each uniform law is years in the making. The process starts with the Scope and Program Committee, which initiates the agenda of the Conference. It investigates each proposed act, and then reports to the Executive Committee whether a subject is one in which it is desirable and feasible to draft a uniform law. If the Executive Committee approves a recommendation, a drafting committee of commissioners is appointed. Drafting committees meet throughout the year. Tentative drafts are not submitted to the entire Conference until they have received extensive committee consideration.

Draft acts are then submitted for initial debate of the entire Conference at an annual meeting. Each act must be considered section by section, at no less than two annual meetings by all commissioners sitting as a Committee of the Whole. With hundreds of trained eyes probing every concept and word, it is a rare draft that leaves an annual meeting in the same form it was initially presented.

Once the Committee of the Whole approves an act, its final test is a vote by states — one vote per state. A majority of the states present, and no less than 20 states, must approve an act before it can be officially adopted as a Uniform or Model Act.

At that point, a Uniform or Model Act is officially promulgated for consideration by the states. Legislatures are urged to adopt Uniform Acts exactly as written, to "promote uniformity in law among the several states." Model Acts are designed to serve as guideline legislation, which states can borrow from or adapt to suit their individual needs and conditions.

When drafting is completed on an act, a commissioner's work has only begun. They advocate the adoption of uniform and model acts in their home states. Normal resistance to anything "new" makes this the hardest part of a commissioner's job. But the result can be workable modern state law that helps keep the federal system alive.

The work of the Conference simplifies the legal life of businesses and individuals by providing rules and procedures that are consistent from state to state. Representing both state government and the legal profession, it is a genuine confederation of state interests. It has sought to bring uniformity to the divergent legal traditions of more than 50 sovereign jurisdictions, and has done so with significant success.

THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS

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Chicago, IL 60611
(312) 915-0195

FISCAL NOTE

STATE OF ALASKA
1998 LEGISLATIVE SESSION

BILL NO. HB321 (H) L&C

Revision Date:

Title: Uniform Prudent Investor Act

Sponsor: Rep. Ryan

Requestor: House Labor and Commerce

Department: Commerce and Economic Development

BRU: Banking, Securities and Corporations

Component: Banking, Securities and Corporations

COMPONENT SERIAL NO.

Expenditures/Revenues (Thousands of Dollars)

OPERATING EXPENDITURES	FY 99	FY 00	FY 01	FY02	FY 03	FY 04
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0
CAPITAL EXPENDITURES	0.0	0.0	0.0	0.0	0.0	0.0
CHANGE IN REVENUES	0.0	0.0	0.0	0.0	0.0	0.0

FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 General Fund						
1005 GF Program Receipts						
1006 GF Mental Health						
Other						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY 98) cost: $ 0.0

POSITIONS

FULL-TIME	
PART-TIME	
TEMPORARY	

ANALYSIS: (Attach a separate page if necessary)

Prepared by: Willis F. Kirkpatrick, Director *Willis F. Kirkpatrick* Phone: 465-2521

Division: Banking, Securities and Corporations Date: 2-5-98

Approved by Commissioner: Deborah B. Sedwick *[signature]* Date: 2-9-98

Agency: Commerce and Economic Development

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FISCAL NOTE

STATE OF ALASKA
1998 LEGISLATIVE SESSION

BILL NO. HB321 (H) L&C

Revision Date:

Title: Uniform Prudent Investor Act

Sponsor: Rep. Ryan

Requestor: House Labor and Commerce

Department: Commerce and Economic Development

BRU: Banking, Securities and Corporations

Component: Banking, Securities and Corporations

COMPONENT SERIAL NO.

Expenditures/Revenues (Thousands of Dollars)

OPERATING EXPENDITURES	FY 99	FY 00	FY 01	FY02	FY 03	FY 04
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES	0.0	0.0	0.0	0.0	0.0	0.0

CHANGE IN REVENUES	0.0	0.0	0.0	0.0	0.0	0.0

FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 General Fund						
1005 GF Program Receipts						
1006 GF Mental Health						
Other						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY 98) cost: $ 0.0

POSITIONS

FULL-TIME	
PART-TIME	
TEMPORARY	

ANALYSIS: (Attach a separate page if necessary)

Prepared by: Willis F. Kirkpatrick, Director Willis Kirkpatrick

Phone: 465-2521

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Fiduciary Trust International

Uniform Prudent Investor Act

Investment Legislation
Governing Trusts and Foundations

As of November, 1997

Fiduciary Trust Company International

BACKGROUND
INFORMATION

Investment Legislation Governing Trusts and Foundations (by State)

As of November, 1997

A model Uniform Prudent Investor Act ("UPIA") was promulgated by the National Conference of Commissioners on Uniform State Laws in 1994 and recommended for enactment by the states. The UPIA allows trustees and similar fiduciaries to employ modern portfolio theory to guide investment decisions, and evaluates a fiduciary's conduct based on a strategy for the total portfolio, rather than on the selection of individual assets. In addition, the UPIA makes the following alterations in the former criteria for fiduciary investment: (A) the tradeoff between risk and return is identified as the fiduciary's central investment consideration; (B) categoric restrictions on types of investments have been abrogated; (C) the concept that fiduciaries should diversify portfolio investments has been integrated into the definition of prudence; (D) the much criticized rule of trust law forbidding the trustee to delegate investment and management functions has been reversed (some jurisdictions impose notice requirements not mandated by the UPIA); and (E) the trustee may be relieved from liability for acts of the agent, if certain requirements are met.

It should be noted that charitable foundations and private trusts are subject to similar investment rules. The UPIA is applicable to foundations organized in trust form. Charitable corporations, on the other hand, are governed in many jurisdictions by the Uniform Management of Institutional Funds Act ("UMIFA"). The far right column of the chart indicates whether a state has adopted UMIFA.

The chart at the right shows the states that have adopted the UPIA, or substantial portions thereof, as of this publication. Additionally, many other states are identified that now require a total portfolio approach to investment management, but which do not otherwise have provisions resembling the UPIA. If a state has no total portfolio statute, the chart makes no representation regarding whether that state's laws contain any other provision resembling the UPIA.

State	Uniform Prudent Inv. Act (or most UPIA provisions) Effective Date	Total Portfolio Statutes (minimal UPIA provisions) Effective Date	Authority
Alabama		5/16/89	Ala. Code §§
Alaska			
Arizona	7/20/96		Ariz. Rev. Stat
Arkansas	3/31/97		Act 940 of 19
California	1/1/96		Cal. Prob. Co
Colorado	7/1/95		Colo. Rev. Sta
Connecticut	6/2/97		Public Act No
Delaware		7/3/86	Del. Code An
Dist. of Columbia		2/1/95	D.C. Super. C
Florida	10/1/93		Fla. Stat. Ann
Georgia		1/1/98	Ga. Code Ann
Hawaii	4/14/97		30 Hawaii Re
Idaho	7/1/97		Idaho Code §
Illinois	1/1/92		760 Ill. Comp
Indiana			
Iowa		4/22/91	Iowa Code A
Kansas	7/1/93		Kan. Stat. An
Kentucky		7/15/96	Kent. Rev. St
Louisiana			
Maine	1/1/97		Me. Rev. Stat
Maryland	10/1/94		Md. Est. & T
Massachusetts			
Michigan			
Minnesota	1/1/97		Minn. Stat. A
Mississippi			
Missouri	8/28/96		Mo. Ann. St
Montana		10/1/89	Mont. Code
Nebraska	4/2/97		Legislative B
Nevada		4/17/89	Nev. Rev. St
New Hampshire			
New Jersey	3/7/97		N.J. Stat. An
New Mexico	7/1/95		N.M. Stat. A
New York	1/1/95		N.Y. Est., P
North Carolina			
North Dakota	8/1/97		N.D. Cent.
Ohio			
Oklahoma	11/1/95		Okla. Stat.
Oregon	9/9/95		Or. Rev. Stat
Pennsylvania			
Rhode Island	8/6/96		R.I. Stat. §§
South Carolina		6/5/90	S.C. Code A
South Dakota	7/1/95		S.D. Codifie
Tennessee		7/1/89	Tenn. Code
Texas		6/16/91	Tex. Prop.
Utah	7/1/95		Utah Code
Vermont			
Virginia	4/6/92		Va. Code A
Washington	7/23/95		Wash. Rev.
West Virginia	7/1/96		W. Va. Co
Wisconsin			
Wyoming			

	(A) Risk/Return Objectives Emphasized	(B) Unrestricted Investment Types Authorized	(C) Diversification of Portfolio as Prudent	(D) Delegation of Investment Management Authoriz	(E) Trustee/Agent Liability Severed	(F) Notice of Delegation Required	Uniform Management of Institutional Funds Act (UMIFA)
20.2 and 19-3-322	No	No	No	Yes	No	No	Yes
							No
§§ 14-7601 to 14-7611	Yes	Yes	Yes	Yes	Yes	No	No
	Yes	Yes	Yes	Yes	Yes	No	Yes
16045 to 16054	Yes	Yes	Yes	Yes	Yes	No	Yes
a §§ 15-1.1-101 to 15-1.1-115	Yes	Yes	Yes	Yes	Yes	No	Yes
140	Yes	Yes	Yes	Yes	Yes	No	Yes
12, § 3302	No	Yes	No	No	No	No	Yes
. R. 5(a)	Yes	Yes	No	No	No	No	Yes
18.11 and 518.112	Yes	Yes	Yes	Yes	Yes	Yes	Yes
3-8-2	No	Yes	No	No	No	No	Yes
statutes 554C	Yes	Yes	Yes	Yes	Yes	No	Yes
10	Yes	Yes	Yes	Yes	Yes	No	Yes
Ann. §§ 5/5 and 5/5.1	Yes	Yes	Yes	Yes	Yes	Yes	Yes
							Yes
33.123	No	No	No	No	No	No	Yes
8-1202 and 17-5004	Yes	Yes	Yes	Yes	Yes	Yes	Yes
277—applies only to corporate fiduciaries	Yes	No	Yes	Yes	No	No	Yes
							Yes
tt. 18-A, § 7-302	Yes	Yes	Yes	Yes	Yes	No	Yes
ode Ann. § 15-114	Yes	Yes	Yes	Yes	No	No	Yes
							Yes
							Yes
501B.151 and 501B.152	Yes	Yes	Yes	Yes	Yes	No	Yes
							No
6.900 to 456.913	Yes	Yes	Yes	Yes	Yes	No	Yes
2-34-114	No	Yes	No	No	Yes	No	Yes
	Yes	Yes	Yes	Yes	Yes	No	Yes
050	No	Yes	No	No	No	No	No
							Yes
20-11.1 to 3B:20-11.12	Yes	Yes	Yes	Yes	Yes	Yes	Yes
5-7-601 to 45-7-612	Yes	Yes	Yes	Yes	Yes	No	No
Trusts Law § 11-2.3	Yes	Yes	Yes	Yes	No	No	Yes
							Yes
9-02-08.1 to 59-02-08.11	Yes	Yes	Yes	Yes	Yes	No	Yes
							Yes
175.60 to 175.72	Yes	Yes	Yes	Yes	Yes	No	Yes
194 to 128.218	Yes	Yes	Yes	Yes	Yes	No	Yes
							No
o 18-15-13	Yes	Yes	Yes	Yes	Yes	No	Yes
7-302	No	Yes	No	No	No	No	Yes
Ann. §§ 55-5-6 to 55-5-16	Yes	Yes	Yes	Yes	No	No	No
5-3-117	No	Yes	No	No	No	No	Yes
§ 113.056	No	Yes	No	No	No	No	Yes
5-7-302	Yes	Yes	Yes	Yes	Yes	No	No
							Yes
45.1	No	Yes	Yes	No	No	No	Yes
§ 11.100.010 et seq.	No	Yes	Yes	No	No	No	Yes
1 to 44-6C-15	Yes	Yes	Yes	Yes	Yes	No	Yes
							Yes
							Yes

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The Uniform Prudent Investor Act and the Future of Trust Investing

John H. Langbein

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The Uniform Prudent Investor Act and the Future of Trust Investing

*John H. Langbein**

In recent years, American law has undergone a fundamental revision of the rules that govern how trustees invest. In 1987 the American Law Institute (ALI) began working on a partial revision of the Restatement of Trusts devoted exclusively to modifying trust-investment law. The ALI approved the new Restatement at its annual meeting in 1990 and released the final text in 1992.[1] Working from a preliminary text of the new Restatement, Illinois enacted legislation in 1991 embodying the key Restatement principles.[2]

In 1991 the Uniform Law Commission[3] began a three-year drafting project to codify the revised Restatement principles as a uniform law, which became the Uniform Prudent Investor Act. The Uniform Law Commission promulgated the final text of the Act in 1994.[4] The American Bar Association approved the Act at its February 1995 midyear meeting.[5] Already in 1995 seven states enacted the Uniform Prudent Investor Act

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* Chancellor Kent Professor of Law and Legal History, Yale University. This article expands upon the Tamisiea Lecture presented at the University of Iowa, November 2, 1995. Some themes of this article were sketched earlier in presentations to the 1995 annual meeting of the American College of Trust and Estate Counsel, Scottsdale, Arizona, March 9-10, 1995. Although I served as the reporter for the Uniform Prudent Investor Act, I must emphasize that the views advanced in this article are mine and do not necessarily represent the views of the Uniform Law Commission. Suggestions from Edward C. Halbach, Jr., and Roger Ibbotson are gratefully acknowledged.

1. Restatement (Third) of Trusts: Prudent Investor Rule (1992). Professor Edward C. Halbach, Jr., of the University of California at Berkeley served as the reporter and principal drafter. He has discussed the project in Edward C. Halbach, Jr., Trust Investment Law in the Third Restatement, 77 Iowa L. Rev. 1151 (1992), substantially republished as Edward C. Halbach, Jr., Trust Investment Law in the Third Restatement, 27 Real Prop., Prob. & Tr. J. 407 (1992); and Edward C. Halbach, Jr., Redefining the "Prudent Investor Rule" for Trustees, 129 Tr. & Est. 4 (Dec. 1990).

2. 760 ILCS §§ 5/5 (prudent investing), 5/5.1 (delegation) (1992). The principal drafter has described the Illinois act in Lyman W. Welch, How the Prudent Investor Rule May Affect Trustees, 130 Tr. & Est. 15 (Dec. 1991), substantially republished as Lyman W. Welch, Action is Needed in Response to Changes in Fiduciary Investment Duty, 18 ACTEC Notes 81 (1992).

3. The Commission's proper name is National Conference of Commissioners on Uniform State Laws (NCCUSL).

4. Unif. Prudent Investor Act (1994), 7B U.L.A. 16 (Supp. 1995) [hereinafter UPIA].

5. Uniform acts are routinely submitted to the American Bar Association (ABA) for approval. The relevant ABA sections customarily appoint advisors to the Uniform Law Commission's drafting committees. The ABA advisor for the Uniform Prudent Investor Act was Joseph Kartiganer.

California,[6] Colorado,[7] New Mexico,[8] Oklahoma,[9] Oregon,[10] Utah,[11] and Washington.[12] The Uniform Act is expected to be widely enacted in the years to come. In advance of the Uniform Act, several states enacted legislation patterned on the 1992 Restatement or on the Illinois act, including Kansas,[13] Florida,[14] Maryland,[15] New York,[16] South Dakota,[17] and Virginia.[18] We thus have a substantial core of states, including some of the most populous, that have already enacted the Uniform Act or something like it. I should also emphasize that the Restatement and the Uniform Act did not invent the reforms that they embody, and that several states, for example, Iowa[19] and Georgia,[20] revised their statutes in advance of the two national law reform projects to incorporate some of the principles that now appear in the Restatement and in the Uniform Act.

The Uniform Prudent Investor Act implements a tightly interconnected set of reforms. These adjustments to the legal regime were driven by profound changes that have occurred across the past generation in our understanding of the investment function. This new learning about the investment process is called the theory of efficient markets, or more broadly, Modern Portfolio Theory (MPT).[21] Four Nobel prizes in economics have thus far been awarded for the academic work that identified and verified the theory of efficient markets,[22] and more will come. As I cover the main features of the Uniform Prudent Investor Act, I have the occasion to point out places in which the influence of MPT is much in evidence. I have tried, however, to avoid the forbidding jargon of the efficient market literature. Lawyers and courts can understand the essential findings of MPT without mastering betas, capital asset pricing models, correlation coefficients, and the like.

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6. Cal. Prob. Code §§ 16045-54 (Deering 1995).
7. Colo. Rev. Stat. §§ 15-1.1-101 to 115 (Supp. 1995) (effective July 1, 1995).
8. N.M. Stat. Ann. §§ 45-7-601 to 612 (Michie 1995) (effective July 1, 1995).
9. Okla. Stat. tit. 60 §§ 175.60-.72 (Supp. 1995) (effective Nov. 1, 1995).
10. 1995 Or. Laws 157 (effective Sept. 9, 1995).
11. Utah Code Ann. § 75-7-302 (1995) (effective July 1, 1995).
12. 1995 Wash. Laws 307 (effective July 1, 1995).
13. Kan. Stat. Ann. § 17-5004 (Supp. 1994).
14. Fla. Stat. chs. 518.11 (prudent investing) & 518.112 (1995) (delegation).
15. Md. Code Ann., Est. & Trusts §§ 15-106, 15-114 (1991 & Supp. 1995).
16. N.Y. Est. Powers & Trusts Law § 11-2.3 (McKinney Supp. 1996) (Prudent Investor Act). The New York legislation is based in part upon an early draft of the Uniform Act.
17. S.D. Codified Laws Ann. §§ 55-5-6 to 14 (Supp. 1995).
18. Va. Code Ann. § 26-45.1 (Michie 1992) (prudent investing).
19. Iowa Code Ann. § 633.123 (West 1992) (amended 1991).
20. Ga. Code Ann. § 53-8-2(c) (1995) (amended 1991).
21. A succinct and elegant introductory text on modern portfolio theory is R.A. Brealey, *An Introduction to Risk and Return from Common Stocks* (2d ed. 1983). A convenient exposition for lawyers is Jonathan R. Macey, An Introduction to Modern Financial Theory (1991) (American College of Trust & Estate Counsel Foundation).
22. Franco Modigliani of MIT (1985), Harry Markowitz of CUNY (1990), Merton Miller of Chicago (1990), and William Sharpe of Stanford (1990).

This Article is meant to serve as a guide to the Uniform Prudent Investor Act. I point to the main reforms and explain what motivated them. I also attempt a look into the future, offering some predictions about how trust-investment practice is likely to change as the principles embodied in the Restatement and the Uniform Act take effect. Among the changes foreseen are greater use of equities; of pooled investment vehicles, such as mutual funds; and of relatively unconventional investments, such as foreign securities and derivatives. I also speak of the tendency to break up trusteeship and allocate its functions among specialized service providers. I suggest that, even though the Uniform Prudent Investor Act is default law that the settlor of the trust can alter or oust, the Act is likely to limit the settlor's power to impose manifestly uneconomic investment restrictions. I also explain why the new trust-investment law is likely to have unsettling effects upon the seemingly quite distinct subject of principal-and-income law, that is, upon the rules that govern the allocations that trustees are commonly obliged to make between current and future beneficiaries of the trust.

I. Older Standards of Prudent Investing

Before canvassing the Uniform Act, I want to cast a brief backward glance at the trust-investment law that descended into the 1980s—the law that the ALI and the Uniform Law Commission determined to reform. Bear in mind that the rules of trust investment law that we are discussing are default rules, rules that the settlor can alter by apt language in the trust instrument.

English law got off to a bad start on trust investing. In 1719 Parliament authorized trustees to invest in shares of the South Sea Company. A number of them did, and when the South Sea "Bubble" burst the next year, share prices declined by 90 percent. The Chancellors took fright and developed a restricted list of presumptively proper trust investments, initially government bonds, later well-secured first mortgages. Lord St. Leonard's Act in 1859 added East India stock, and across the decades, some dribbles of legislation approved various other issues. Only in 1961 was the English statute amended to allow trustees to invest in equities more generally, and even then the investment was subject to a ceiling of half the trust fund.[23] That legislation remains in force, although an official revision commission has begun to deliberate on reforming it.

Some American jurisdictions had a similar history in the nineteenth and early twentieth centuries, developing so-called legal lists[24] of court-

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23. A useful account of the history of trust investment law in England appears in A.H. Oosterhoff, *Trustees' Powers of Investment: A Study Prepared at the Direction of the Ontario Law Reform Commission* 5-23, 35-44, 49-50 (1970).
24. The New York case of King v. Talbot, 40 N.Y. 76 (1869), came to exemplify legal list jurisprudence. The court restricted trustees to investments in government bonds or well secured mortgages and forbade corporate issues. The court reasoned that since a trustee

approved or legislatively-approved investments, which were initially restricted to government bonds and first mortgages, but grudgingly expanded in some states to include selected corporate issues.

The path of the future in American law led away from legal lists, however, and was forged in Massachusetts. In 1830, in the celebrated case of *Harvard College v. Amory*,[25] the Supreme Judicial Court adopted what came to be known as the prudent man rule.

Trustees, said the Massachusetts court, should "observe how men of prudence . . . 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."[26] The Massachusetts rule represented a great advance[27] by abandoning the attempt to specify approved types of investment. Prudence is another word for reasonableness, and the prudent man rule echoed the contemporaneously developed reasonable man rule in the law of negligence. The standard of prudent investing was the standard of industry practice—what other trustees similarly situated were doing. Investment practice under the prudent man rule led rapidly to judicial approval of the use of corporate securities, both equities and bonds, in trust accounts. By the 1940s many American states had adopted by statute a version of the Massachusetts rule that the American Bankers Association promoted on behalf of corporate fiduciaries.[28] The Uniform Prudent Investor Act is designed to replace that act.

The prudent man rule as applied by the courts came to be encrusted with a strong emphasis on avoiding so-called "speculation," whatever that meant.[29] (Recall the language from *Harvard College v. Amory*, cautioning the trustee to invest "not in regard to speculation" and to treat "the probable safety of the capital" as central.)[30] As late as the 1959 Restatement we find the assertion that "the purchase of shares of stock on margin or purchase of bonds selling at a great discount because of uncertainty whether they will be paid on maturity" is speculative and

cannot use the trust fund to operate a business, neither can the trustee invest in corporate securities "in which [the trust fund] is necessarily exposed to the hazard of loss or gain, according to the success or failure of the enterprise." Id. at 85-86.

25. 26 Mass. (9 Pick.) 446 (1830).

26. Id. at 461.

27. On the history of trust investment law in the United States, see Lawrence M. Friedman, The Dynastic Trust, 73 Yale L.J. 547, 551-72 (1964). *See generally* George G. Bogert & George T. Bogert, The Law of Trusts and Trustees §§ 612-14 (rev. ed. 1993).

28. *See* Mayo A. 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, 501-03 (1951). For the text of the bankers' model act, the so-called Model Prudent Man Investment Act, see id. at 508-09.

29. Bevis Longstreth, Modern Investment Management and the Prudent Man Rule 3-6 (1986).

30. Quoted supra text accompanying note 25.

imprudent.[31] In some jurisdictions investing in junior mortgages, no matter how well secured, was per se imprudent.[32] The view crystallized that an investment in a "new and untried enterprise"[33] was inherently speculative and imprudent. Ludicrous judicial applications of the notion of speculation continued in some jurisdictions into recent times.[34]

Trustees in the first half of the twentieth century, preoccupied with avoiding speculation and preserving capital, were inclined to emphasize long-term government and corporate bonds as the characteristic trust investment. Experience with inflation after World War II taught that bonds placed significant inflation risk on the bondholder. Investments in debt could therefore experience declines in real value as severe as in equities. We now know that, in inflation-adjusted terms, the long-term real rate of return on equities has greatly exceeded bonds. The Sinquefield/Ibbotson studies estimate the inflation-adjusted rate of return on stocks since the 1920s at about 9 percent per year, as compared to about 3 percent for bonds.[35] Fiduciaries have adapted to this knowledge, and through the second half of the century, have tended to increase the proportion of equity in trust accounts, at least in those trust accounts that can bear the greater volatility of equities.

II. The Uniform Prudent Investor Act

I turn now to the Uniform Prudent Investor Act, with a view to identifying and explaining its main reforms. As the title of the Act makes clear, the legislation retains the prudence standard.[36] As did the 1992 Restatement, the Act takes the opportunity to unisex the prudent man, who has now become the prudent investor. The Act directs the trustee to invest "as a prudent investor would . . . ."[37]

In giving content to the prudence label, the Act makes three great changes in the law. All three were presaged in the 1992 Restatement. First, the Act articulates a greatly augmented duty to diversify trust investments.[38] Next, in place of the old preoccupation with avoiding speculation, the Act substitutes a requirement of sensitivity to the risk

31. Restatement (Second) of Trusts § 227 cmt. f (1959).

32. 3 Austin W. Scott & William F. Fratcher, The Law of Trusts § 227.6, at [illegible] (4th ed. 1988).

33. Restatement (Second) of Trusts § 227 cmt. f (1959).

34. For example, in First Alabama Bank of Montgomery v. Martin, 425 So. 2d 415, 427 (Ala. 1982), *cert. denied*, 461 U.S. 938 (1983), the Supreme Court of Alabama surcharged a bank trustee for 17 disappointing stocks held in the bank's common trust fund. The court reasoned that the 17 were speculative because the bank purchased them in part with a view to obtaining capital appreciation when sold, and thus the issues had not been suitable long-term trust investments.

35. Roger G. Ibbotson & Rex A. Sinquefield, Stocks, Bonds, Bills, and Inflation: Historical Returns (1926-1978) 20-30 (2d ed. 1979).

36. UPIA §§ 1, 2(a).

37. Id. § 2(a).

38. Id. § 3.

tolerance of the particular trust, directing the trustee to invest for "risk and return objectives reasonably suited to the trust."[39] Finally, the Act reverses the much criticized nondelegation rule of former law and actually encourages trustees to delegate investment responsibilities to professionals.[40]

A. *Diversification*

A duty to diversify trust investments has been recognized in American trust law for about a century.[41] In recent decades the importance of diversification has been increasingly emphasized among investment professionals, and accordingly, the trustee's duty to diversify has become more acute—for example, in ERISA, the 1974 federal pension legislation, a fiduciary must diversify the investments of participants and beneficiaries to minimize risk of loss unless doing so is clearly imprudent.[42] The 1992 revision of the Restatement of Trusts integrated the duty to diversify into the very definition of prudent investing.[43]

The Uniform Prudent Investor Act demands that the "trustee *shall* diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."[44] The official Comment to the Act identifies two situations in which resisting diversification might be appropriate: first, when the tax cost of selling low-basis securities would outweigh the gain from diversification; and second, when the settlor mandates that the trust retain a family business. When, however, the trust investor starts with cash in hand, failing to diversify is inexcusable.

The emphasis on diversification also underlies another prominent feature of the Uniform Act, the portfolio standard of care in section 2(b), which reads: "A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of

39. Id. § 2(b).

40. Id. § 9.

41. *E.g.*, Dickinson, Appellant, 152 Mass. 184, 25 N.E. 99 (1890); Restatement (Third) of Trusts § 227 (1992). Many states have no explicit authority on point. In *In re Saeger's Estate*, 340 Pa. 73, 16 A.2d 19 (1940), the Pennsylvania Supreme Court questioned the duty to diversify. In view of the growing emphasis on the duty to diversify discussed in the text above, I think it unlikely that *Saeger* would remain good law in Pennsylvania. Older New York cases resistant to, or hesitant about, the duty to diversify are collected in 3 Scott & Fratcher, supra note 32, § 228, at 505-06 n.10. A recent New York case imposes liability for a trust's excess concentration of 71% of its assets in a single blue chip stock (Eastman Kodak) which experienced a long decline in value. Estate of Jones, N.Y.L.J., Jul. 5, 1995, at 31 (Sur. Ct. Monroe Cty. 1995) (I owe this reference to Richard Covey.) The New York prudent investor act, supra note 16, mandates diversification and thus resolves the matter for New York prospectively.

42. ERISA mandates "diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." Employee Retirement Income Security Act § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C) (1988).

43. Restatement (Third) of Trusts: Prudent Investor Rule § 227(b) (1992).

44. UPIA § 3 (emphasis added).

the trust portfolio as a whole . . . ."[45] The official Comment says: "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."[46]

This insistence on diversifying investments responds to one of the central findings of Modern Portfolio Theory, that there are huge and essentially costless gains to diversifying the portfolio thoroughly. To understand why, begin with the obvious truth that some securities are riskier than others. Investors demand to be paid to bear the greater risk. For example, a start-up computer software company in Silicon Valley entails a far larger risk of disappointing returns or total failure than does a seasoned blue chip such as Mobil Oil or General Electric. If you are a Silicon Valley entrepreneur who wants me to invest in your start-up firm, you must offer me an expected return (that is, a combination of dividends and capital appreciation on the securities) that is higher than Mobil or GE will pay me in order to induce me to invest in your riskier venture. This calculation is called the risk/return curve: The higher expected return on the investment compensates me for bearing the greater risk of the investment being disappointing.

Modern Portfolio Theory isolates three distinct components of the risk of owning any security: market risk, industry risk, and firm risk. Market risk is common to all securities; it reflects general economic and political conditions, interest rates, and so forth. Industry risk, by contrast, is specific to the firms in a particular industry or an industry grouping. Finally, firm risk refers to factors that touch the fortunes only of the individual firm. Thus, if we take the international oils for an example, we recall that all the producers suffered from the 1973 Arab oil embargo (industry risk), but only Exxon incurred the liabilities arising from the great Alaskan oil spill of March 1989 (firm risk).

The capital market investigators have actually been able to compute the approximate weight of the three elements that comprise the risk of securities ownership. In round numbers, market risk has been reckoned at 30 percent; the risk of industry and other groupings at 50 percent; and firm risk at 20 percent.[47] These numbers underlie the intense preoccupa-

45. Id. § 2(b).

46. Id. § 2 cmt. ("Portfolio standard"). The UPIA's portfolio standard of care derives from comparable language in the Restatement (Third) of Trusts: Prudent Investor Rule § 227(a) (1992), which states that the prudent investor rule 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 . . . ." The total portfolio standard decisively rejects the contrary strand in the older case law that is "[t]he focus of inquiry . . . is . . . on the individual security as such, and factors relating to the entire portfolio are to be weighed only along with others in reviewing the prudence of the particular investment decisions." *In re Bank of New York (Spitser)*, 323 N.E.2d 700, 703 (N.Y. 1974).

47. Brealey, supra note 21, at 117. Brealey's actual numbers are 31% market risk; 12% industry risk; 37% other groupings; and 20% firm risk. The passage in the above text consolidates industry and other groupings and rounds it to 50%.

tion with diversification as the means of reducing the risk of investing. By definition, market risk cannot be eliminated through diversification, since market risk is common to all securities. But industry risk and firm risk can be reduced greatly through diversification. To continue with the example of the oil industry, contrast an investor who owned only international oil shares in 1973 with an investor whose portfolio was broadly diversified across many industries. The oil embargo damaged the international oils and the automobile and airline industries, but it triggered a boom in domestic oils, in coal stocks, in synthetic fuels, in the energy conservation firms, and in the oilfield equipment industry. We see, therefore, that industry risk is often negatively correlated. Owning stocks in these other industries would, in part, have offset the damage to the industries harmed by the embargo.

Likewise, within an industry, diversification reduces risk. Since I cannot predict the Alaskan oil spill, or any other firm-specific hazard, I can lower my exposure to such firm-specific risks by investing not only in Exxon, but also BP, Shell, Mobil, Texaco, and the others. Indeed, it commonly happens that the performance of firms in the same industry is negatively correlated—the success of one firm comes at the expense of its competitors. Efficient market theory instructs us that it is impossible to outsmart the market by predicting which securities will do better or worse.[48] Owning many securities enhances the chances of offsetting losers with winners.[49]

In the literature of Modern Portfolio Theory, a telling expression has been coined to describe what is wrong with underdiversification: *uncompensated risk*. No one pays the investor for owning too few stocks. Recall that when I spoke of the difference between the Silicon Valley start-up and Mobil Oil, I said that the greater risk intrinsic to the start-up was reflected in its expected return. The investor faced with a choice between mature blue chips and an imperiled new venture will prefer the blue chips unless the new venture offers a superior return, a risk premium. Moving out on the risk/return curve in this way, we routinely observe that the investor who bears the greater risk is compensated for it. By contrast, no one compensates the investor for having a portfolio that neglects to hold securities in enough industries and firms to achieve effective diversification. Underdiversification entails needless risk, risk that can be avoided by constructing a sufficiently large and representative portfolio.

Diversification tends to push the investor toward very large portfolios. Although much of the benefits of diversification can be achieved with a carefully selected smaller portfolio,[50] optimal diversification probably

48. *See infra* text accompanying notes 94-98.

49. Brealey computes that a one-stock portfolio will exhibit 40% variability in a year. A market-matching portfolio exhibits 22% variability in a year. Thus, optimal diversification cuts risk by almost half. Brealey, supra note 21, at 111-12 & Tbl. 7.1.

50. Brealey estimates that ten stocks exceptionally well-selected for diversification can achieve 87% diversification; twenty such stocks, 93%; 50 such, 97%; 100 such, 98%. Id. at 112 & Tbl. 7.1.

requires a portfolio containing hundreds of issues. Relatively few investors, or for our purposes, relatively few trust funds have that much money to invest. Accordingly, an investor who seeks to eliminate the uncompensated risk of underdiversification will usually need to invest in some form of pooled investment vehicle, such as mutual funds or bank common trust funds.

B. Sensitivity to the Risk/Return Curve in Place of the Ban on Speculation

The Uniform Prudent Investor Act eliminates the old categoric restrictions on particular types of investments, such as the prohibition on junior mortgages. Section 2(e) of the Act provides: "A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act]." The official Comment explains:

> The universe of investment products changes incessantly. Investments that were at one time thought too risky, such as equities, or more recently, futures, are now used in fiduciary portfolios. By contrast, the investment that was at one time thought ideal for trusts, the long-term bond, has been discovered to import a level of risk and volatility—in this case, inflation risk—that had not been anticipated.[51]

The idea that some securities are intrinsically too risky for trust investors collides with the central findings of Modern Portfolio Theory. MPT teaches that the risk intrinsic to any marketable security is presumptively already discounted into the current price of the security. Hence, on an expected return basis, the risk is compensated risk. Thus, for example, there is no reason to think that the shares of a bankrupt company are mispriced. The securities markets are so efficient at discounting information about future profitability that today's price fully impounds the future prospects for any firm, even a bankrupt firm, on an expected value basis.

Furthermore, the risk of a high-risk investment can be materially reduced through diversification. That is why sophisticated investors who invest in start-up or otherwise fragile firms commonly employ venture capital funds, which spread the risk of failure of any single firm across a portfolio of many firms. The same logic underlies so-called vulture funds that invest in bankrupt or troubled firms. Some of the firms will fail, but many will thrive. A basket of such securities offers the likelihood of a high net return on an expected return basis.

The drafters of the Uniform Prudent Investor Act reasoned that "trust beneficiaries are better protected by . . . emphasis on close attention to risk/return objectives . . . than in attempts to identify categories of

& Tbl. 7.1.

51. UPIA § 2 cmt. ("Abrogating categoric restrictions").

investment that are per se prudent or imprudent."[52] The heart of the Act, section 2(b), states that the "trustee's investment and management decisions" are required to "hav[e] risk and return objectives reasonably suited to the trust."[53] The Act recognizes that investment returns correlate strongly with risk. However, as the official Comment explains, "tolerance for risk varies greatly with the financial and other circumstances of the investor, or in the case of a trust, with the purposes of the trust and the relevant circumstances of the beneficiaries."[54] By way of illustration, the Comment observes that if the "main purpose" of the particular trust "is to support an elderly widow of modest means," that trust "will have a lower risk tolerance than a trust to accumulate for a young scion of great wealth."[55]

Thus, the Act aspires to free trustees from the old preoccupation with avoiding speculation. Should we expect to see future trust portfolios stuffed with penny stocks, Polish zloty futures, and Czarist Russian bonds? The answer, of course, is no. For most trusts and trustees, the outer reaches of the risk/return distribution will be every bit as unsuitable as before. What has changed is that the trustee is now able to examine the risk tolerance of each particular trust and to tailor that trust's investment policy accordingly.

C. *Delegation*

The last of the great reforms of the Uniform Prudent Investor Act is to put the final nails in the coffin of the much criticized former rule that forbade trustees to delegate investment and management functions.[56]

1. *The Received Nondelegation Rule*

The rule against delegating investment functions was a branch of the general nondelegation rule of trust law. As formulated in the 1959 Restatement, the nondelegation rule places the trustee "under a duty to the beneficiary not to delegate to others the doing of acts which the trustee can reasonably be required personally to perform."[57] The rationale for the nondelegation rule has always been murky.[58] The core notion is to protect the settlor's reliance when the personality of the trustee is a vital component of the settlor's intention. We can well imagine the case in which the settlor's decision to establish a trust is motivated by confidence in the good judgment of the particular trustee, especially when the trust bestows discretion upon the trustee in matters of distribution, that is, in allocating shares among beneficiaries. Accordingly, we can understand a rule that says that if the particular trustee accepts the trust, the trustee cannot dump it off on someone else—at least not without following the procedures for trustee resignation and trustee succession that are contained in the trust instrument or in the default law.

The traditional nondelegation rule was, however, overbroad. Courts tended to read the requirement that the trustee not delegate "acts which the trustee can reasonably be required personally to perform"[59] as a prohibition on delegating any function that looked to be important. The courts attempted to distinguish pedestrian activities, so-called ministerial functions, which the trustee could delegate, from discretionary functions that were nondelegable. The drafters of the second Restatement perpetuated this standard even while admitting that they could identify no "clear-cut line dividing the acts which a trustee can properly delegate from those which he cannot properly delegate."[60] The nondelegation rule effectively forced the trustee to conduct personally all major aspects of administering the trust, necessarily including investment. The second Restatement was crystal clear about investing: "A trustee cannot properly delegate to another power to select investments."[61]

As the investment function has grown ever more complex, there is ever less reason to believe that nonspecialists are fit to conduct it. Especially when family members or other amateurs serve as trustees, the need for outside investment expertise is often acute. The old nondelegation rule permitted such trustees to take advice from outside specialists, but required the trustees to go through the motions of appearing to evaluate the advice and to form an independent judgment about whether or not to follow it. Often enough, this resulted in de facto delegation. "When the investment advisor 'recommends' and the trustee routinely 'decides' to follow the advice, the trustee in reality is delegating the selection of investments."[62]

Dissatisfaction with the nondelegation rule in investment matters

52. Id.

53. Id. § 2(b).

54. Id. § 2 cmt. ("Risk and return").

55. Id.

56. UPIA § 9. The nondelegation rule for investment matters as formulated in the second Restatement reads: "A trustee cannot properly delegate to another power to select investments." Restatement (Second) of Trusts § 171 cmt. h (1959).

57. Restatement (Second) of Trusts § 171 (1959). The second Restatement carries this language forward from the first Restatement, see Restatement of Trusts § 171 (1935).

58. For discussion of the purposes of the rule, see John H. Langbein, Reversing the Nondelegation Rule of Trust-Investment Law, 59 Mo. L. Rev. 105, 106-10 (1994).

59. Restatement (Second) of Trusts § 171 (1959). The second Restatement carries this language forward from the first, see Restatement of Trusts § 171 (1935).

60. Restatement (Second) of Trusts § 171 cmt. d (1959). Instead of a standard, the second Restatement pointed to some illustrative factors, including "the amount of discretion involved," the size of the assets in question, and the trustee's ability to deal with the matter." Id. The emphasis on distinguishing delegable ministerial functions from nondelegable discretionary functions has proved to be a labeling game, because "even the most menial of tasks involves some discretion . . . ." William L. Cary & Craig B. Bright, The Delegation of Investment Responsibility for Endowment Funds, 74 Colum. L. Rev. 207, 224 (1974) (emphasis in original).

61. Restatement (Second) of Trusts § 171 cmt. h (1959).

62. John H. Langbein & Richard A. Posner, Market Funds and Trust-Investment Law, Am. B. Found. Res. J. 1, 20 (1976).

became intense. In recent decades a variety of special-purpose statutes reversed the nondelegation rule for investment and other specialized functions, the Uniform Trustees' Powers Act in 1964,[63] the Uniform Management of Institutional Funds Act in 1972,[64] and ERISA,[65] the federal pension reform law, in 1974.[66] Early in the history of the mutual fund industry, it was feared that a trustee could not properly invest in mutual fund shares without violating the nondelegation rule (on the theory that the trustee was delegating the investment choices to the mutual fund manager).[67] The mutual fund industry responded by securing legislation that remains in force in most states expressly authorizing trustees to invest in mutual funds.[68]

2. *Abrogating the Nondelegation Rule*

The 1992 Restatement achieves a major reform of the nondelegation rule. Nominally, the Restatement leaves the general nondelegation principle intact, but effectively reduces it to a subrule of the duty of prudent administration and makes it easy to overcome. The new rule reads: "A trustee has a duty personally to perform the responsibilities of the trusteeship *except as a prudent person might delegate* those responsibilities to others."[69] Applying that norm to the investment function, the new Restatement not only empowers the trustee to delegate investment and management powers, it provides that the trustee "may sometimes have a duty . . . to delegate [investment] functions . . . in such manner as a prudent investor would delegate under the circumstances."[70]

The Uniform Act follows the Restatement in crafting a delegation regime. Section 9(a) empowers the trustee to "delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances."[71] As replacement safeguards, the Act imposes duties of care, skill, and caution on trustees in selecting agents, in formulating the terms of the delegation, and in reviewing "the

63. 7B U.L.A. 743 (1985).

64. 7A U.L.A. 705 (1985).

65. ERISA § 402(c)(3), 29 U.S.C. § 1102(c)(3).

66. The prodelegation measures in these statutes are discussed in Langbein, supra note 58, at 111-14.

67. So held in Marshall v. Frazier, 159 Or. 491, 80 P.2d 42 (Or. 1938), rejected in *In re* Rees, 85 N.E.2d 563 (Ohio 1949).

68. *E.g.*, Cal. Prob. Code § 16223 (Deering 1991); Mo. Rev. Stat. § 362.550 (1994); N.J. Rev. Stat. § 3B:14-13 (1994).

69. Restatement (Third) of Trusts: Prudent Investor Rule § 171 (1992) (emphasis added).

70. Id. § 171 cmt. j. The new Restatement makes clear that the trustee must "exercise prudence in the degree or manner of delegation. Prudence thus requires the exercise of care, skill, and caution in the selection of agents and in negotiating and establishing the terms of delegation." Id. § 171 cmt. a.

71. UPIA § 9(a).

agent's performance and compliance with the terms of the delegation."[72] The Act provides that the trustee who complies with these standards "is not liable . . . for the decisions or actions of the agent to whom the function was delegated."[73] Instead, an aggrieved beneficiary must look exclusively to the agent, who "owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation."[74]

The official Comment explains the "tension"[75] inherent in a permissive delegation rule. "If the trustee delegates effectively, the beneficiaries obtain the advantage of the agent's specialized investment skills or whatever other attributes induced the trustee to delegate."[76] However, "if the trustee delegates to a knave or an incompetent, the delegation can work harm upon the beneficiaries."[77] The requirement that the trustees use care, skill, and caution in selecting agents, in formulating the terms, and in monitoring compliance "is designed to strike the appropriate balance between the advantages and the hazards of delegation."[78]

3. *Minimizing Costs*

In connection with delegation, I conclude this survey of the main features of the Uniform Act by directing attention to a seemingly unrelated provision of the Act, section 7, which deals with investment costs. It provides that "[i]n 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."[79] There is nothing novel about the trustee's duty to minimize costs in every facet of trust administration.[80] As the official Comment remarks, "Wasting beneficiaries' money is imprudent. In devising and implementing strategies for the investment and management of trust assets, trustees are obliged to minimize costs."[81]

72. Id. § 9(a)(3).

73. Id. § 9(c).

74. Id. § 9(b).

75. Id. § 9 cmt. ("Protecting the beneficiary against unreasonable delegation").

76. UPIA § 9 cmt.

77. Id.

78. Id. The Comment continues:

> The trustee's duties of care, skill, and caution in framing the terms of the delegation should protect the beneficiary against overbroad delegation. For example, a trustee could not prudently agree to an investment management agreement containing an exculpation clause that leaves the trust without recourse against reckless mismanagement. Leaving one's beneficiaries remediless against willful wrongdoing is inconsistent with the duty to use care and caution in formulating the terms of the delegation.

Id.

79. Id. § 7.

80. *See* Restatement (Second) of Trusts § 188 (1959).

81. UPIA § 7 cmt.

The Uniform Act foresees that practice under the Act's permissive delegation regime will be a main sphere for applying the duty to minimize costs. The official Comment observes: "The trustee must be alert to protect the beneficiary from 'double dipping.' If, for example, the trustee's regular compensation schedule presupposes that the trustee will conduct the investment management function, it should ordinarily follow that the trustee will lower its fee when delegating the investment function to an outside manager."[82]

III. The Future of Trust Investing

What will the future bring under this new legal regime for trust investing?

A. *Greater Use of Equities*

This Article has emphasized that the new Restatement and the Uniform Prudent Investor Act are designed to liberate trust investors from the former preoccupation with "avoiding speculation." Extremely conservative investing will continue to be appropriate for trust accounts that cannot bear the volatility of riskier assets. But for trusts that can bear some exposure to the greater volatility characteristic of equities, the superior long-term returns will justify the risk. As a practical matter, therefore, the Uniform Act's invitation to trustees to tailor investments to the risk tolerance of the particular trust is likely to result in greater use of equities, apart from the most risk-averse trusts.[83]

Charitable trusts and foundations are particularly likely candidates for increasing their exposure to equities. The Prefatory Note to the Uniform Act observes that although the "Act is centrally concerned with the investment responsibilities" of private trusts, "the prudent investor rule also bears on charitable" trusts.[84] Because charitable trusts and foundations have exceptionally long time horizons in comparison with the typical private trust, they are uniquely suited to ride out the down-market cycles that inhere in stock-market investing.[85]

B. *More Pooling, Less Individual Security Selection*

My most confident prediction is that the future will see trustees making ever greater use of pooled investment vehicles. It will be ever less common for a trustee to construct a portfolio of individually selected securities. Increasingly, the main work of the fiduciary investor will be what has come to be called asset allocation. The trustee will form a view of the needs, resources, and risk tolerances of the beneficiaries of the particular trust. The trustee will then decide what proportion of the portfolio to invest in what classes of assets. These choices will take the form of allocating the trust assets among large, diversified portfolios, primarily mutual funds and bank common trust funds. Under the Uniform Act, both the enhanced duty to diversify and the portfolio standard of care point us in that direction. As I have previously emphasized, few trusts have the resources to achieve thorough diversification without using pooled vehicles.

The movement away from individual stock selection responds to the two central discoveries of Modern Portfolio Theory. One of these findings I have already discussed—the large and essentially costless returns to be had from optimizing diversification. The other great lesson from MPT is the understanding of why individual stock selection is so perilous—why, that is, investors find it so hard to pick winners and to avoid losers. For persons who are not familiar with the remarkable insights of MPT on this subject, a brief overview may be useful.

1. *Empirical Evidence on Institutional Portfolios*

Over the past generation, dozens of research projects, mostly conducted from university finance departments, have produced astonishing empirical data on the investment performance of professional portfolio managers. The early studies were based on data from investment companies, that is, mutual funds, but subsequent studies have replicated the results for other types of institutional portfolios. These studies have found that professionally managed institutional portfolios as a group actually underperformed the broad stock market averages such as the Standard and Poor's 500 stock Index.[86] "The funds did not show superior

82. Id. § 9 cmt. ("Costs"). For more on the concern with double dipping in delegation policy, see Langbein, supra note 58, at 108-09.

83. A leading New York corporate fiduciary, Bankers Trust, has published a statement on the investment ramifications of New York's version of the prudent investor act, see supra note 10. Bankers Trust foresees as "a probable result of Prudent Investor legislation . . . an increase in the proportion of equities in trust accounts." Bankers Trust New York Corp., Investment Implications of the Prudent Investor Act 3 (1995) (on file with author) [hereinafter Bankers Trust Statement]. The statement reasons: "Generally, a higher equity exposure produces higher variability of trust values, and therefore, more risk. However, this incremental risk can be mitigated through diversification." Id.

Using a variety of empirical data, a recent finance study concludes that the traditional prudent man standard explains the tendency of bank fiduciary investors to overemphasize the equities of large mature companies, by comparison with the greater risk-tolerance shown by mutual funds and other types of institutional investors. Diane Del Guercio, The Distorting Effect of the Prudent-Man Laws on Institutional Equity Investments, 40 J. Fin. Econ. 31 (1996).

84. UPIA, Prefatory Note ("Implications for charitable and pension trusts") (citing the 1959 Restatement for the familiar proposition that "[i]n making investments of trust funds the trustee of a charitable trust is under a duty similar to that of the trustee of a private trust. Restatement of Trusts § 389 (1959).").

85. The case for greater equity exposure in charitable portfolios is developed in John A. Ellis & Lowell S. Smith, Let Go of Your Old Investment Assumptions, Foundation News, Jan.-Feb. 1994, at 34. See also John A. Ellis & Lowell S. Smith, Investing in U.S. Securities Is a Violation of Your Fiduciary Duty, Foundation News, Nov.-Dec. 1995, at 24; John A. Ellis, The Prudent Investor and Charitable Trusts, 133 Trusts & Estates, Dec. 1994, at 38.

86. See Brealey, supra note 21, at 54-55 (summarizing data for mutual funds from 1955-1964 and for bank, insurance company, and investment managers' portfolios from 1968-77).

judgment either in picking stocks or anticipating general market movements."[87] Further, no individual fund outperformed the market with a consistency greater than the law of averages would predict.[88] A fund that performed well one year was as likely to perform poorly the next year as it was to continue doing well.

Similar results continue to be reported. For example, across the ten years ending in 1993, the Morningstar mutual fund research organization found that "diversified U.S. stock funds returned an average 12.8%, compared with 14.9% for the Standard & Poor's 500-stock index."[89] An important scholarly examination of pension fund investments in common stocks published in 1992 concluded that "pension fund equity managers seem to subtract rather than add value relative to the performance of the Standard & Poor's 500 Index."[90] The authors of the study computed that managed U.S. pension equity portfolios underperform the unmanaged averages by about 1.5 percent, which translates to a loss of about $15 billion a year.[91]

I began learning about this empirical work on securities prices in the early 1970s as a young law teacher at the University of Chicago, which was then a hotbed of efficient market research. I still remember my initial sense of disbelief about the findings, because they were so counterintuitive. How was it possible that the sophisticated and experienced investment professionals managing the great institutional portfolios could achieve results so disappointing? These managers were the best and the brightest. They worked under compensation arrangements that gave them powerful incentives to achieve the best possible results in the portfolios that they managed. Yet the data showed that they couldn't even hit the side of the barn, in the sense that they had been unable to match the performance of the broad market averages.

In 1973 Burton Malkiel published his celebrated popularization of Modern Portfolio Theory, titled *A Random Walk Down Wall Street*, a book now in its fifth edition. He taunted the professionals with the claim "that a blindfolded chimpanzee throwing darts at the [stock tables in the] *Wall Street Journal* can select a portfolio that performs as well as those managed by the experts."[92] The book caused some resentment, because as Malkiel

87. James H. Lorie & Mary T. Hamilton, The Stock Market: Theories and Evidence 95 (1973) (summarizing study done by Peter Williamson, Measuring Mutual Fund Performance, Fin. Analysts J., Nov.-Dec. 1971, at 78-84).

88. *See* Brealey, supra note 21, at 65.

89. Jonathan Clements, Boggled by Fund Picking?, Wall St. J., May 20, 1994, at C1.

90. Josef Lakonishok, Andrei Shleifer, & Robert W. Vishny, The Structure and Performance of the Money Management Industry, *in* Brookings Papers on Economic Activity: Microeconomics 339, 378 (M. Baily & C. Winston eds., 1992) [hereinafter Lakonishok].

91. Id. at 379.

92. Burton G. Malkiel, A Random Walk Down Wall Street 14 (5th ed. 1990).

later acknowledged, "financial analysts in pin-striped suits do not like being compared with bare-assed apes."[93]

2. *Efficient Markets*

What explains this astonishing evidence? Why have the professional investment managers performed so poorly? Modern Portfolio Theory supplies a crisp answer to that question. In a nutshell, the insight is that the professional portfolio managers are *not* incompetent bunglers. Indeed, just the opposite. They are so good at what they do that they effectively cancel each other out.

To understand why, start with the basics.[94] The price of a security represents the present discounted value of its future earnings. Further, for every buyer there must be a seller—someone who has formed an opposite judgment about the value of that future earnings stream at the security's current price. If all investors agreed that a particular security was a bargain at its current price, no one who owned the security would sell it at that price. Only an increase in price would induce sellers to sell. This is why we can say that, presumptively, any security is correctly priced at its current trading level.

To outperform the market—that is, consistently to identify undervalued or overvalued securities in advance of other investors—an investor must predict future earnings with superior speed and accuracy. But here the task becomes daunting. New information about individual companies is disseminated rapidly as a result of modern communications systems. The securities laws have largely choked off inside information as a source of advantage in trading. Economic developments, technological innovation, foreign affairs, political events, social changes—all profoundly affect the prices of securities, yet these phenomena are notoriously difficult to foresee.

Professional securities analysts are thus largely limited to interpreting information already in the public domain and available to other analysts. In order to outperform the market the portfolio manager has to be consistently better at making such interpretations than the thousands of competing professionals who are interpreting the same data. The theory of efficient markets posits that everything that is known or knowable about the price of a publicly traded security is *already fully reflected in its price*. The securities markets are so efficient in discounting information and pricing securities that not even the professionals can consistently identify undervalued and overvalued securities before other investors get there. The indifferent performance record of professional investment managers is, therefore, "exactly what we should expect in an efficient market."[95]

93. Id. at 24.

94. The following three paragraphs derive from John H. Langbein & Richard A. Posner, The Revolution in Trust Investment Law, 62 A.B.A. J. 887, 888 (1976).

95. Brealey, supra note 21, at 66.

One response to the lesson that you cannot beat the market is that you might make a considered judgment to cease attempting it, especially if you can pocket the savings from not trying. A vast proportion of all fiduciary investing is now conducted "passively," in so-called index or market funds. These funds undertake simply to replicate the performance of the broad market indexes.[96] In the mid-1970s when market funds first appeared, they attracted only a few hundred million dollars, most of it from the AT&T pension funds. Today, hundreds of billions of dollars in American equities are indexed.[97]

3. *Inefficient Markets*

Not all markets are efficient. The reason that Malkiel's dart-throwing chimpanzee can outperform most of the professionals is that the chimp is throwing darts at a table of market prices. The chimp is a free rider, taking advantage of the accuracy of the information already impounded in the published prices for publicly traded securities. But some assets do not have a market price. Two such classes of assets that are prominent in family wealth, and hence tend to show up in trusts, are real estate and close corporations. There is no market price for your house. Your house is unique, hence yesterday's trade of a house nearby does not accurately value your house. Likewise, because there is no orderly market for close corporation shares, the chimp with the darts cannot hit a market price for them.

To conclude: Modern Portfolio Theory has taught us that the game of stock picking is costly and futile for most investors, especially small investors, while emphasizing the large and essentially costless gains that are to be had from maximizing diversification. These twin insights point the fiduciary investor—that is, the prudent investor—strongly toward the use of pooled investment vehicles that are large enough to achieve high levels of diversification at reasonable cost. The investment path of the future for trusts, especially smaller trusts, is the mutual fund or the bank common trust fund.

96. The 1992 Restatement makes clear that investing in index funds is prudent. Restatement (Third) of Trusts: Prudent Investor Rule § 227 cmt. h (1992); id. reporter's note, § 227, at 78-79.

97. It has recently been computed that the 200 largest defined benefit pension funds hold $377 billion in index funds, of which $284 billion is in domestic equities, $35 billion in foreign equities, and the rest in bonds. The 200 largest defined contribution funds hold $84 billion in index funds, $80 billion of it in equities, the rest in bonds. Pensions & Investments, Jan. 22, 1996, at 62-63. The same journal reported total domestic indexed assets of tax-exempt investors (mostly pension funds) at above $600 billion as of December 1, 1995. Indexed Assets Leap 39.9% for Year, Pensions & Investments, Feb. 19, 1996, at 1.

C. *International Investing*

By freeing trustees from the old concern to avoid speculation, and by relieving them of the categoric restrictions forbidding particular sorts of investments, the Restatement and the Uniform Act will make it easier for the trust investor to include in the portfolio relatively novel types of assets, when such assets are likely to enhance diversification or to improve expected return on a risk-adjusted basis.

The best example of this new openness to fiduciary investing is occuring in foreign securities. Until the 1980s, it was relatively uncommon to find foreign securities in American trust portfolios.[98] There have been a variety of quite legitimate concerns about investing abroad. The liquidity of most foreign markets is inferior to that of the American markets, transaction costs on foreign exchanges are higher, the regulatory and accounting standards abroad are often less exacting than in the United States, and currency risk introduces a further source of volatility. Nevertheless, these drawbacks pale when contrasted against the great advantages of international investing.

Foreign securities enhance diversification. As of year-end 1994, American equities constituted 35.1 percent of the capitalization of the world's equity markets. "To ignore non-U.S. markets is to ignore 64.9 percent of the total global market."[99] Furthermore, the world's securities markets tend to move against each other rather than in alignment. Back in the early 1980s Richard Brealey showed "that a well diversified international portfolio is only about . . . two thirds as risky as a diversified portfolio of U.S. stocks."[100] Returns so superior led Brealey to conclude: "You need a very positive reason not to invest a significant proportion of your stock portfolio overseas."[101]

Investing abroad has boomed. Between 1975 and 1992, total international equity mutual fund assets increased from $800 million to over $45 billion.[102] There has been a comparable increase in international investing among pension funds, charitable endowments, bank common trust funds, and other fiduciary investors. Using data from the National Association of College and University Business Officers, the *New York Times*

98. The 1959 Restatement recalled: "In the earlier decisions the courts were inclined to look with disfavor on investments outside the United States or even outside the State in which the trust was administered. It is quite otherwise today." Restatement (Second) of Trusts § 227 cmt. l (1959).

99. Ibbotson Associates, "World Equity Market Capitalization" (1995) (on file with author).

100. Brealey, supra note 21, at 118. Extensive supporting data is reviewed in Bruno Solnik, International Investments 91-118 (3d ed. 1996). It has recently been argued that most of the superior returns associated with foreign stocks in recent years result from currency fluctuations, and that among foreign stocks, only the small stock and riskier so-called "value" stocks enhance returns. Rex A. Sinquefield, Where are the Gains from International Diversification?, Fin. Analysts J. 8 (Jan-Feb. 1996).

101. Brealey, supra note 21, at 121.

102. Ibbotson Associates, "Growth of International Investing" (1995) (on file with author).

recently reported that 7.5 percent of college and university endowments are now invested in foreign equities. For Yale University, the *Times* reported 12 percent of the endowment in foreign equities.[103] Foreign holdings constituted 7.2 percent of the assets of United States pension funds as of 1993 and are projected to reach 11.5 percent in 1998.[104]

The 1992 Restatement expressly endorses trust investment in foreign securities.[105] The Uniform Act does not single out any asset class for special approval, but by emphasizing diversification, the total-portfolio standard of care, and the abrogation of categoric restrictions on types of investment, the Uniform Act leaves no doubt that it buttresses international investing.[106]

D. Derivatives

Derivatives constitute another category of unconventional assets destined to become more prominent in fiduciary portfolios. Scandals connected with the use of derivatives have been front page news in recent months. Rogue traders have inflicted huge losses on the Daiwa Bank, on the Common Fund, and on the venerable but now defunct Barings Bank. Companies as sophisticated as General Electric and Proctor & Gamble are litigating about large losses sustained from investments in derivatives. Orange County, California, is in bankruptcy thanks to the county treasurer's penchant for investing in derivatives.[107] From a distance, therefore, derivatives seem to be well worth avoiding, especially if you are a trustee charged with investing prudently for your beneficiaries.

As is so often the case, however, the headlines tell only part of the story. The scandals involve cases in which derivatives were used in a fashion that increased portfolio risk enormously. Embarrassed investors were effectively placing immense bets on the future of interest rates, or in the case of Barings, on the future price levels of the Japanese stock market.

103. Universities Taking on Risks to Overcome Fiscal Squeeze, N.Y. Times, July 24, 1995, at A1, A7.

104. Solnik, supra note 100, at 576.

105. Restatement (Third) of Trusts: Prudent Investor Rule § 227, cmts. f, l (1992); id. reporter's note, at 97-98.

106. The Bankers Trust Statement, "Investment Implications of the Prudent Investor Act," accords:

> Many non-U.S. investments behave differently from U.S. equity and fixed income securities, thereby providing incremental returns without increasing risk levels. In many cases, [non-U.S. investments] can actually reduce risk. This reduction of volatility, or risk management, is the primary reason for the trend toward global portfolio management.

Bankers Trust Statement, supra note 83, at 4.

107. Some of these adventures are recounted in George Crawford, A Fiduciary Duty to Use Derivatives?, 1 Stan. J.L. Bus. & Fin. 307 (1995); and Donald L. Horwitz, Derivatives: The Basics on Terms and Risks, 5 Bus. L. Today 38 (Sept.-Oct. 1995), which also contains a useful introduction to the typology of derivatives. For an extensive discussion of the characteristics of derivatives and their use in portfolio management, see The Handbook of Fixed Income Securities 1077-1274 (Frank J. Fabozzi et al. eds., 4th ed. 1995).

Such investments are highly unlikely to qualify in a private trust account under any formulation of prudence, because the downside risk is larger than the risk tolerance of almost any trust investor.

There are, however, risk-reducing uses of derivatives. The Uniform Act's abrogation of categoric restrictions on types of investments allows trustees to use derivatives in such cases. George Crawford, in his intriguingly titled article, "A Fiduciary Duty to Use Derivatives?," illustrates a particularly compelling case.[108] Crawford posits a situation involving an elderly woman whose assets consist disproportionately of a large block of shares in the Philip Morris Company. She bought the shares decades ago, and they have appreciated hugely. She goes to the local bank and sets up a trust for herself for life, with the remainder to her siblings. She transfers the Philip Morris shares to the trust, together with her other holdings. The trust is seriously underdiversified; sixty percent of its assets are tied up in Philip Morris stock. Alas, the bank as trustee faces a difficult problem: Selling Philip Morris stock would result in a taxable gain, with perhaps 30 percent of the proceeds being lost to taxation. Under the rule that allows stepped-up basis at death, that tax liability would be completely avoided if the trust retained the stock until the settlor's death.

In traditional trust administration, the trustee would be faced with a choice between selling the shares, thus incurring the tax cost; or holding the shares and running the risk of underdiversification. In Crawford's parable, the trustee opts to hold and remain underdiversified. Soon thereafter, Philip Morris plunges from $78 per share to $52 per share.[109] Crawford suggests that the trustee had a third alternative, an alternative so compelling that the trustee might be liable for breach of the duty of prudent investing for failing to have taken it. The trustee should have bought a derivative, a put option on Philip Morris common, that would have increased in value in the event that the price of the underlying common stock declined. Buying put options can be costly, but for a number of large capitalization stocks, including Philip Morris, low-cost put options called LEAPS ("long-term equity appreciations") can be purchased. Crawford runs the numbers and shows that the advantage to holding the Philip Morris and offsetting the risk of decline by buying LEAPS is so overwhelming by comparison either with selling the shares and paying the tax bill or doing nothing and risking the loss from underdiversification that the prudence standard should compel the use of the derivative.

As Crawford's example suggests, I think we can confidently predict that the coming decades will witness ever greater use of risk-reduction strategies employing derivatives in trust portfolios.

108. Crawford, supra note 107.

109. Crawford, supra note 107, at 313.

E. Reduced Deference to the Paper Trail

An odd trait of the older trust investment law in deciding whether a trustee has invested prudently has been the inclination to give great weight to the trustee's internal procedures for investing and monitoring investments. If a corporate trustee's file recites a plenitude of deliberation —an investment committee, a securities selection committee, and a portfolio manager for the particular trust, all busily pumping quarterly memoranda about their due deliberateness into the file—the courts have sometimes been willing to treat this paper trail as presumptive evidence of prudence.[110] A practitioner treatise remarks on this phenomenon: "In cases involving the propriety of investments, the decision-making process may be as important as the decision itself, at least for purposes of determining the trustee's responsibility."[111]

I suspect that the courts have tended to fall back on evidence of seemingly sound internal procedures because the substantive standard of prudent investing has been so imprecise. Proceduralism is a common retreat in fields in which substantive law provides inadequate guidance —American administrative law is a prominent example. For the future, however, particularly as regards the intensified duty to diversify under the new Restatement and the Uniform Act, I predict that the courts will feel less need to retreat to the proceduralism of the paper trail. No amount of paper trail can excuse the five-bond or ten-stock portfolios still found in too many trust accounts.

The greater objectivity and precision of the modern standards for prudent investing manifest themselves well beyond the duty to diversify. For example, as trust investing moves toward ever greater use of broad-based portfolios, it will become easier to measure investment performance and to identify substandard returns. Many types of mutual funds and common trust funds are easily comparable. Most sponsors offer the chocolate, vanilla, and strawberry of corporate bond portfolios—short, intermediate, and long term. Most offer a comparable array of U.S. treasury bond funds. And we are now seeing ever increasing standardization of types of equity funds.

Consider, therefore, a simple case. Suppose that a trustee determines to invest twenty percent of the trust in an intermediate-term bond fund. Suppose, further, that the particular intermediate bond fund that the trustee chooses persistently underperforms other intermediate-term bond funds on account of drastically higher expense ratios. In view of the trustee's duty to monitor,[112] the burden will more easily shift to the trustee to explain why the trustee chose that particular fund. Under the

110. Perhaps the most exaggerated example is Stark v. United States Trust Co., 445 F. Supp. 670 (S.D.N.Y. 1978), a gullible opinion by the normally perceptive Judge Edward Weinfeld.

111. A. Walter Nossaman et al., Trust Administration and Taxation § 29.05[2] (1995).

112. UPIA § 9(a), supra text accompanying note 72.

prudence standard, the comparability of increasingly standardized fund types will allow trustees (and the courts who oversee trustees when beneficiaries are unhappy) greater precision in examining investment performance. The point is not that a disappointing fund or fund year is ipso facto imprudent—far from it. The point is that the growing comparability of fund types provides a more precise and objective benchmark for evaluating claims that a certain fund is so manifestly inferior to competitors that investing in it, or retaining it, is imprudent.

F. Increased Scrutiny of Uneconomic Settlor Instructions

I would also predict that the greater clarity of the new trust investment law will result in less deference to the wishes of the trust settlor in an uncommon but troubling case—the case in which the settlor attempts to impose a manifestly stupid investment restriction on the trust.

Take as the starting point the proposition, strongly endorsed in section 1(b) of the Uniform Act,[113] that almost all trust law is default law, rules that yield to the contrary wishes of the settlor. Trust law presumes that the settlor has the best interests of the beneficiaries at heart when the settlor imposes restrictions on the disposition of trust property. If, for example, I leave my summer cottage on Lake Adams in trust for my children with instructions that it not be sold but kept in the family for recreational use, that instruction will be honored even if the beneficiaries would rather not set foot on the shores of Lake Adams ever again.[114] Under conventional American trust law, the settlor's property rights are indulged. As settlor, I am entitled to decide what is best for my beneficiaries, subject only to the rule against perpetuities.

There are, however, limitations. If I devise property to a trust directing that the trustee erect equestrian statues of me in public squares in Iowa, that provision will be invalidated. A private trust must be for the benefit of the beneficiaries; a charitable trust must satisfy standards of public benefit. The trust to endow Iowa with bronze, equestrian Langbeins achieves neither.[115]

Even when the settlor's instruction is not manifestly loony, the deviation doctrine allows a court to alter an unwise investment restriction "if necessary to carry out the purposes of the trust."[116] The leading case

113. "The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust." UPIA § 1(b), 7B U.L.A. 19 (Supp. 1996).

114. "If the continuance of the trust is necessary to carry out a material purpose of the trust, the beneficiaries cannot compel its termination." Restatement (Second) of Trusts § 337(2) (1959).

115. Id. § 418(c) (invalidating trusts for capricious purposes); accord id. § 124 cmt. g. Compare M'Caig v. University of Glasgow, [1907] Sess. Cas. 231 (Scotland), voiding a trust to erect statues of the testator and other family members on lands devised by the testator, discussed in 2 Scott & Fratcher, supra note 32, § 124.7, at 277-78. On the public benefit standard, the so-called doctrine of charitable purposes, see Restatement (Second) of Trusts § 368 (1959).

116. Restatement (Second) of Trusts § 167(1) (1959).

involved a trust set up by Joseph Pulitzer for his children, in which he forbad the trustees to sell the *New York World* newspaper. When the paper became unprofitable, the trustees received judicial approval to sell it anyhow.[117] The reasoning in such cases is that subsequent experience has revealed a conflict between the settlor's dominant purpose, which is to benefit the trust beneficiaries; and the settlor's subsidiary purpose, which is to benefit them in a particular way—in *Pulitzer*, by keeping the *New York World* in the trust. The court is simply preferring the dominant purpose, in order to carry out the settlor's presumed intent.

Suppose, however, that the trust instrument in *Pulitzer* had foreseen and recited the danger that the paper might become unprofitable, and had directed retention of the investment in any event. I have no doubt that the court in *Pulitzer* would have ordered the trustees to sell the newspaper despite the settlor's direction to retain it. The settlor's instruction to retain the newspaper at all costs would come to resemble my instruction to litter the Iowa landscape with equestrian statues. If the settlor directs an objectively stupid investment policy, the court will direct deviation even though the settlor anticipates the circumstance.[118] The settlor is presumed to intend to benefit the beneficiaries, but if it can be shown that a term of the trust manifestly harms their interests, the court will order deviation from it. A private trust must be for the benefit of the beneficiaries.

Now consider a type of investment instruction that is closer to reality.[119] The settlor has worked all his life for, let us say, IBM. Through stock options and company sponsored investment plans, he has accumulated a large block of IBM common stock. He dies, leaving the block in trust with instructions not to sell it. The block is the only substantial asset of the trust, and because the settlor's death results in a stepped-up basis, selling the block incurs no tax cost. Suppose, further, that the settlor leaves a letter explaining his thinking. "I worked for IBM for 35 years, they were wonderful to me, they helped me buy the stock, and the stock zoomed in value throughout my career. You just cannot do better."

What is happening in this case is that the settlor is imposing his supposed investment wisdom on the trust in circumstances in which the investment strategy is objectively stupid and imprudent. We now know that the advantages of diversifying a portfolio of securities are so great that it is

117. *In re* Pulitzer, 249 N.Y.S. 87 (N.Y. Sur. Ct. 1931), *aff'd mem.*, 260 N.Y.S. 975 (N.Y. App. Div. 1932).

118. *E.g.*, Colonial Trust Co. v. Brown, 135 A. 555, 564 (Conn. 1926) (holding void certain restrictions as to the height of buildings to be erected on trust real estate because "the restrictions are opposed to the interests of the beneficiaries of the trust").

119. The reported cases instance trusts with permission to retain rather than outright direction. *See, e.g.*, Baldus v. Bank of Cal., 530 P.2d 1350 (Wash. Ct. App. 1975); Warmack v. Crawford, 195 S.W.2d 919 (Mo. Ct. App. 1946); First Nat'l Bank of Boston v. Truesdale Hosp., 192 N.E. 150 (Mass. 1934).

folly not to do it. I am not saying that you can never have an underdiversified trust fund. It will remain common to place a family firm or a family farm in trust, notwithstanding that such a trust will often be underdiversified. There's nothing wrong with using a trust as part of the succession arrangements for a family enterprise. I further concede, following the official Comment to the Uniform Prudent Investor Act,[120] that there will remain cases in which the tax cost of diversifying a low-basis asset may outweigh the gain.[121] When, however, the trust assets are cash or cash-equivalent, in the sense that diversification can be achieved at little cost, I believe that the courts will come to view the advantages of diversification as so overwhelming that the settlor's interference with effective diversification will be found to be inconsistent with the requirement that a private trust must be for the benefit of the beneficiary.

C. *Fractionation of Trusteeship*

Trusteeship entails three relatively distinct functions: investment, administration, and distribution. *Investment* includes not only the initial selection of securities or other assets, but also the tasks of monitoring the investments for continuing suitability, investing new funds, and voting the shares. *Administration* includes the range of accounting, reporting, and tax filing. The responsibility for taking custody of securities is another branch of trust administration. Unusual trust assets may require other administrative work—maintaining and leasing real estate, insuring and safekeeping the Picasso and the diamond tiara, and so forth. *Distribution* is sometimes mechanical, but trust instruments often bestow upon trustees the discretion to spray, sprinkle, invade, accumulate, terminate, and so forth. Distribution, therefore, requires interpreting and applying the sometimes complex language of the trust instrument; and it commonly involves contact with the current beneficiaries, in order to keep abreast of their needs and circumstances.

In former centuries, when ancestral land was the prototypical trust asset, these three functions of trusteeship were inextricably merged. The trustees were often not much more than nominees—mere stakeholders—and the family that lived on the land managed it. As financial assets have become the characteristic asset of the modern managerial trust, there is ever less reason for these three relatively disparate functions—investment, administration, and distribution—to remain consolidated in a single pair of hands. No deep connection exists between, for example, being good at working with beneficiaries on the distribution side, and being expert at investing trust funds or preparing fiduciary tax returns.

As Modern Portfolio Theory and the modernized prudent investor norm drive fiduciaries to use ever larger portfolios, there will be ever less reason to think that family trustees, and even small bank trustees, can

120. UPIA § 3 cmt.

121. *But see supra* notes 108-09 and accompanying text.

competently conduct the investment function in-house. The delegation doctrine that is legitimated under the 1992 Restatement and the Uniform Act[122] facilitates the use of outside investment products and outside investment managers. Bank trust departments are making ever greater use of mutual funds.[123] When the funds are internally managed, they constitute a close alternative to bank-operated common trust funds. When the bank as trustee uses externally managed mutual funds, the trustee commonly retains the asset allocation decisions for the particular trust in-house while effectively delegating detailed portfolio management to the outside investment company. This is an intermediate position between completely internalized investment management and complete delegation of the investment function.

One consequence of legitimating the delegation of investment functions will likely be a greater willingness on the part of lawyers to serve as trustees.[124] Lawyers bring expertise to the interpretation of trust instruments, and the typical law firm exhibits more stable personnel practices than the perennial revolving door that has been such a troubling feature of bank trust departments. Thus, on the distribution side, lawyers and law firms have formidable comparative advantages as fiduciaries. By contrast, lawyers have no particular reason to be in the investment business—at least if the investment function entails the work of actively constructing and maintaining portfolios as opposed to making or overseeing asset allocation decisions among externally managed portfolios. The delegation doctrine may encourage more lawyers and law firms to accept trusteeships, by keeping distribution work in-house, while facilitating the delegation of detailed investment and administrative functions to specialized providers.

II. *Principal and Income*

I conclude my efforts to peer into the future of trust investing by turning to a seemingly quite distinct subject: the rules governing how trustees allocate the receipts from trust investments between principal and income. The new trust-investment law is undermining the practices that trustees have long followed for discharging their duty of impartiality to multiple beneficiaries. We are learning that the duties of prudent investing and of impartiality have had a more intimate connection than has been understood. Traditional principal-and-income concepts will not survive in the world of MPT-driven investing.

122. *See supra* notes 60-62 and accompanying text.

123. The subject has its own treatise: Melanie L. Fein et al., Mutual Fund Activities of Banks (1993).

124. I have elsewhere had occasion to point to some of the advantages that lawyers can bring to trusteeship as well as some of the dangers. John H. Langbein, Taking a Look at the Pluses and Minuses of the Practice, 128 Tr. & Est. 10 (Dec. 1989). The American Bar Association's most recent guidance on the topic is reported in Bradley R. Cook, *Principles for Attorneys Acting in Other Fiduciary Roles*, 6 Prob. & Prop. 6 (Mar./Apr. 1992).

Most trusts provide for multiple interests, commonly a life estate, followed by remainders—for example, to my widow for her life, remainder to my issue. Trust law requires the trustee in such cases to adhere to what is called the duty of impartiality. The Restatement version says: "If a trust is created for beneficiaries in succession, the trustee is under a duty to the successive beneficiaries to act with due regard to their respective interests."[125] In allocating the receipts and expenses of the trust, the current beneficiary "is entitled to, and only to, the net income"[126] of the trust. Other investment returns, especially capital appreciation, accrue to the corpus of the trust. The Uniform Principal and Income Act[127] and comparable nonuniform legislation regulate corporate distributions, assigning dividends and interest to income, while accruing stock splits and other capital-account transactions to the remainder interest.

In former centuries, when agricultural real estate was the typical trust asset, the concept of net income had an intuitive, largely self-defining basis, which left scant discretion in the trustee. The life tenant was entitled to the fruits and rents of the land. Difficulty in ascertaining what was income arose only at the margin, with gravel pits and timber stands and the like.[128] As the portfolio of financial assets displaced agricultural land from the prototypical modern trust, the concept of trust income became vastly more manipulable in the hands of the trustee.

In modern circumstances, the trustee's investment decisions largely determine the income allocation to the current beneficiary. If the trustee loads the portfolio with the shares of so-called growth companies that retain their profits for internal expansion and pay little or no dividends, conventional income will be impaired. By contrast, were the trustee to skew the portfolio toward high-yielding stocks and bonds, which tend to deliver most of their return in dividends and interest rather than to experience much capital appreciation, the trust's investment policy would favor the current beneficiary and impair the remainder interest. At either extreme, or anywhere between, the trustee who has investment discretion *effectively chooses the income level by choosing the investments.* The duty of impartiality constrains the trustee by requiring "due regard" to the interests of principal and income, but within the sphere of discretion that the duty of impartiality permits, trustees commonly make investment decisions with a view to achieving the desired income level.

By distorting investment choices in order to maximize a particular form of return (whether dividends and interest or capital appreciation), conventional trust investment practices that are designed to satisfy

125. Restatement (Second) of Trusts § 232 (1959).

126. Id. § 233(1)(a). Manifestly, this default regime is altered when the trust grants the trustee discretion over whether or in what shares to distribute income, or when the trust grants the trustee a power to invade corpus for the income beneficiaries.

127. Unif. Principal & Income Act (1931 & 1962 Acts), 7B U.L.A. 183 (1985).

128. Notable topics in the early treatise, Edwin A. Howes, Jr., The American Law Relating to Income and Principal 5-12 (1905).

principal-and-income concerns come into tension with Modern Portfolio Theory. Thus, for example, the trustee who is administering a trust that needs to achieve a high level of current income may feel obliged to invest heavily in bonds, even though it is known that equities outperform bonds across the long term on a total-return basis. The conventional principal-and-income rules drive that trustee to accept a *lower* total return in order to obtain a particular *form* of return—interest rather than capital appreciation. In many trust portfolios that could prudently tolerate greater risk by holding a higher proportion of equities, the trustees have refrained from investing appropriately in equities because such a portfolio commonly produces less current income.

The lesson, in the words of Joel Dobris, is that "investing should not be connected with principal and income allocation."[129] Instead, the trustee should first invest to maximize total return, and then, in a separate and subsequent step, "allocate the return as fairly as possible."[130] In a prominent article published in 1986, Jeffrey Gordon observed that skewing the portfolio to achieve a particular income/principal allocation also impairs diversification.[131]

Our traditional notion that the current beneficiary automatically receives all the "income" has concealed from us the truth that the trustee's investment policy largely determines how much that income will be. Accordingly, an MPT-driven regime that would allow the trustee to invest for the maximum return suitable to the trust, regardless of form, and then to allocate to income that portion that the trustee determines to be appropriate for discharging the duty of impartiality, would involve no fundamental departure from the inner functional balance of the present law. Under either scheme, the trustee decides how much of the trust's investment return to devote to the income interest. But greater candor about the relationship between investing and allocating would allow the trustee to follow investment practices that would produce superior returns for both current and remainder beneficiaries.

Two main suggestions have been made for devising allocation

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129. Joel C. Dobris, The Probate World at the End of the Century: Is a New Principal and Income Act in Your Future?, 28 Real Prop., Prob. & Tr. J. 393, 412 (1993).

130. Id.

131. Such a portfolio "is not optimally diversified" because it

> has not been assembled with the objective of producing the greatest expected returns for the risk. It is easy to see why systematic exclusion of companies with low dividends but high reinvestment rates upsets a diversification scheme, but there is no assurance that a portfolio that emphasizes balance between high and low dividend paying securities will be well-diversified otherwise. The point is that the allocation of total returns between "income" and "principal" forced by settled trust law is profoundly inconsistent with the portfolio theory paradigm.

Jeffrey N. Gordon, The Puzzling Survival of the Constrained Prudent Man Rule, *in* Longstreth, *supra* note 20, at 195, 210, *substantially reprinted in* Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U. L. Rev. 52, 100-01 (1987).

formulas to facilitate total-return investing: the unitrust, and equitable reallocation. The unitrust is common in the world of foundations and charitable trusts,[132] (and in tax planning for individuals after the enactment of Chapter 14 of the Internal Revenue Code).[133] Under a unitrust, all the investment gains for the accounting period are initially assigned to principal, without regard to form (that is, whether dividends, interest, or capital appreciation). Thereafter, a spending formula (for example, five percent of principal, or the inflation rate plus two percent) is used to determine the share for current-year distribution. It is no accident that the unitrust has thus far thrived mostly in the tax-exempt world of the IRC § 501(c)(3) organization, where there is no tax reward for preferring capital gains over dividends and interest, and no tax penalty for recognizing capital gains. That is to say, our rules of taxation, as well as our rules for allocating principal and income, can impede total-return investing for taxable trusts.

Under a system of equitable reallocation, the trustee would retain the conventional form-driven categories as the initial stage of principal-and-income allocation. If, however, the trustee were to determine that the outcome achieved for the particular trust by applying those form-driven rules did not correctly balance the needs of current and remainder beneficiaries, the trustee would have the duty to reallocate the returns in order to discharge the duty of impartiality.

As I write, a Uniform Law Commission drafting committee is wrestling with proposed revisions to the Uniform Principal and Income Act, including the challenge of adapting the principal-and-income rules to the world of total-return investing under the Uniform Prudent Investor Act. The committee considered unitrust solutions but is presently inclined to recommend a limited form of equitable reallocation.[134] It remains to be seen whether this proposal will survive in the draft, and whether the full Commission will endorse it.

I suspect that some decades will be needed to harmonize fully the present tensions among total return-investing as facilitated by the prudent investor paradigm, recognition-based income taxation, and principal-and-income law. The Uniform Prudent Investor Act does not even address these issues. But by committing American trust-investment law to the main principles of Modern Portfolio Theory, the Act has brought awareness of these tensions onto the agenda that confronts legal policymakers and practicing lawyers in trust and estate law, and that is a giant first step.

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132. 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 (1993).

133. *See* IRC § 2702 (1994) (creating special valuation rules in case of transfers of interests in trusts); Louis S. Harrison, The Real Implications of the New Transfer Tax Valuation Rules: Success or Failure?, 47 Tax L. 885, 91[illegible] (1994).

134. Unif. Principal and Income Act (Oct. 1995 draft).

Fiduciary Trust International

FYI

cc:

Uniform Prudent Investor Act

Investment Legislation
Governing Trusts and Foundations

As of November, 1997

Fiduciary Trust Company International

BACKGROUND
INFORMATION

Investment Legislation Governing Trusts and Foundations (by State)

As of November, 1997

A model Uniform Prudent Investor Act ("UPIA") was promulgated by the National Conference of Commissioners on Uniform State Laws in 1994 and recommended for enactment by the states. The UPIA allows trustees and similar fiduciaries to employ modern portfolio theory to guide investment decisions, and evaluates a fiduciary's conduct based on a strategy for the total portfolio, rather than on the selection of individual assets. In addition, the UPIA makes the following alterations in the former criteria for fiduciary investment: (A) the tradeoff between risk and return is identified as the fiduciary's central investment consideration; (B) categoric restrictions on types of investments have been abrogated; (C) the concept that fiduciaries should diversify portfolio investments has been integrated into the definition of prudence; (D) the much criticized rule of trust law forbidding the trustee to delegate investment and management functions has been reversed (some jurisdictions impose notice requirements not mandated by the UPIA); and (E) the trustee may be relieved from liability for acts of the agent, if certain requirements are met.

It should be noted that charitable foundations and private trusts are subject to similar investment rules. The UPIA is applicable to foundations organized in trust form. Charitable corporations, on the other hand, are governed in many jurisdictions by the Uniform Management of Institutional Funds Act ("UMIFA"). The far right column of the chart indicates whether a state has adopted UMIFA.

The chart at the right shows the states that have adopted the UPIA, or substantial portions thereof, as of this publication. Additionally, many other states are identified that now require a total portfolio approach to investment management, but which do not otherwise have provisions resembling the UPIA. If a state has no total portfolio statute, the chart makes no representation regarding whether that state's laws contain any other provision resembling the UPIA.

State	Uniform Prudent Inv. Act (or most UPIA provisions) Effective Date	Total Portfolio Statutes (minimal UPIA provisions) Effective Date	Authority
Alabama		5/16/89	Ala. Code §§
Alaska			
Arizona	7/20/96		Ariz. Rev. Stat
Arkansas	3/31/97		Act 940 of 19
California	1/1/96		Cal. Prob. Code
Colorado	7/1/95		Colo. Rev. Stat
Connecticut	6/2/97		Public Act No
Delaware		7/3/86	Del. Code Ann
Dist. of Columbia		2/1/95	D.C. Super. C
Florida	10/1/93		Fla. Stat. Ann
Georgia		1/1/98	Ga. Code Ann
Hawaii	4/14/97		30 Hawaii Re
Idaho	7/1/97		Idaho Code §
Illinois	1/1/92		760 Ill. Comp
Indiana			
Iowa		4/22/91	Iowa Code A
Kansas	7/1/93		Kan. Stat. Ann
Kentucky		7/15/96	Kent. Rev. St
Louisiana			
Maine	1/1/97		Me. Rev. Stat
Maryland	10/1/94		Md. Est. & T
Massachusetts			
Michigan			
Minnesota	1/1/97		Minn. Stat. A
Mississippi			
Missouri	8/28/96		Mo. Ann. St
Montana		10/1/89	Mont. Code
Nebraska	4/2/97		Legislative B
Nevada		4/17/89	Nev. Rev. St
New Hampshire			
New Jersey	3/7/97		N.J. Stat. A
New Mexico	7/1/95		N.M. Stat. A
New York	1/1/95		N.Y. Est., P
North Carolina			
North Dakota	8/1/97		N.D. Cent.
Ohio			
Oklahoma	11/1/95		Okla. Stat.
Oregon	9/9/95		Or. Rev. Stat
Pennsylvania			
Rhode Island	8/6/96		R.I. Stat. §
South Carolina		6/5/90	S.C. Code A
South Dakota	7/1/95		S.D. Codif.
Tennessee		7/1/89	Tenn. Code
Texas		6/16/91	Tex. Prop.
Utah	7/1/95		Utah Code
Vermont			
Virginia	4/6/92		Va. Code A
Washington	7/23/95		Wash. Rev.
West Virginia	7/1/96		W. Va. Code
Wisconsin			
Wyoming			

	(A) Risk/Return Objectives Emphasized	(B) Unrestricted Investment Types Authorized	(C) Diversification of Portfolio as Prudent	(D) Delegation of Investment Management Author	(E) Trustee/Agent Liability Severed	(F) Notice of Delegation Required	Uniform Management of Institutional Funds Act (UMIFA)
20.2 and 19-3-322	No	No	No	Yes	No	No	Yes
							No
§§ 14-7601 to 14-7611	Yes	Yes	Yes	Yes	Yes	No	No
	Yes	Yes	Yes	Yes	Yes	No	Yes
16045 to 16054	Yes	Yes	Yes	Yes	Yes	No	Yes
§§ 15-1.1-101 to 15-1.1-115	Yes	Yes	Yes	Yes	Yes	No	Yes
140	Yes	Yes	Yes	Yes	Yes	No	Yes
12, § 3302	No	Yes	No	No	No	No	Yes
R. 5(a)	Yes	Yes	No	No	No	No	Yes
18.11 and 518.112	Yes	Yes	Yes	Yes	Yes	Yes	Yes
3-8-2	No	Yes	No	No	No	No	Yes
Statutes 554C	Yes	Yes	Yes	Yes	Yes	No	Yes
10	Yes	Yes	Yes	Yes	Yes	No	Yes
Ann. §§ 5/5 and 5/5.1	Yes	Yes	Yes	Yes	Yes	Yes	Yes
							Yes
33.123	No	No	No	No	No	No	Yes
8-1202 and 17-5004	Yes	Yes	Yes	Yes	Yes	Yes	Yes
277—applies only to corporate fiduciaries	Yes	No	Yes	Yes	No	No	Yes
							Yes
tit. 18-A, § 7-302	Yes	Yes	Yes	Yes	Yes	No	Yes
Code Ann. § 15-114	Yes	Yes	Yes	Yes	No	No	Yes
							Yes
							Yes
501B.151 and 501B.152	Yes	Yes	Yes	Yes	Yes	No	Yes
							No
56.900 to 456.913	Yes	Yes	Yes	Yes	Yes	No	Yes
72-34-114	No	Yes	No	No	Yes	No	Yes
	Yes	Yes	Yes	Yes	Yes	No	Yes
050	No	Yes	No	No	No	No	No
							Yes
20-11.1 to 3B:20-11.12	Yes	Yes	Yes	Yes	Yes	Yes	Yes
45-7-601 to 45-7-612	Yes	Yes	Yes	Yes	Yes	No	No
Trusts Law § 11-2.3	Yes	Yes	Yes	Yes	No	No	Yes
							Yes
59-02-08.1 to 59-02-08.11	Yes	Yes	[illegible]	Yes	Yes	No	Yes
							Yes
175.60 to 175.72	Yes	Yes	[illegible]	Yes	Yes	No	Yes
194 to 128.218	Yes	Yes	Yes	Yes	Yes	No	Yes
							No
to 18-15-13	Yes	Yes	Yes	Yes	Yes	No	Yes
7-302	No	Yes	No	No	No	No	Yes
Ann. §§ 55-5-6 to 55-5-16	Yes	Yes	Yes	Yes	No	No	No
3-3-117	No	Yes	No	No	No	No	Yes
§ 113.056	No	Yes	No	No	No	No	Yes
3-7-302	Yes	Yes	Yes	Yes	Yes	No	No
							Yes
35.1	No	Yes	Yes	No	No	No	Yes
§ 11.100.010 et seq.	No	Yes	Yes	No	No	No	Yes
1 to 44-6C-15	Yes	Yes	Yes	Yes	Yes	No	Yes
							Yes
							Yes

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11 '9*

SENATE COMMITTEE REPORT

DATE: 3/25/98

FURTHER: Finance

DATE TURNED IN TO OFFICE: 3-30-98

Judiciary Committee considered HOUSE BILL NO. 321 am

"An Act relating to trusts, to the prudent investor rule, and to standards of care applicable to personal representatives, conservators, and trustees; and providing for an effective date."

and recommends:

[ ] be replaced with ______ CS ______________________(________)

[ ] adopt previous ______ CS __________ ______________________(________)

[ ] attached amendment(s)

[ ] adopt Letter of Intent by ____________________ Committee

[ ] further referral to the ____________________ Committee

Senate Bill:
[ ] same title
[ ] new title

House Bill:
[ ] same title
[ ] technical title
[ ] new: SCR#______

SIGNING DO PASS	DP	OTHER RECOMMENDATIONS	NR	DNP	AM
Mike Miller	✓	Dave Donley	X		
CHAIR: Robin Taylor	✓	CHAIR:			

NEW FISCAL NOTE(S):

Department	Date	Zero	Fiscal

PREVIOUS FISCAL NOTE(S):*

Department	Date	Zero	Fiscal
CLED/Banking & Securities	2-9-98	✓	

[ ] APPROPRIATION -- no fiscal note

*Include fiscal notes accompanying Governor's bill