ALASKA LEGISLATURE COMMITTEE FILES 1997-1998 0072

9332 HOUSE LABOR & COMMERCE

CONSEQUENCES

NO, REPRESENTATIVE ROKEBERG, YOUR BILL ON CUTTING THE LEGISLATIVE SESSION DOWN TO 90 DAYS IS LUDICROUS WE REALIZE THAT UNDER THE ILLEGAL AND UNCONSTITUTIONAL WAYS YOU "LIKE TO OPERATE", I E. "NO PUBLIC HEARINGS, OR CLOSING OFF TELECONFERENCES TO THE PEOPLE" SO THEY CAN'T PROTEST THIS ILLEGAL ACTION, AND GETTING YOUR SELF-SERVING LEGISLATION PASSED "KNOWING THAT IT IS ILLEGAL AND/OR NOT REQUIRING THAT THE DRAFTING ATTORNEY TO "OBEY THE LAW BY CHECKING BILLS FIRST FOR LEGALITY, AS IN THE CASE OF H.B. 400, WILL "SHORTEN THE LEGISLATURE TIME", BUT, WE ARE HERE TO TELL YOU, "ALASKA IS NOT YET A COMPLETELY FASCIST GOVERNMENT, NO MATTER HOW HARD YOU LEGISLATORS ARE TRYING TO MAKE IT SO." WE ARE HOLDING YOU LEGALLY ACCOUNTABLE THIS YEAR AND WILL GET YOU WHERE IT HURTS: EXPOSING YOU TO PUBLIC SCRUTINY AND CIVIL RIGHT'S SUIT FOR MONEY DAMAGES.

SINCERELY,

SYLVIA SULLIVAN,
PRESIDENT AFJS

EXH 10B

Employer Accounts and Average Tax Rates by Rate Type and Industry

Table 3.5

1996 Employers by Rate Type

Industry	A-Rated No.	A-Rated % of A-Rated	B-Rated No.	B-Rated % of B-Rated	C-Rated No	C-Rated % of C-Rated	Total No.	Total % of Grand Total
Agriculture, For. & Fish	208	1.6	29	1.6	11	3.4	248	1.7
Mining	144	1.1	15	0.8	4	1.2	163	1.1
Contract Construction	1,611	12.6	298	16.0	48	14.7	1,957	13.0
Manufacturing	420	3.3	88	4.7	20	6.1	528	3.5
Trans., Commun., & Util.	938	7.3	124	6.7	29	8.9	1,091	7.3
Trade	3,556	27.7	387	20.8	78	23.9	4,021	26.8
Finance, Ins., & Real Estate	775	6.0	70	3.8	5	1.5	850	5.7
Services	4,968	38.7	677	36.4	108	33.0	5,753	38.3
Public Administration	125	1.0	2	0.1	12	3.7	139	0.9
Unclassified	85	0.7	170	9.1	12	3.7	267	1.8
Total	12,830	100.0	1,860	100.0	327	100.0	15,017	100.0
Percent of Grand Total		85.4		12.4		2.2		100.0

C-RATED
33.0
23.9
56.9%

4,021
5,753
9,774
BUSINESSES

38.3
26.5
65.1%
OF INDUSTRY
IN-ALASKA

Average Employer Tax Rates

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Total	3.4	4.27	4.79	4.05	3.08	2.54	2.38	2.43	2.51	2.63
Agriculture, For. & Fish.	3.88	4.69	6.21	4.57	3.53	2.88	2.72	2.81	2.93	3.03
Mining	3.71	4.79	5.38	4.46	3.31	2.73	2.71	2.76	2.86	2.97
Contract Construction	4.20	5.24	5.84	5.00	3.81	3.19	3.05	3.14	3.21	3.31
Manufacturing	3.60	4.67	5.15	4.40	3.33	2.79	2.68	2.78	2.81	2.89
Trans., Commun., & Util.	3.28	4.16	4.67	3.96	3.12	2.53	2.35	2.44	2.50	2.61
Trade	3.22	4.10	4.63	3.90	2.98	2.45	2.28	2.33	2.45	2.57
Finance, Ins., & Real Estate	2.93	3.84	4.39	3.66	2.76	2.23	2.02	2.04	2.05	2.19
Services	3.10	3.95	4.48	3.84	2.90	2.30	2.22	2.28	2.35	2.48
Public Administration	3.58	4.47	5.01	4.18	3.27	2.72	2.50	2.35	2.36	2.45
Unclassified	3.69	4.71	4.89	4.15	3.12	2.77	2.70	2.60	2.80	2.77

Notes: A-rated firms are those which have been subject to the Employment Security Act for four or more quarters and therefore qualify for a rate determination based on their quarterly payroll experience. Employers are assigned a rate class based on their payroll decline experience as compared to all other ratable employers. Employers with a low quarterly payroll decline receive more favorable rates than those employers showing more excessive declines in quarterly payroll figures.

B-rated firms are those which have been subject to the Employment Security Act for fewer than four quarters immediately preceding the computation date and must pay the standard industry tax rate.

C-rated firms are those which fail to pay contributions or file reports on a timely basis and must pay contributions at the highest rate.

Percentages may not add up to 100% due to rounding.

Source: Alaska Department of Labor, Research and Analysis Section: Taxable Wages Within Size of Payroll Code, Report No. BRT 5500 P.

EXH. 191

Employer Accounts and Average Tax Rates by Rate Type and Industry

Table 3.5

1995 Employers by Rate Type

Industry	A-Rated No.	A-Rated % of A-Rated	B-Rated No.	B-Rated % of B-Rated	C-Rated No	C-Rated % of C-Rated	Total No.	Total % of Grand Total
Agriculture, For. & Fish.	204	1.6	32	1.6	7	2.6	243	1.7
Mining	147	1.2	24	1.2	2	0.7	173	1.2
Contract Construction	1,584	12.7	309	15.9	26	9.6	1,919	13.0
Manufacturing	415	3.3	81	4.2	18	6.6	514	3.5
Trans., Commun., & Util.	950	7.6	128	6.6	32	11.8	1,110	7.5
Trade	3,470	27.8	429	22.1	70	25.7	3,969	27.0
Finance, Ins., & Real Estate	783	6.3	68	3.5	4	1.5	855	5.8
Services	4,748	38.0	693	35.7	97	35.7	5,536	37.6
Public Administration	128	1.0	0	0.0	9	3.3	137	0.9
Unclassified	68	0.5	179	9.2	7	2.6	254	1.7
Total	12,495	100.0	1,943	100.0	272	100.0	14,710	100.0
Percent of Grand Total		84.9		13.2		1.8		100.0

Average Employer Tax Rates

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Total	2.67	3.4	4.27	4.79	4.05	3.08	2.64	2.38	2.43	2.51
Agriculture, For. & Fish.	3.31	3.88	4.69	5.21	4.57	3.53	2.88	2.72	2.81	2.93
Mining	2.88	3.71	4.79	5.38	4.46	3.31	2.73	2.71	2.76	2.86
Contract Construction	3.35	4.20	5.24	5.84	5.00	3.81	3.19	3.05	3.14	3.21
Manufacturing	2.88	3.69	4.67	5.15	4.40	3.33	2.79	2.68	2.76	2.81
Trans., Commun., & Util.	2.55	3.28	4.16	4.67	3.96	3.12	2.53	2.35	2.44	2.50
Trade	2.44	3.22	4.10	4.63	3.90	2.96	2.45	2.28	2.33	2.45
Finance, Ins., & Real Estate	2.27	2.93	3.84	4.39	3.66	2.75	2.23	2.02	2.04	2.05
Services	2.42	3.10	3.95	4.48	3.84	2.90	2.38	2.22	2.28	2.35
Public Administration	2.78	3.58	4.47	5.01	4.18	3.27	2.72	2.50	2.35	2.36
Unclassified	3.07	3.69	4.71	4.89	4.15	3.12	2.77	2.70	2.66	2.80

Notes: A-rated firms are those which have been subject to the Employment Security Act for four or more quarters and therefore qualify for a rate determination based on their quarterly payroll experience. Employers are assigned a rate class based on their payroll decline experience as compared to all other ratable employers. Employers with a low quarterly payroll decline receive more favorable rates than those employers showing more excessive declines in quarterly payroll figures.

B-rated firms are those which have been subject to the Employment Security Act for fewer than four quarters immediately preceding the computation date and must pay the standard industry tax rate.

C-rated firms are those which fail to pay contributions or file reports on a timely basis and must pay contributions at the highest rate.

Percentages may not add up to 100% due to rounding.

Source: Alaska Department of Labor, Research & Analysis
Taxable Wages Within Size of Payroll Code Report No. BRT 5500 P.

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

03-25-98P02:16 RCVD

MEMORANDUM March 25, 1998

SUBJECT: Does HB 319 violate an employee's right to privacy (Employee's expectation of privacy in an employer's premises)

TO: Representative Norman Rokeberg
Attn: Janet Seitz

FROM: Teresa B. Cramer TBC
Legislative Counsel

You have asked whether HB 319 violates the right of privacy clause in the state constitution. Article I, sec. 22 of the Constitution of the State of Alaska reads:

> The right of the people to privacy is recognized and shall not be infringed. The legislature shall implement this section.

The bill states that, absent an agreement to the contrary, an employee has no expectation of privacy with respect to an employer's premises and equipment and requires the employee to permit the employer to have reasonable access to them. The bill allows the employer and employee to enter into a specific agreement varying this general rule.

The language of the bill would appear to apply this presumption of no expectation of privacy even to housing supplied to an employee by an employer. As I discussed with Janet on the telephone, this unintended extension of the bill to a person's living quarters would be hard to defend against a constitutional challenge based on an individual's right to privacy. Amendment A.3 clarifies that the bill applies only to business premises and this memo assumes that the bill is so limited in scope.

The bill is intended to permit an employer to control the use of the employer's business premises, including use of the employer's computer equipment. Sec. 23.10.450 would preclude an employee from asserting that the employee had an expectation of privacy in material stored in the employee's work space or on the computer used by the employee at work. "Employer" is not defined in the bill. This memo assumes that both public and private employers are covered. It would be clearer for the bill to define the term.

The right to privacy has been litigated in the context of an intrusion by the government into an individual's life. In the time available to me I have not found a case applying the state's right to privacy to an interaction between private individuals without state action. The language of the right to privacy in art. I, sec. 22, does not appear to limit its scope to

governmental action. In the absence of a history of court interpretation, I cannot say with certainty how a court would rule on a challenge from an employee that a private employer had violated the employee's right to privacy. Assuming that the court would apply the same test that it uses for considering claims to invasion of privacy by the government, I believe the bill would withstand a constitutional challenge.

In Jones v. Jennings, 788 P.2d 732, (Alaska 1990), the state supreme court considered whether the personnel records of two Anchorage police officers were protected from disclosure to the plaintiff, who had filed a damage action against the officers. The court upheld the superior court's order that the records be made available to the plaintiff. In reaching this decision the court said:

> the Alaska Constitution expressly protects the right of privacy for Alaska citizens. We have discussed previously that one who asserts a right to privacy must exhibit a subjective expectation of privacy "that society is prepared to recognize as reasonable." It is plausible for an employee to expect that the details contained within his personnel file are confidential and not subject to public scrutiny. Yet we do not approach this case, and the officers' right to privacy, in a vacuum. The right to privacy is not absolute. Rather, "there must be a ... balancing of conflicting rights and interests."

Id., at 737 - 738 (citations omitted). HB 319 addresses both whether an employee can have "a subjective expectation of privacy" in the business equipment and premises of his or her employer and whether "society is prepared to recognize" that expectation as reasonable. Sec. 23.10.450 answers "no" to both questions, unless the employer and employee have a specific agreement to the contrary. Given the limitation of the bill to business premises (as opposed to residences supplied by an employer) and given that the bill requires employees to give employers only "reasonable" access to the premises and equipment used by the employer, I believe that the bill would withstand constitutional challenge.

TC:jdr:lmb
98-192.jdr

COMMITTEE:
House Labor & Commerce Standing Committee

DATE: March 25, 1998

Subject of meeting:

HB 319: EMPLOYEES: NO EXPECTATION OF PRIVACY

SIGN-IN

PLEASE PRINT!

NAME	ADDRESS (MAILING / ZIP)	PHONE	REPRESENTING	DO YOU WANT TO TESTIFY ?
Mike McMullen	P.O. Box 110201 Juneau, AK 99811	465-4434	Div. of Personnel	Answer Questions
Wendy Redman			Ug A	yes

0-LS1211\A.1
Cramer
3/20/98

Hudson moved to adopt

AMENDMENT 1

OFFERED IN THE HOUSE BY REPRESENTATIVE ROKEBERG

TO: HB 319

Page 1, line 5, following "specific":

Insert "written"

Page 1, line 8:

Delete "an"

Insert "a written"

0-LS1211\A.2
Cramer
3/25/98

AMENDMENT 2

OFFERED IN THE HOUSE BY REPRESENTATIVE ROKEBERG

TO: HB 319

Page 1, line 4, following "**site.**":

Insert "(a)"

Page 1, following line 11:

Insert a new subsection to read:

"(b) In this section, "employer" means a person who has one or more employees and includes the state, the University of Alaska, the Alaska Railroad, and political subdivisions and public corporations of the state."

0-LS1211\A.3
Cramer
3/25/98

Amendment 3 moved

AMENDMENT

OFFERED IN THE HOUSE BY REPRESENTATIVE ROKEBERG

TO: HB 319

Page 1, line 6:

Delete "premises and"

Insert "business premises and business"

Page 1, line 7:

Delete "premises and"

Insert "business premises and business"

Page 1, line 9:

Delete "premises and"

Insert "business premises and business"

Page 1, line 10, following "employer's":

Insert "business"

03/25/98 LEGISLATIVE TELECONFERENCE NETWORK SYSTEM LTN1150
15:12:12 PARTICIPANT LIST (ALL PARTICIPANTS) BY:VAL
TCN:80535 SCHEDULED FOR:03/25/98 15:15 TO 17:15 FOR:VAL
PUBLIC HEARING HOUSE LABOR & COMMERCE

LOCATION:VALDEZ

HB 319	MS	SYLVIA	SULLIVAN	AFJS	TESTIFY

ALSO HB 438 And HB 400

legislative apprentice and personal assistant

Headquarters:
217 2nd Street, Suite 201
Juneau, Alaska 99801
(907) 586-2323 FAX 463-5515

ALASKA
STATE
CHAMBER
OF COMMERCE

February 27, 1998

Representative Norman Rokeberg
Alaska State Legislature
State Capitol
Juneau, Alaska 99801

Dear Representative Rokeberg:

At a meeting earlier this week, the Legislative Committee of the Alaska State Chamber of Commerce discussed the four pieces of legislation introduced by you and for which you requested our comments or position. I am able to respond to you with the following:

ASCC supports HB 319, regarding an employer's right to reasonable access to premises and equipment supplied by the employer.

We took no position on the other bills:

- HB 433, offering a tax credit to businesses for employing state residents who graduate from Alaska post-secondary education institutions
- HB 435, regarding the definition of consumer price index
- HB 458, regarding beer and wine licenses for golf courses

Generally, it is the State Chamber's practice to limit the issues we become active in each year to a specific few priorities adopted by our membership. Of the sixty-eight issues submitted by the membership this year for consideration, only twelve were adopted as priorities. The criteria for an issue to be included in our priorities is that it must be consistent with the mission and purpose of the State Chamber, and it must be of significant importance to business statewide. We believe this concentration of effort increases our effectiveness.

ASCC's Legislative Committee is responsible for monitoring all legislation and determining what action is necessary should additional issues arise that may significantly affect business. We do, therefore, appreciate your efforts to keep us informed on the issues on which you are working. We know that you are committed to strengthening Alaska's economy through economic development and that you are a friend to business. We sincerely thank you for your continuing efforts on our behalf.

Sincerely,

Pamela LaBolle

Pamela La Bolle
President

03-03-98[illegible]

ALASKA MINERS ASSOCIATION, INC.

501 W. Northern Lights Blvd., Suite 203, Anchorage, Alaska 99503 FAX: (907) 276-7997 Telephone: (907) 276-0347

February 6, 1998

FEB - 9 1998

Honorable Norm Rokeberg
State House of Representatives
Capitol Building
Juneau, AK 99801

RE: House Bill 319, Privacy on Employer Premises

Dear Representative Rokeberg,

Thank you for the opportunity to comment on House Bill 319 which addresses the issue of employee privacy on the premises of an employer and equipment owned by an employer. The Alaska Miners Association supports HB-319 and we encourage its passage.

The appropriate relationship between the rights of an employee to privacy and the rights of an employer has been a topic of discussion for many years. However, with the expanded use of computers and E-mail the need for clearly defining this relationship has become more important. In the past, business and product security could be monitored and controlled by controlling the flow of drawings, specifications, business contacts, customers, etc. (also for the mining industry - land status, drill logs and mine plans) all of which were hard copies of the respective items.

The expanded use of computers and E-mail has significantly changed this situation. The ability of a business to safeguard its proprietary information has become more difficult and this legislation will help answer some of the potential problems that have developed.

We urge passage of House Bill 319. If we can be of further assistance in this matter please contact me.

Sincerely,

Steven C. Borell, P.E.
Executive Director

Labor Relations

MEMORANDUM

STATE OF ALASKA
DEPARTMENT OF ADMINISTRATION

To: Personnel Contacts
All Divisions
Department of Administration

Date: October 8, 1996

File No:

Phone: 465-5658

From: Mary M. Wanie
Human Resources Manager
Division of Administrative Services
Department of Administration

Subject: State Policy Regarding Use of Office Technologies

FOR IMMEDIATE DISTRIBUTION

Earlier today Commissioner Boyer issued a memorandum to all division directors concerning the referenced policy, which refines the existing policy on use of office technology. A copy of the policy is attached, which you may photocopy for further distribution.

I am asking for your assistance in distributing the policy to each employee within your span of control and assuring it is read, signed by both the employee and supervisor, and returned to the Human Resources Section for retention in the employee's record. Please check with your division director prior to distribution to avoid the possibility of duplication. In order to implement the policy as expeditiously as possible, please make every effort to have the signed policy distributed and returned within the week and all should be returned by October 18. I have also attached a computer listing of all of your division's employees as of yesterday along with their ~~supervisor's name~~. Please return this listing certifying that each employee has been given the policy, along with the hard copy of the signed policy.

witness

This memo and policy attachment has also been sent by e-mail to facilitate distribution to all personnel contacts. If you have questions, please call me.

Thank you for your help on this project as well as for your assistance on so many other projects throughout the year.

cc: Sharon Barton, Director
Division of Administrative Services

ALASKA STATE LEGISLATURE
House of Representatives

COMMITTEE ASSIGNMENTS:

LABOR & COMMERCE COMMITTEE, CHAIRMAN
SPECIAL COMMITTEE ON OIL & GAS, MEMBER
JUDICIARY COMMITTEE, MEMBER
CORRECTIONS BUDGET SUBCOMMITTEE, MEMBER
ADMINISTRATION BUDGET SUBCOMMITTEE ,MEMBER
HESS BUDGET SUBCOMMITTEE, MEMBER

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Representative Norman Rokeberg

SPONSOR STATEMENT
HOUSE BILL 319

An Act relating to an employee's expectation of privacy in employer premises
By Representative Norman Rokeberg

House Bill 319 addresses a contemporary issue. With the advent of modern technology and the use of same in office places, many employees are using employer's equipment to access the Internet and send e-mail messages. While some employers have policies in place that make the employer's policy on this use plain, many do not. House Bill 319 would make it clear that, absent an agreement to the contrary, an employee has no expectation of privacy on an employer's premises.

My 1998 House District 11 survey posed the following question: Should state law allow an employer the right to regulate all employee use of employer facilities and equipment? (i.e., internet, computer games, etc.). An overwhelming majority (341) favored such a law while a minority (86) opposed.

A lawsuit involving the University of Alaska at Fairbanks brought this matter to my attention. An employee should not have the ability to use an employer's equipment and then not expect the employer to be able to terminate that employee for improper use of such equipment.

House Bill 319 does permit the employee and employer to negotiate an agreement regarding access to premises and equipment. It is a step towards protecting both the employer and the employee and helping each party understand the other party's rights in the areas of workplace privacy and use of premises and equipment.

I would urge your support of this legislation.

ED1:3/23/98

ALASKA STATE LEGISLATURE
House of Representatives

COMMITTEE ASSIGNMENTS:

LABOR & COMMERCE COMMITTEE, CHAIRMAN
SPECIAL COMMITTEE ON OIL & GAS, MEMBER
JUDICIARY COMMITTEE, MEMBER
CORRECTIONS BUDGET SUBCOMMITTEE, MEMBER
ADMINISTRATION BUDGET SUBCOMMITTEE ,MEMBER
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Representative Norman Rokeberg

SECTIONAL ANALYSIS
HOUSE BILL 319
By Representative Norman Rokeberg

Title: An Act relating to an employee's expectation of privacy in employer premises.

Section 1: Adds a new section to AS 23.10. New section provides that there is no expectation of privacy in an employment site. Absent a specific agreement permitting the employee to limit the employer's access to premises and equipment, an employee shall permit the employer to have access to the employer's premises and equipment. This includes information stored on a computer or computer network supplied by the employer.

ED1:3/23/98

State Policy Regarding
Personal Use of State Office Technologies
(Revised)

It is in the best interest of the state to encourage Alaska's state employees to learn to use the new office technologies that are fundamental to their future success as state employees. Use of technology that meets ethical standards and provides exposure, education, or experience is allowable and encouraged under this policy.

The office environment has a wide variety of technologies such as: digital telephone services (voice mail, message broadcasting, message and call forwarding), fax servers, image scanning and copying (color, reduction, enlargement, binding, collating), shared and stand-alone computers (fixed, portable), pagers (text and voice), cellular phones, data networks (local, regional, global), dial-up network facilities, Global Positioning Systems (fixed, portable), VHF and CB radios (fixed, portable), and wireless dispatched office pick-up/delivery courier services.

Use of office technologies is no different from use of any other state-provided item in the work place. Executive Branch public employees of the State of Alaska must conform to applicable Alaska statutes, orders, and codes. Recognizing the very different agency missions or division-specific needs, agencies may adopt more stringent, specific, or detailed guidelines. Reasonable use and common sense must prevail in the work place use of office technologies. All policies must contain:

Prohibited uses of office technologies (not necessarily limited to the following):

1. Use for any purposes which violate a United States or State of Alaska law or the Alaska Administrative Code.

2. Use for any commercial activities, including commercial advertising, unless specific to the charter, mission, or duties of the government agency.

3. Use for access to or distribution of indecent or obscene material or child pornography.

4. Harassing other users, computing systems, and/or damaging or altering the software components of same.

5. Use for fundraising, political campaign activities, or public relations activities not specifically related to state government activities.

6. Any activity which adversely affects the availability, confidentiality, or integrity of any office technology.

The Executive Branch Ethics Act states a public employee may not "use state time, property, equipment, or other facilities to benefit personal or financial interests" (AS 39.52.120(b)(3)). Further, "standards of ethical conduct for members of the executive branch need to distinguish between those minor and inconsequential conflicts . . . and those conflicts of interests that are substantial and material." (AS 39.52.110(a)(3))

Applicable Statutes, Administrative Orders, and Codes that you may refer to include, but are not limited to: AS 39.52, Alaska Executive Branch Ethics Act; Administrative Order #81, Nondiscrimination and Nonharrassment; Administrative Code 9 AAC 52, Alaska Executive Branch Code of Ethics; AS 39.25.160, Alaska Little Hatch Act; AS 24.60, Legislature Standards of Conduct.

The State of Alaska reserves the right to routinely monitor Internet and E-mail use by individuals and report such use to appropriate supervisors. Contents of state employees' computers are also subject to "Public Records" requests.

This policy is to be read and signed by all employees in the presence of their supervisor or agency human resources staff and filed in each employee's personnel file. The signature of the employee constitutes acknowledgment of their obligation to abide by the policy. Use of the Internet and other office technology is a revocable privilege. User accounts and password access may be withdrawn if a user violates this policy. Violations may also result in possible personnel action up to and including termination, and depending on the severity, may result in criminal prosecution and/or civil liability. After reading and signing this policy, state employees have 48 hours after the date signed to clear any material that does not conform with this policy from any office technology.

_____	_____
Signature of Employee	Signature of Witness
_____	_____
Printed Name of Employee	Printed Name of Witness
_____	_____
Department	Department
_____ _____	_____ _____
PCN Date	PCN Date

ADN 10-18-97

Fired UAF carpenter says Internet porn browsing was research

The Associated Press

FAIRBANKS — A former university employee testified this week that he surfed the Internet for child pornography during work hours because he wanted to show others how easily accessible the material was.

"My curiosity took over," said William Tuttle, a former carpenter who was fired this summer for possessing child pornography at the university. "I thought, 'Good Lord, it's only six clicks away.' "

Tuttle, 47, said he was researching the topic to educate himself and two friends, a librarian and a schoolteacher. University of Alaska police arrested Tuttle in June and charged him with four counts of possession of child pornography.

Tuttle's lawyer, Bill Satterberg, has challenged whether university police had the legal authority to search a filing cabinet drawer and seize five computer discs.

Tuttle spent nearly an hour on the stand Thursday explaining why he downloaded images onto a personal storage device. He said he was trying to figure out how groups posted the pornographic images. Tuttle said he was also trying to figure out how other people jammed up the sites.

He was the final witness to testify in an evidentiary hearing that spanned three days.

Tuttle's case has sparked a legal debate over privacy expectations in the public work sector. Satterberg claims university officials overstepped their bounds by not getting a warrant to search Tuttle's office.

University officials claim they were operating under the physical plant's computer-use policy, which states that any equipment attached to a university computer is considered university property. They say this extends to disks recovered from the drawer of a filing cabinet where Tuttle kept belongings.

Tuttle said he never saw the physical plant's computer policy until the second week in June, a week after university police seized his computer.

District Judge Charles Pengilly said there are three key issues in the case. Pengilly said the first is whether the university's computer policy is valid. Acting personnel director Carolyn Chapman testified she had no proof that the policy was ever reviewed by the university's legal staff.

Pengilly said the second pivotal issue in the case is whether university police needed a warrant to search Tuttle's drawer. The third question is whether university police needed a warrant to access the disks from which the pornographic images of children were allegedly recovered.

Another oral argument is scheduled for Nov. 14.

Jerry Cramer

FAIRBANKS
Daily News-Miner

■ Obituaries B-2
■ Faith B-3-4
■ Local Events B-8,

LOCAL

Rod Boyco, City Editor; 459-7575

Friday, October 17, 1997

IN BRIEF

LOCAL

Staff reports

Friendship Day held at Alaskaland

International Friendship Day t for 1-6 p.m. Saturday at the kaland Civic Center. The event, held each year since 1986, is held near the Oct. 24 anniversary of the founding of the United Nations.

The free event will feature about 20 groups each performing song, music and dance for 15 minutes. The idea is for people from a variety of countries to become more acquainted with each other.

Among the performers are the Yupik Eskimo Dancers, the Fairbanks Youth Orchestra, Ben Eielson Senior High School, and The Silver Spur Dancers.

For more information on International Friendship Day, call 452-7346.

Mini-library to open

at Chatanika Lodge

Man says he was researching child porn

By AL SLAVIN
Staff Writer

A former university employee testified Thursday that he surfed the World Wide Web for child pornography during work hours because he wanted to show others how easily accessible the material really was.

"My curiosity took over," said William Tuttle, a former carpenter who was fired this summer for possessing child pornography at the university. "I thought, 'Good Lord, it's only six clicks away.'"

Tuttle, 47, said he was researching the topic in order to educate himself and two other friends, a librarian and schoolteacher. University of Alaska police arrested Tuttle in June and charged him with four counts of possession of child pornography.

Tuttle's lawyer, Bill Satterberg, has challenged whether university police had the legal authority to search a filing cabinet drawer and seize five computer discs.

Tuttle spent nearly an hour on the stand Thursday explaining why he downloaded images onto a personal storage device. He said he was trying to figure out how groups posted the pornographic images. Tuttle said he was also trying to figure out how other people jammed up the sites.

He was the final witness to testify in an evidentiary hearing that spanned three days. Tuttle said he never saw the physical plant's computer policy until the second week in June, a week after university police seized his computer.

"To tell you the truth, I didn't look at it," Tuttle said. "It was kind of after the fact."

Tuttle's case has sparked a legal debate over privacy expectations in the public work sector. Satterberg claims university officials overstepped their bounds by not getting a warrant to search Tuttle's office.

University officials claim they were operating under the physical plant's computer use policy, which states that any equipment attached to a university computer is considered university property. They believe this extends to disks recovered from the drawer of a filing cabinet where Tuttle kept belongings.

District Judge Charles Pengilly identified three key issues for Satterberg and the prosecutor, Assistant District Attorney Leslie Dickson. Pengilly said the first issue regards whether the computer policy is valid or not.

Satterberg questioned the university's acting personnel director, Carolyn Chapman, about the 2-year-old policy. Chapman said an employer has a right to provide a safe environment for employees and to monitor productivity.

But she said employees are not asked to waive their right to privacy. Chapman said she had no proof that the policy was ever reviewed by the university's legal staff.

Pengilly said the second pivotal issue in the case is whether university police needed a warrant to search Tuttle's drawer. The third and final question will decide whether university police needed a warrant to access the disks from where the pornographic images of children were allegedly recovered.

Another oral argument is scheduled for Nov. 14.

Loggers await

contract

Nov. 28 97

Clips from the

Fairbanks Daily News-Miner

Computer questions

The detection and prosecution of a university employee who tapped into child pornography sites on the Internet raises some tough questions about the proper approach to workplace privacy. The university appears to have acted reasonably, but putting its actions under the legal system's very powerful microscope may help clarify some issues.

To start, District Court Judge Charles Pengilly has ruled that the searches of a university carpenter's file cabinet and the disks found in it were lawful. The incident began when a physical plant computer manager was testing a monitoring program and discovered that the carpenter appeared to be logging onto some pornographic sites while at work. The search of the cabinet was conducted without a warrant by a University of Alaska Fairbanks security official but with the consent of the carpenter's boss. Child pornography, which is illegal to possess, was discovered later on the disks. The carpenter was charged with the crime. (The propriety or wisdom of such censorship of possession, as opposed to publication, is an another entire issue in itself).

University policy clearly states that employees have no reasonable expectation of absolute privacy when they use the university's computer system. And when they are at work, their supervisors have the right (and the obligation to taxpayers) to make sure the employees are performing their duties.

However, such simple statements are easily undermined by the complexities of the real world. How does one treat, for example, computer network use by a faculty member working at home? Also, despite asserting the right to investigate anything on the system at any time, the central UAF computing center's policy is to require a search warrant when law enforcement officials ask to look into an individual's files. There is obviously a strong sense that some degree of privacy ought to be afforded people.

While all this is being sorted out, maybe the best policy is for people to view computers like they would a typewriter with carbon paper. If you don't want to chance a co-worker or supervisor stumbling across something embarrassing or illegal, then don't type it on carbon paper at work because someone might find the copies in the trash can. And think about your electronic disk files as you would paper files—if it's stored in your office, its privacy can't be guaranteed.

Pengilly's ruling wasn't a total victory for the university, though. He did note that the physical plant computer policy contained an overly broad claim, one that had university employees in other departments concerned. The policy said that its usage guidelines applied to "any computing resources connected to or used directly with the Physical Plant Information Systems." If applied elsewhere on campus, that kind of language could potentially describe computers owned personally by employees who log onto their university-supplied Internet accounts from home.

A computing policy group at UAF is talking about some of these issues and has a draft policy out for discussion. It can be read at www.uaf.edu/ua-policy.

DK/see about getting copy of opinion - I'm going to visit after I read policy - Pls share this w/ DIS folks

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Electronic Monitoring

Is monitoring e-mail or phone conversations an invasion of worker privacy or a business necessity? The answer to this question is not cut and dry, and technological advances in electronic mail systems and Internet access are further muddying the waters.

Traditionally, some employers have monitored employees' telephone conversations, citing a business need to maintain or improve standards of customer service and employee performance.

Now, employers have also begun setting guidelines on the use of electronic mail systems, justifying their right to regulate the form and content of e-mail by citing their ownership of the equipment used to transmit messages and their desire to minimize legal liability for inappropriate communications. Telephone voice-mail systems and Internet activities are other relatively new areas where employers have asserted their right to monitor worker activity.

"New technology presents new threats to privacy," according to Robert Belair, an attorney in Washington, D.C., specializing in workplace privacy issues. Both employers and employees have a lot of misconceptions about monitoring with regard to e-mail and other technological advancements, he added.

Rebecca Locketz, legal director for the American Civil Liberties Union's workplace rights project, agreed that as technology increases in the workplace, so do workers' concerns about being monitored. "We are getting more and more calls from people who are beginning to understand just how invasive this can be," she said.

Put It In Writing

Employers should have written monitoring policies, management experts suggest. Employers that do not have monitoring policies and do not inform employees that they are being monitored can face invasion-of-privacy claims, as well as wrongful termination lawsuits, according to management attorney Victor Schachter of the San Francisco law firm Schachter, Kristoff, Orenstein & Berkowitz.

Schachter stressed the importance of letting employees know up front whether they are being monitored and under what circumstances the monitoring will take place.

"Tell your employees what the rules of the game are," Belair advised. He also recommended that employers carefully examine their need to monitor employees to make sure the practice is driven by business needs and is not gratuitous.

Belair stressed that employers need to be aware of their legal rights to monitor before undertaking any type of action.

Federal, State Laws

Federal and state laws address the rights of employers to conduct, and the rights of employees to be protected from, telephone and electronic monitoring at work.

In general, state laws either mirror or exceed federal provisions. Where a state law affords greater privacy protection, it supersedes federal law. With regard to telephone monitoring, for example, federal law permits the "interception" of communications as long as one of the parties to the conversation has given consent; however, 11 states require the consent of all participating parties to make interception clearly lawful. As a means of avoiding consent problems, employers sometimes place recordings on incoming lines to tell callers they might be monitored.

In addition, the Fourth Amendment to the U.S. Constitution, which prohibits unreasonable searches and seizures and protects the privacy rights of public-sector employees, has been held to apply to instances of employee monitoring in the public sector.

Despite federal and state laws addressing monitoring, employees who feel they have been improperly monitored currently have very little recourse, Locketz lamented. The restrictions on monitoring telephone calls, for example, include exceptions for business-related calls. The business-related exception "basically swallows up the rule," she said. The determination of what is a business call is "a murky area," Locketz said.

While telephone monitoring presents several dilemmas for employers and employees, Locketz said "the tougher cases are the e-mail cases."

Most employers feel that because they supply the computers to employees, they have a right to view any electronic transmissions, Locketz said. "We would like to see some limits," she said. For one thing, the ACLU asserts that employees should be notified in advance about any e-mail monitoring, Locketz said.

An employee sending personal e-mail messages during his lunch break is on his own time and his communications are "none of the employer's business, as long as [the employee] is not improperly using the resources of the employer," she added.

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ANALYSIS

Debate Over Employer E-Mail Policies Is Complicated By NLRB Decision That Messages Were Protected By LMRA

DEVELOPMENT: E-mail has become almost as common as the telephone in today's workplace, but the relatively new communication tool has already offered employers more conundrums that Alexander Graham Bell's invention ever did.

E-mail has been a lightning rod of controversy, with errant, off-color messages becoming grist for lawsuits. Employer monitoring of e-mail systems and the related questions of privacy and free speech rights have been other side effects. The ease of sending and receiving messages has caused information overload for some workers, while employers worry that more time is being wasted than saved by electronic messaging.

Now add to the mix the issue of protected activity, spurred on by an NLRB decision last February that may give employers even more cause to reconsider their stance on company e-mail practices. An employment attorney warns that employers may be seeing more instances of nonmanagement workers—both unionized and nonunion—claiming that their e-mail activities are protected under federal labor law.

Timekeeping Systems

In the NLRB ruling, an employee who was fired after sending electronic mail messages to co-workers was found to be engaged in activity protected by the Taft-Hartley Act. *Timekeeping Systems Inc.*, 323 NLRB No. 30, 154 LRRM 1233.

According to the board, the CEO of a nonunion computer company sent workers an e-mail message detailing proposed changes in vacation policy and inviting worker comment. He said the changes would give workers more vacation days per year. An employee responded via e-mail, disputing the CEO's assertions and claiming that not only would the new policy result in workers getting the same number of annual paid days off, but that workers would lose flexibility in when they could take days off. After a co-worker praised the proposed vacation policy, the employee sent another message to all workers that called the CEO's assertions "false."

Claiming that the employee's conduct was disappointing and "inappropriate," the executive ordered him to write a public policy or face termination. When the employee refused to apologize, he was fired.

The NLRB held that the employee's e-mail messages constituted concerted activity protected by Section 7 of the statute. He was trying to clear up any confusion over the vacation proposal and enlist the aid of co-workers in preserving a vacation policy he felt would better serve the workplace, the board found. Although the employee's e-mail messages had

"arrogant overtones," they were not so intolerable as to forfeit statutory protection, the board concluded, ordering him reinstated with back pay.

New Twist On Protected Activity?

Section 7 protects "concerted activities for the purpose of collective bargaining or other mutual aid or protection." No union need be involved, and activity by a single employee may be protected if it seeks to initiate, induce, or prepare for group action. *Prill v. NLRB* (Meyers Industries), 835 F.2d 1481, 127 LRRM 2415 (CA DC 1987), cert. denied, 487 U.S. 1205, 128 LRRM 2664 (1988). In evaluating the legality of an employer's response to concerted activity, it is the effect of the employer's action, not the employer's motive, that is important. *NLRB v. Burnup & Sims Inc.*, 379 U.S. 21, 57 LRRM 2385 (1964) (discharge of union supporters was unlawful even if employer honestly believed they had threatened to dynamite plant). But concerted activity may be carried on in such a way as to forfeit the protection of the act. *NLRB v. IBEW Local 1229* (Jefferson Standard Broadcasting Co.), 346 U.S. 464, 33 LRRM 2183 (1953).

The unique twist to *Timekeeping Systems*, supra, is that the employee used the company's e-mail system—rather than posting a notice on a bulletin board or speaking out at a meeting—to communicate this displeasure with a company policy. According to Victor Schachter, a management attorney with Schachter, Kristoff, Orenstein and Berkowitz in San Francisco, with the growing attention being given e-mail issues, these types of cases—involving the use of e-mail for protected activity—likely will become more prevalent. It's "the 21st century's version of protected activity," Schachter said.

The NLRB typically is lenient to employees when drawing the line between protected activity and insubordination, Schachter said, noting that employees can be quite abusive when voicing opinions and still be protected under the statute.

According to management attorney John Fox, the NLRB ruling is in keeping with the statutory definition of concerted activity. "It's simply applying traditional board laws to the specific and unique context of protected, concerted activity accomplished through the vehicle of e-mail," he said. The NLRB correctly did not allow the employee's choice of e-mail as his medium to affect its ruling, Fox said. "However an employee accomplishes protected, concerted activity is irrelevant to the protection the statute affords," he said.

Fox noted that if an employee's message that disparages corporate policy is sent only to management, "then it seems really clear that the employee is protected." Fox, who is with the law firm Fenwick & West in Palo Alto, Calif., explained that such a message represents no direct threat to the employer's maintenance of order in the workplace.

But when an employee sends such a message to the entire workforce, it presents a more difficult dilemma for the employer, Fox said. The

employer might have grounds for discipline if the message was threatening or inflammatory, he contended. If, however, the message is nothing more than griping about a management decision, the employer would have no right to take action against the worker, Fox said. While the employer may not appreciate the employee's sentiments, the e-mail message is really no different from a complaint posted on a company bulletin board, he added.

Free Speech, Privacy Rights

A workplace rights expert says the NLRB ruling could have broader implications than just those involving concerted activity, noting that it could be a step toward granting employees at least some free speech and right to privacy when they send messages over company e-mail systems.

According to Rebecca Locketz, legal director for the American Civil Liberties Union's workplace rights project, the NLRB decision might be creating a wedge into the currently nonexistent privacy rights for employees using company e-mail systems, although she allowed that this case really is not about privacy. "As it stands now, employees have no privacy rights with respect to their e-mail," she said. But with *Timekeeping Systems*, Locketz said, "there's at least an opening to creating some [privacy] rights for the employee."

Locketz agreed with the NLRB's decision, saying employees should "be given more latitude" in what they send over e-mail if the message pertains to employment matters. If the employee was sending political messages over the company's e-mail system, she said, "that's a whole other matter." In such a case, the employer would have grounds for termination, Locketz said.

Best Defense: E-Mail Policy

Is there anything employers can do to minimize the chance that employees will blast them via e-mail and retain the protection of the Taft-Hartley Act? Having a policy regulating employees' use of the company e-mail system and uniformly enforcing it might have changed the outcome of *Timekeeping Systems*, Schachter suggested.

"Whatever company policy applies to other corporate communications should apply to e-mail," said Victor Parra, president and CEO of the Electronic Messaging Association in Arlington, Va. A well-communicated policy should get employees to think of e-mail messages in the same way they think of memos sent out on company letterhead, he said.

Employers should make it clear that e-mail is for business purposes only and evenly enforce the policy, said employment attorney Sally D. Garr. Employers that allow certain nonbusiness transmissions over e-mail while restricting others will find themselves running into trouble, said Garr, who is in the Washington, D.C., office of the San Francisco-based law firm Pillsbury, Madison & Sutro. For example, if an employer allows e-mail

messages from employees trying to rent out their beach houses, it cannot then turn around and not allow messages about the company's vacation policy, she said.

But if the employer has a policy clearly stating that e-mail can be used only for business purposes, it would be able to take action against an employee who, for example, sends messages lambasting corporate programs or uses it for union organizing purposes, according to Garr. Where employers get into hot water is when they do not enforce the policy evenly, she added. "It really requires the employer to be vigilant," she said.

Garr allowed that defining what can and cannot be sent on a company's e-mail system can be difficult. "It's hard to draw the line," she said, noting that an e-mail complaint sent directly to a manager might be acceptable but that employers do not want the entire staff spending half their days discussing company policy over electronic transmissions.

Business-only e-mail policies are making inroads in some quarters. A year ago, Xerox Corp. had no specific policy pertaining to e-mail, instead relying on general corporate rules of responsibility and decorum to govern the messaging system. But recently, the company instituted a business-purposes-only policy and reserves the right to monitor employee messages, explained corporate spokesman Brent Laymon. According to Laymon, Xerox implemented the policy when it switched to an e-mail system with much broader access to outside transmissions. "Suddenly, the universe was much larger and seemed like a less secure place than it once did," he said.

Reining In An E-Mail Policy

While experts agree that e-mail policies can help stave off a number of potential headaches for employers, a consultant warns than an overly Draconian policy may do more harm than good.

Gil Gordon, principal of Gil Gordon Associates, a telecommuting consulting firm in Monmouth Junction, N.J., said e-mail policies can be compared to dress codes in that a dress code that tells employees exactly what they can and cannot wear to work becomes overbearing and might actually dispose some employees toward wanting to defy the policy. Likewise, with e-mail policies, employers are better off giving employees basic guidelines on what is appropriate use of the system rather than having a "threatening or punitive" policy.

Gordon suggests that in cases in which employees use e-mail as a means to complain about company policies and practices, managers should "look at these kinds of things as symptoms of problems rather than as problems themselves." Rather than stifling the information flow by banning certain e-mail transmissions, employers might be better off accepting that e-mail has many advantages and some downsides, Gordon said. "That's just something we have to live with," he added.

—By Simon J. Nadel with additional reporting by Susan Lightner

This case highlights the multitude of problems that arise when individuals thought to be independent contractors are found to be employees. Under these circumstances, the employer may be held liable for back taxes and withholdings (plus any applicable penalties), overtime pay (plus liquidated damages), and unemployment compensation. Additionally, not only will the mislabeled individuals be eligible to participate in employee benefit plans and programs, but the past failure to include or count them may jeopardize the tax exempt or qualified status of those plans. Accordingly, it is always advisable to closely examine your work force to ensure that your freelancers or independent contractors are bona fide and not really employees in disguise.

Vizcaino v. Microsoft Corporation, 1996 U.S. App. (LEXIS) 26021 (October 3, 1996, 9th Cir.).

E-mail and Voice Mail: Liability Waiting to Happen?

The use of E-mail and other communication technology has exploded over the past few years. The E-mail explosion, as well as the widespread use of voice mail, has provided many advantages for business communication. Indeed, for many businesses E-mail and voice mail have become essential systems to function in the workplace and to compete in the marketplace.

E-mail and voice mail systems allow employees and employers to communicate more efficiently and quickly, thus saving time and money. With the rapid growth of telecommuting, E-mail has become to many persons an indispensable tool. Maintaining electronic networks also has allowed employers to track employee productivity, efficiency, and work quality. Employers have enjoyed these improvements in productivity and efficiency and have found that clients increasingly demand the service advantages which result from E-mail and voice mail technologies.

But use of E-mail and voice mail can pose real trouble for employers. The improper use of such systems may waste employers' resources as well as expose them to legal liability.

E-mail Monitoring and Potential for Privacy Claims. As use of E-mail has grown, so has employer monitoring of employees' E-mail communication. But E-mail monitoring can result in traps filled with privacy claims against the unwary employer.

Many states and courts have recognized that citizens have a right of privacy. Although the courts have generally sided with the employer and dismissed those E-mail lawsuits, the expenses of defending such litigation can be high.

A former employee of the Pillsbury Company recently filed a lawsuit in federal court in Pennsylvania over his claim of wrongful interception of his E-mail communication by Pillsbury. The employee received messages from his supervisor over Pillsbury's E-mail system on his computer at home. The employee responded, exchanging personal E-mail messages with his supervisor. The employee's E-mail messages concerned sales management and contained threats to "kill the backstabbing bastards" and referred to a planned company party as the "Jim Jones Koolaid affair." After intercepting the employee's E-mail, Pillsbury decided to terminate him for transmitting what it deemed to be inappropriate and unprofessional comments over the company's E-mail system.

The employee, believing that his privacy had been violated, turned to the federal court for relief. He sued the Pillsbury Company, claiming that his termination was in violation of public policy, which precluded the company from terminating him in violation of his right to privacy. The court, after evaluating Pennsylvania's privacy law, decided that the employee did not have a valid claim under the circumstances. The court determined that the employee did not have a reasonable expectation of privacy in the E-mail communication voluntarily made by him to his supervisor over Pillsbury's E-mail system. The voluntary nature of the comments, as well as the fact that no personal information about the employee was disclosed, led to a conclusion that no privacy interests were violated. Although Pillsbury was successful in defending against the lawsuit, the dispute probably could have been avoided.

At least part of the reason for the lawsuit was the fact that the employee believed his E-mail messages were private. Pillsbury apparently did not have any written policies concerning the use of its E-mail system. Moreover, it had assured its employees in an informal manner that E-mail could not be intercepted and would be kept confidential and privileged. In short, the company's failure to establish a written and consistent E-mail policy contributed to the problem.

Pillsbury is not alone. Lack of a written E-mail policy is an all too common oversight by many employers. A survey by *MacWorld*, a national computer magazine, revealed in 1993 that most companies that monitor E-mail conceal doing so and that very few have a written policy on electronic monitoring. You're asking for trouble if you do the same.

Watch Out for Voice Mail, Too! A recent case involving an office romance that was uncovered and revealed to an employee's jilted spouse shows why it is important to reduce employees' expectations of privacy and implement proper procedures for monitoring such communications. The employee sued

McDonald's for "eavesdropping" on voice mail messages he left for his lover at work.

The employee found himself in hot water when a McDonald's franchisee discovered the steamy messages and began playing them back for the employee's wife. The employee claimed that his privacy rights were violated by the surreptitious review and replay of the messages. The employee said he had been told that the code to retrieve messages from his voice mail box was unknown to anyone else, and he had assumed the contents would be kept private and confidential.

The case settled, but the lesson is still clear: draft and implement a written policy for your electronic communications systems now, including voice mail, before you find yourself in court defending a lawsuit.

A Written Policy Is a Must. The message from these cases is that it is important to diminish employees' expectations of privacy regarding E-mail and voice mail and to avoid incidents of questionable monitoring of such communication. Employers must control the privacy expectations of their employees from the very beginning by creating an explicit electronic communication policy which is explained to the employees.

When implementing an electronic communication policy, be sure to consider some essential points. First, make sure the nature of the E-mail and voice mail systems is described and that all of the employees are told that such systems are to be used for legitimate business purposes and business communication only. Second, employees must be informed that the employer reserves the right to access and disclose contents of all E-mail and voice mail messages in accordance with applicable law or when a legitimate business need arises. Finally, the policy should provide that all access without the consent of the sender or recipient of the message can be done only after obtaining executive or management approval. There may be other issues unique to an employer's business, existing communication system, or work force that need to be considered when drafting an electronic communication policy.

The most important aspect of any electronic communication policy is to state the employer's procedures and expectations as clearly as possible. Some examples include:

- E-mail is a written and electronic means of communication. The company's E-mail system consists of (describe company's E-mail capabilities, including whether the system consists of an internal E-mail system, E-mail through proprietary gateways to third parties, and/or Internet E-mail). An employee should not transmit anything in an E-mail message, whether internal or external, that he or she would not be comfortable writing in a letter or memorandum using company letterhead.
- All E-mail and voice mail capabilities are provided to employees at the company's expense to assist internally in the conduct of company business and (if applicable) externally in communicating for legitimate business purposes.
- The company will not monitor E-mail and voice mail messages as a routine matter and will not tolerate the unauthorized access or use of them. However, the company reserves the right to access E-mail and voice mail messages and to disclose them to others. This policy also applies to password-protected messages. Any access without the consent of the sender or recipient must be done with executive or management approval.
- E-mail and voice mail may not be used for any messages that reasonably may be considered offensive, discriminatory, defamatory, disparaging, or threatening to any employee or any other person or entity. The company's policies against sexual or other harassment apply fully to the use of E-mail and voice mail.
- The E-mail and voice mail systems are provided to facilitate the company's business communications. The use of such systems for outside business ventures, to leak confidential or privileged information, or for personal, political, or religious causes is prohibited. The excessive or inappropriate use of such systems for personal business also is prohibited.
- By using the company's E-mail and voice mail systems, employees consent to this policy and the company's right to monitor and access E-mail and voice mail communication.
- Employees who misuse or abuse the E-mail and voice mail systems or policies set forth above may be subject to discipline up to, and including, discharge.

Those employers who implement a written policy, and make sure their employees know about it, help provide themselves with a basis for legal protection and, in the process, maintain good employee relations. Indeed, at least one recent study has shown that there was far greater acceptance of message monitoring among employees when they were notified about that possibility up front by their employer.

U.S. Supreme Court to Decide Numerous Workplace Issues

When the U.S. Supreme Court opened its new term on October 7 of this year, it had already granted

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Clips from the
Fairbanks Daily News-Miner
Nov. 27 97

UAF wins initial round in seizure of computer disks

By AL SLAVIN
Staff Writer

The university's right to monitor a worker's performance outweighs the worker's right to privacy when it comes to the case of a University of Alaska Fairbanks employee accused of possessing child pornography at work.

Fairbanks District Judge Charles Pengilly ruled Wednesday that computer disks were properly seized from William Tuttle's filing cabinet in UAF's physical plant and can be used at his criminal trial.

But Pengilly conceded that the issue is far from over.

"It's a critical issue of first impression and it needs to be decided by the appellate court before it can go to trial," said Pengilly, noting a lack of existing Alaska case law about computer privacy.

Tuttle also wants the issue resolved before his criminal trial on four counts of possessing child pornography. His attorney had tried to block the disks from being used as evidence, claiming they were taken during an illegal search.

"This has to be appealed because it affects so many more people than me," Tuttle said. "I just don't like being tied to the front of the train."

Pengilly called Tuttle's case the most interesting one he had come across since he began practicing law. He said existing case law required him to strike a balance between Tuttle's right to privacy and UAF's right to monitor workplace performance.

Pengilly struck down the physical plant's existing computer policy, which claims ownership of any item attached to a university computer. "The policy is simply not sufficient to justify the searches here," he said.

But the judge said the physical plant's computer system manager, Dean Tabor, was within his right to monitor Internet travels that departed from Tuttle's work station.

Tuttle, 47, was arrested in July, a month after university police seized computer disks containing child pornography from his office filing cabinet. He was subsequently fired from his carpenter's position in the school's physical plant. He claimed he was researching the sites so he could inform others how easily it could be accessed.

Tuttle said he is in arbitration with the university over his firing. He said university officials offered to remove the incident from his record and let him resign in order to avoid any more time in the spotlight.

He said university employees have offered calls of support and provided him with at least $6,000 to offset legal expenses.

See UAF

Tuttle's attorney, Bill Satterberg, described Pengilly's decision as a death knell for employee privacy in the workplace. Satterberg believes university police invaded his client's privacy when they searched the filing cabinet in Tuttle's office, which doubled as a break room for plant employees.

Clips from the
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Porn case sparks rights debate

By AL SLAVIN
Staff Writer

A trip through cyberspace has William Tuttle in a legal maze still under construction.

Souvenirs recovered from Tuttle's computer and disks at the University of Alaska Fairbanks have him facing criminal charges of possessing child pornography. He has lost his $42,000-a-year job at the UAF physical plant.

But just how police obtained the keepsakes—electronic images of young girls in lewd acts—has surfaced as a core issue in the case against the employee of 25 years.

A supervisor's search of Tuttle's computer system and personal disks may test the bounds of workplace privacy law as it relates to public employers and computer technology.

Tuttle's lawyer wants evidence thrown out, saying the university needed court permission to search the work station and personal computer disks. A hearing is scheduled Monday before District Judge Charles Pengilly.

"There is a serious question regarding the legality of going into someone's private belongings at work," said Tuttle's lawyer, Bill Satterberg. "The issue coming up Monday is about the right to search somebody's personal belongings. What are the rights of the employee at work?"

The university considers the computer, and anything attached to it, to be university property. It claims a supervisor identified an illegal use and turned it over to police.

Tuttle, who faces up to a year in jail, pleaded innocent July 15 to four counts of possessing child pornography. He was fired four days later.

"Obviously these two things are very inter-related," said Patty Kastelic, UAF's human resources director.

Tuttle, a 47-year-old UAF graduate, had worked at the university for 25 years. His union has appealed the firing. But Kastelic said the university stands firm.

"It was certainly inappropriate use of university equipment on university time," Kastelic said. "To my knowledge, there has never been a case like this."

A legal search?

Tuttle's world started to crumble in early June when physical plant network manager Dean Tabor installed a software program called ON-Technology's On-Guard Internet Site Manager. It allowed Tabor to monitor his employees' Internet trips.

Court files show Tabor's review indicated someone had accessed questionable sites over Tuttle's terminal. Tabor said the sites' content involved "underage pornography and male homosexuals."

Tabor checked Tuttle's computer the following day and found someone had intentionally erased the scroll, which retains the addresses of sites visited on the World Wide Web.

On June 4, Tabor again looked at Tuttle's computer. This time he copied files from the computer's hard drive. The images reportedly showed juvenile females engaged in sexual activity.

Tuttle's computer was seized along with 10 discs from a cabinet in his office. Images had also been downloaded onto the computer discs.

Tabor gave the information to the UAF Police Department and then testified when police obtained a search warrant to enter Tuttle's home. Police went looking for computer printouts but came away with pictures of a young female with balloons under her shirt and an inventory of 10 pornographic videotapes.

Tabor also identified Tuttle as the computer's primary user. Satterberg, however, said the computer was shared by several people and that Tuttle's computer password was taped to the terminal.

PLUGGED IN—The Computing and Communications' Micro Lab at the University of Alaska Fairbanks allows users to access the Internet. A criminal case against a university employee who is accused of downloading child pornography could test the limits of privacy law.

Clips from the
Fairbanks Daily News-Miner
Oct 5 97
Sunday

COMPUTER: Courts left to decide employee privacy rights

For the attorney, the issue reeks of George Orwell and Big Brother. In addition to challenging the computer and disc searches, Satterberg also questions whether Tabor had the legal authority to download them.

"They went to his office, went into his locker, took the discs that he personally bought at Fred Meyer and downloaded them," he said, "and on the basis of that went to obtain their search warrant."

That, he said, is wrong. Authorities should have first had a search warrant to pry into the computer and discs, which he compared to a purse or handbag. Should an employer be able to search those without a warrant?

"The issue isn't what you find, it's how you find it," he said.

UAF Police Chief Terry Vrabec defended the search. He said his officers consulted the state district attorney's office in Fairbanks and followed standard search warrant procedures.

"At this point, I would say that we filed everything, to the best of our knowledge, with the correct procedures," Vrabec said. "We did the best that we could within the guidelines."

New rules in the computer age

Those guidelines are based on traditional legal standards, which are now being applied to an evolving field of computer technology. The Computer Crime Division of the U.S. Department of Justice has created its own set of guidelines for local agencies to follow.

Dave Banisar, a lawyer at the Electronic Privacy Information Center, recently reviewed them. Several of his points may relate to Tuttle's case:

- Public employees are protected against unreasonable computer searches under the Fourth Amendment except for "non-investigatory, work-related intrusions" or "suspected work-related employee misfeasance."
- Individual employees may have a right to privacy that cannot be waived by a co-worker or supervisor in the same office.
- Search warrants should be obtained before computers are searched. Without one, a prosecutor should argue that the user could not have expected privacy.

Assistant District Attorney Leslie Dickson claimed, in her response to Satterberg's motion to suppress evidence, that Tuttle had no expectation of privacy. Dickson said this was evident because he downloaded information onto his own computer discs.

Under university policy, those discs—or anything else attached to an employee's work computer—become university property.

"If the university had the authority to access the discs, it certainly had the authority to decipher the contents," Dickson wrote in her court filing. One of those discs contained both work information and a piece of evidence used to charge Tuttle.

Should Tuttle have expected privacy within the university system?

Part of the answer may hinge on his relationship with his employer. Many employers now spell out just what an employee can anticipate. No one should expect privacy on their work computer unless it has been clearly established beforehand, according to one law professor.

"It's an employer's system so long as he has not created any expectations," said George Trubow, a professor of technology and privacy law at John Marshall Law School in Chicago. "Complaints about it are frequent as employees are discovering that employers are monitoring their e-mail."

A private university would not face search problems in a situation similar to UAF and Tuttle, Trubow said. A private employer is free to peruse its computer system and turn questionable items over to police.

UAF, however, falls into the "state agency" category and faces limitations instilled under the Constitution. The Fourth Amendment provides an individual with the right to be free from unreasonable searches. It also guarantees the right to be "secure in their persons, houses, papers and effects" from government intrusion.

Where now?

The Tuttle case has prompted university officials to take a closer look at access on a system of considerable size—7,500 individuals access the Internet on 5,000 network connections.

"We've just opened up Internet access to students' rooms," said Steve Smith, UAF's computer network director. "We've got another 63 modem lines coming in so people can dial in from home."

That poses another set of computer search issues. Does the university have the right to search a home computer connected to the system? Or the home itself for computer discs?

The university's ability to monitor Web site traffic is limited by the search software, which cannot search an entire network, and by a staff too few in number to track the high volume of data.

Smith said the university also has another reason for not wanting to monitor Web traffic: It does not want to be the content police.

"We treat this along the same lines as the library does with patron records in that those are confidential," he said. "We don't keep a record of what's been checked out unless it's necessary to check the system."

Smith said he didn't think he would readily turn over such records to police. "We'd probably draw the line on that and say that we have to have legal justification."

Clips from the

Fairbanks Daily News-Miner

Oct. 7 97

UAF manager tells how evidence gathered in child pornography case

By AL SLAVIN
Staff Writer

A computer network manager said Monday that two university police officers monitored another employee's Internet travels from a separate terminal in order to catch him viewing child pornography.

"They were basically waiting in my office at the monitor for a red flag to come up," said Dean Tabor, network manager for the University of Alaska Fairbanks physical plant.

When the "red flag" didn't materialize, the officers decided to seize William Tuttle's computer and some disks kept in a filing cabinet.

Tuttle was charged with four counts of possessing child pornography. But his attorney, Bill Satterberg, has challenged whether the officers had the right to search Tuttle's computer and disks without a warrant.

Tabor testified for an hour Monday during a hearing to decide whether the evidence should be suppressed. He said it was his job to monitor the capacity and activity on the physical plant's computer system.

He used a software program that not only gauged Internet traffic but also identified questionable sites with a red flag icon. Tabor said he noticed questionable sites and traced them back to a computer in Tuttle's office.

See HEARING, Page B-2

HEARING: Evidence in child porn case

Continued from Page B-1

"I viewed a couple of sites as they came by and said this is obviously not work related," Tabor said.

Tabor said one of the sites contained pornographic images of underage males and females. He contacted his supervisor, Joan Stagno, and they met with University of Alaska Fairbanks Police Chief Terry Vrabec, who was then a sergeant.

Tabor said Vrabec instructed him to monitor Tuttle's computer activity. He downloaded more images the next day and gave them to Vrabec. Tabor said Vrabec wanted to catch Tuttle in the act. Tabor had the ability to monitor images seconds after they appeared on Tuttle's screen.

Vrabec grew tired of waiting and seized the equipment from Tuttle's office, he said. They later obtained a search warrant to seize computer printouts from Tuttle's home.

The disks, Tabor said, had been attached to a university computer and are considered university property under the physical plant's computer use policy.

Tabor drafted that policy two years ago and initially suggested that employees' e-mail should be considered private. He said plant manager John Phillips vetoed that concept and decided that all communications were departmental property.

Privacy in the workplace has become a central issue in Tuttle's case.

The prosecution has argued in legal briefs that Tuttle knew others could monitor the system and could not have expected privacy.

Satterberg claims university officials needed a warrant to conduct the initial Web search. He does not believe that university officials or police had the right to seize the disks from Tuttle's personal work space or files from the computer.

Satterberg also challenged whether police had the right to download the disks, which contained additional pornographic images. The hearing is scheduled to resume Wednesday morning before Fairbanks District Judge Charles Pengilly.

Clips from the

Fairbanks Daily News-Miner

Nov. 27 97

UAF: Court

Pengilly called it a "perfectly appropriate" use of the tracking system device. Tabor testified that he was reviewing the system's capacity when he noticed that someone at Tuttle' work station was visiting questionable sites.

Tabor informed his boss, John Phillips, the physical plant manager. At one point, Tabor simultaneously monitored Tuttle's Internet visits from another computer. University Police Chief Terry Vrabec waited alongside Tabor in the hopes that Tuttle would tap into a questionable site.

When that did not occur, Vrabec searched Tuttle's work area with the consent of Tabor and Phillips. Vrabec said he considered the disks, which were later found to contain pornographic images of children, to be university property. Pengilly said Tabor's suspicions were reasonable and justified him taking a closer look at computer traffic emanating from Tuttle's work station.

He also said Tabor and Phillips had "the authority to grant access for a search, a warrantless search."

Satterberg questioned the judge's ruling and noted that Phillips never testified at the evidence suppression hearings in October.

He said Tabor's monitoring violated federal eavesdropping laws that prohibit the unauthorized interception of a communication and argued that it was the equivalent of a conversation conducted over a telephone line.

Pengilly disagreed and questioned whether accessing information on the Internet was more in line with opening an encyclopedia.

0-LS1211\A

HOUSE BILL NO. 319

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTIETH LEGISLATURE - SECOND SESSION

BY REPRESENTATIVE ROKEBERG

Introduced: 1/14/98
Referred: Labor and Commerce, Judiciary

A BILL

FOR AN ACT ENTITLED

"An Act relating to an employee's expectation of privacy in employer premises."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

* Section 1. AS 23.10 is amended by adding a new section to article 7 to read:

Sec. 23.10.450. No employee expectation of privacy in employment site. In the absence of a specific agreement to the contrary, an employee has no expectation of privacy with respect to premises and equipment supplied by the employer, and an employer may have reasonable access to premises and equipment supplied by the employer to the employee. In the absence of an agreement permitting the employee to limit the employer's access to premises and equipment, an employee shall permit the employer to have access to the employer's premises and equipment, including information stored on a computer or computer network supplied by the employer.

New Text Underlined [DELETED TEXT BRACKETED]

COMMITTEE COPY

HB

321

FISCAL NOTE

02-09-98P04:44 RCVD

STATE OF ALASKA
1998 LEGISLATIVE SESSION

BILL NO. HB321 (H) L&C

Revision Date:
Title: Uniform Prudent Investor Act

Department: Commerce and Economic Development
BRU: Banking, Securities and Corporations
Component: Banking, Securities and Corporations

Sponsor: Rep. Ryan
Requestor: House Labor and Commerce

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 Phone: 465-2521
Division: Banking, Securities and Corporations Date: 2-9-98
Approved by Commissioner: Deborah B. Sedwick Date: 2-9-98
Agency: Commerce and Economic Development

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HOUSE COMMITTEE REPORT

(7)
Date Referred to Committee: January 15, 1998 **FURTHER REFERRALS:** **Finance**

Date of Committee Action: 2/16/98

The LABOR AND COMMERCE Committee considered: **HB 321**

HOUSE BILL NO. 321 **UNIFORM PRUDENT INVESTOR ACT**

"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."

recommends it be replaced with the following committee substitute _____
[ ] the same title
[ ] a new title

[ ] additional referral to _____ Committee
[ ] attached amendment(s)

ADOPTS: _____ Letter of Intent

ATTACHES NEW FISCAL NOTE(s): (Dept) APPROVES PREVIOUS: (Dept/Date)

[ ] fiscal note(s) _____ [ ] fiscal note(s) _____

[X] zero fiscal note(s) DCED [ ] zero fiscal note(s) _____

SIGNING WITH RECOMMENDATIONS	DP	DNP	NR	AM
	✓			
	✓			
	✓			
	✓			

CHAIR'S SIGNATURE _____ 2-16-98

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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 Tamiment 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 Karliganer.

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.

6. Cal. Prob. Code §§ 16045-54 (Deering 1995).
7. Colo. Rev. Stat. §§ 15-1.1-101 to 116 (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) & 518.12 (1995) (delegation).
15. Md. Code Ann., Est. & Trusts §§ 15-106, 15-114 (1994 & Supp. 1995).
16. N.Y. Est. Powers & Trusts Law § 11-2.3 (McKinney Supp. 1994) (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 1992).
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-

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 Review Commission 8-23, 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 §§ 613-14 (rev. ed. 1985).

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. Hevis Longstreth, Modern Investment Management and the Prudent Man Rule 5-6 (1986).

30. Quoted supra text accompanying note 26.

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 448-49 (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. 958 (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 inexcuseable.

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* Saegere Estates, 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 *Saegere* 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 18, 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 (Spitzer), 325 N.E.2d 700, 703 (N.Y. 1974).

47. Ibbotson, supra note 21, at 117. Ibbotson'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, 95%; 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

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

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).

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

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 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]

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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 565 (Ohio 1949).
68. *E.g.*, Cal. Prob. Code § 16223 (Deering 1991); Mo. Rev. Stat. § 362.550 (1994); N.J. Rev. Stat. § 3B:14-15 (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).
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

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 16. 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).").

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

85. The case for greater equity exposure in charitable portfolios is developed in John A. Edie & Lowell S. Smith, Let Go of Your Old Investment Assumptions, Foundation News, Jan.-Feb. 1994, at 54. *See also* John A. Edie & Lowell S. Smith, Investing in U.S. Securities Is a Violation of Your Fiduciary Duty, Foundation News, Nov.-Dec. 1993, at 24; John A. Edie, The Prudent Investor and Charitable Trusts, 133 Trusts & Estates, Dec. 1994, at 35.

86. *See* Brealey, supra note 21, at 54-55 (summarizing data for mutual funds from 1955-1984 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 1995, 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 05 (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 55.

89. Jonathan Clements, Boggled by Fund Picking?, Wall St. J., May 20, 1996, at C1.

90. Josef Lakonishok, Andrei Schleifer, & 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 55.

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 $327 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, Pension & 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 1973 and 1992, total international equity mutual fund assets increased from $800 million to over $43 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 91-116 (3d ed. 1995). 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.[104] 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.[105]

The 1992 Restatement expressly endorses trust investment in foreign securities.[106] 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.[107]

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 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.

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 Norcaman et al., Trust Administration and Taxation § 29.05[2] (1995).

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

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. 18 (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.*, Halsius 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.

G. 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 § 5 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[121] facilitates the use of outside investment products and outside investment managers. Bank trust departments are making ever greater use of mutual funds.[122] 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.[123] 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 50-82 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."[124] In allocating the receipts and expenses of the trust, the current beneficiary "is entitled to, and only to, the net income"[125] of the trust. Other investment returns, especially capital appreciation, accrue to the corpus of the trust. The Uniform Principal and Income Act[126] 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.[127] 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 (1997 & 1964 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 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.

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 29, at 105, 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).

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 (1990) (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, 916 (1994).

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

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February 19, 1998

Honorable Norman Rokeberg, Chair
House Labor & Commerce Committee
Alaska State Legislature
Room 24-A, M/S 3100
Juneau, Alaska 99801-1182

HAND DELIVERED

Re: House Bill 321, Uniform Prudent Investor Act

Dear Representative Rokeberg:

I understand that HB 321, proposing enactment of the Uniform Prudent Investor Act, is in your committee. I support this measure, urge you to schedule it for an early hearing, and urge a "Do Pass" recommendation from your committee.

You will find enclosed a copy of my January 30, 1998 letter to the sponsor, Representative Joe Ryan, along with my February 2, 1998 letter to Professor Richard Wellman, the nation's preeminent authority on the Uniform Probate Code (and a uniform law commissioner from Georgia). Also attached is Professor Wellman's February 10 reply to me, expressing his agreement with the modifications that HB 321 makes in the Uniform Probate Code. He also supports our enactment of the Uniform Prudent Investor Act.

Thanks for considering these comments and the attachments, and I hope that we can get this bill enacted this year.

Yours truly,

Art Peterson

Arthur H. Peterson
Uniform Law Commissioner
for Alaska

Enclosures (3)

cc w/Wellman corresp.:
Representative Joe Ryan
Rest of Alaska's ULC Delegation

JOINT EDITORIAL BOARD FOR UNIFORM PROBATE CODE

February 10, 1998

Reply Address: University of Georgia
School of Law
Athens, GA 30602-6012

Arthur H. Peterson, Esq.
Dillon & Findley
The Ebner Bldg.
350 North Franklin St.
Juneau, AK 99801

Dear Art,

Your letter of February 2 and enclosures was on my desk when I returned today following three days in Chicago for a drafting committee meeting.

I agree that the adjustments in the Probate Code that are included in the Uniform Prudent Investor Act bill are appropriate. I am delighted that Alaska appears to be about to enact the Uniform Prudent Investor Act.

Hope you are fine. We are.

Cheers,

Dick

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February 2, 1998

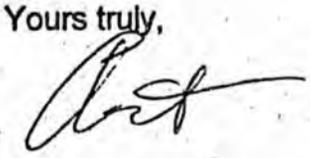
Professor Richard V. Wellman
University of Georgia
School of Law
Athens, GA 30602

Re: Uniform Prudent Investor Act

Dear Dick:

You will find enclosed a copy of our House Bill 321, proposing enactment of the Uniform Prudent Investor Act, and my January 30, 1998 letter to the sponsor regarding it. The drafter in our Legislative Affairs Agency added a couple of amendments to the Uniform Probate Code, which do not appear in the official NCCUSL version. My quick glance at them indicates that they are okay, as mentioned in my letter to the sponsor. What do you think?

Yours truly,



Arthur H. Peterson
Uniform Law Commissioner
for Alaska

Enclosure

AHP/ph

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January 30, 1998

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

HAND DELIVERED

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:

UPC §2-703

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;

UPC § 5-417 (1969 version)

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

UPIA § 11

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;

UPC §7-302

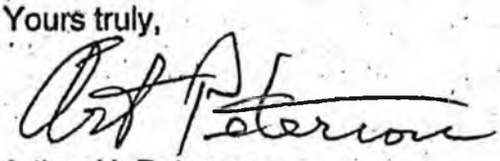
4. sec. 4 of the bill repeals AS 13.36.075, the current section that sets out a trustee's standard of care and performance, again to be consistent with the amendments made in secs. 1 and 2; the substance of existing AS 13.36.075 is set out and expanded upon in proposed AS 13.36.205 (at pages 2 and 3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



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 State Legislature
House of Representatives

COMMITTEE ASSIGNMENTS:

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

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

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PHONE (907) 258-8161

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

MEMORANDUM

TO: Representative Norman Rokeberg, Chairman
Labor & Commerce Committee

FROM: Representative Joe Ryan JR

RE: HOUSE BILL NO. 321

DATE: 16 January 1998

Please schedule a hearing for House Bill No. 321 at your earliest convenience. Thank you for your consideration.

Alaska State Legislature

House of Representatives

COMMITTEE ASSIGNMENTS:

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MILITARY & VETERANS AFFAIRS
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Representative Joe Ryan
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02-16-98P12:32 RCVD

SPONSOR STATEMENT

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.

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Phone & fax 907-258-6051
E-mail lsjkj@aol.com
February 15, 1998

Representative Joe Ryan
Alaska State Capitol
Room 420
Juneau, Alaska 99801-1182

02-16-98P12:32 RCVD

Re: House Bill 431, Uniform Prudent Investor Act

Dear Representative Ryan:

It is good to see you sponsoring the Uniform Prudent Investor Act in the Legislature. As an Alaska appointee to the National Conference of Commissioners on Uniform State Laws, I participated in Conference floor debates concerning the Act which was completed in 1994. It is well drafted, and thirteen states already have adopted it.

Alaskans often own property difficult for a trustee or other fiduciary to handle under traditional common law, which primarily concerns interest bearing instruments and often is construed to limit investments by a beneficiary to such instruments. Many fiduciaries find themselves holding mines, family business, fishing boats, real estate, zero coupon bonds, and other property which doesn't produce interest, and feel compelled under common law to liquidate such properties when common sense dictates otherwise. The Prudent Investor Act makes it clear that a fidiciary must use good sense rather than rigid guidelines in carrying out fiduciary duties, and consider the current status of markets, tax consequences of liquidation, and other factors before taking such action.

I urge adoption of House Bill 431.

Sincerely,

L. S. (Jerry) Kurtz, Jr.

STATE OF ALASKA

TONY KNOWLES, GOVERNOR

DEPARTMENT OF LAW

OFFICE OF THE ATTORNEY GENERAL

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

02-12-98P12:52 RCVD

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

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

ALASKA TRUST COMPANY
Wealth Management Specialists

February 9, 1998

02-10-98P12:32 RCVD

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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atrust@mobilaska.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 let 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

HB

323

FISCAL NOTE

STATE OF ALASKA
1998 LEGISLATIVE SESSION

BILL NO. HB 323

Revision Date:
Title: "An Act relating to credited service in the public employees retirement system."
Sponsor: Representative Brice
Requestor: (H) L&C

Department Affected: Administration
BRU: Centralized Administrative Services
Component: Retirement and Benefits
COMPONENT SERIAL NO. 2271

Expenditures/Revenues: (Thousands of Dollars)

OPERATING EXPENDITURES	FY 99	FY 00	FY 01	FY 02	FY 03	FY 04
PERSONAL SERVICES	0	0	0	0	0	0
TRAVEL	0	0	0	0	0	0
CONTRACTUAL	215.0	0	0	0	0	0
SUPPLIES	0	0	0	0	0	0
EQUIPMENT	0	0	0	0	0	0
LAND & STRUCTURES	0	0	0	0	0	0
GRANTS, CLAIMS	0	0	0	0	0	0
MISCELLANEOUS	0	0	0	0	0	0
TOTAL OPERATING	215.0	0	0	0	0	0
CAPITAL EXPENDITURES	0	0	0	0	0	0
CHANGE IN REVENUES ( )	0	0	0	0	0	0

FUND SOURCE: (Thousands of Dollars)

1002 Federal Receipts	0	0	0	0	0	0
1003 GF Match	0	0	0	0	0	0
1004 GF	0	0	0	0	0	0
1005 GF/Program Receipts	0	0	0	0	0	0
1037 GF/Mental Health	0	0	0	0	0	0
OTHER	215.0	0	0	0	0	0
TOTAL	215.0	0	0	0	0	0

Estimate of any current year (FY 98) cost: $ 0

POSITIONS:

FULL-TIME	0	0	0	0	0	0
PART-TIME	0	0	0	0	0	0
TEMPORARY	0	0	0	0	0	

ANALYSIS: (Attach a separate page if necessary.) The $215.0 is needed to hire contractors to update the division's computer systems to accommodate the proposed changes. In addition to contractor time, division staff will dedicate time to make system changes and the impacted school districts may also need to update their systems.

This change would affect approximately 6,660 current PERS members.

(continued on next page)

Prepared by: Guy Bell
Division: Retirement and Benefits
Phone: 465-4470
Date:

Approved by Commissioner: Mark Boyer
Agency: Department of Administration
Date: 2/11/98

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FISCAL NOTE
STATE OF ALASKA

1998 LEGISLATIVE SESSION BILL NO. HB 323

ANALYSIS: (continued)

To fund this increased service credit, the consolidated PERS contribution rate would increase by .58 percent. The State payroll is estimated to be $657,600,000 in FY99 and remain stable each year thereafter. The University of Alaska (U of A) PERS payroll is estimated to be $83,400,000 in FY 99 and remain stable each year thereafter.

The State cost of $4,297,700 is calculated as follows:

Estimated FY99 State PERS salaries	$657,600,000	
The increase in contribution rate	X .58%	
TOTAL PERS costs		$3,814,000
Plus estimated U of A salaries	$ 83,400,000	
The increase in contribution rate	X .58%	
TOTAL PERS costs		$483.700
Total FY99 State Costs		**$4,297,700**

In addition to the State's costs noted above, political subdivision costs would increase by $3,223,00 in FY99 based on estimated salaries of $555,700,000. The political subdivision salaries are also estimated to remain constant each year thereafter.

Estimated FY99 Political subdivision PERS salaries	$555,700,000	
The increase in contribution rate	X .58%	
TOTAL PERS costs		$3,223,000
Total FY99 Political Subdivision Costs		**$3,223,000**

Since this legislation is prospective, there will be no change on past service liability associated with this legislation.

Total FY99 Costs **$7,520,700**

ALASKA STATE LEGISLATURE
House of Representatives

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Labor and Commerce Committee

L&C Has Not Received A Fiscal Note

From The Effected Departments

HOUSE COMMITTEE REPORT

(7)
Date Referred to Committee: January 15, 1998 **FURTHER REFERRALS:** **HES**

Date of Committee Action: 4/22/98

The LABOR AND COMMERCE Committee considered: **HB 323**

HOUSE BILL NO. 323 **PERS CREDIT FOR NONCERTIFICATED EMPLOYEES**

"An Act relating to the calculation of credited service in the public employees' retirement system for noncertificated employees of school districts, regional educational attendance areas, and state boarding schools; and providing for an effective date."

recommends it be replaced with the following committee substitute CSHB 323(L&C) [ ] the same title [ ] a new title

[ ] additional referral to _____ Committee
[ ] attached amendment(s)

ADOPTS: _____ Letter of Intent

ATTACHES NEW FISCAL NOTE(s): (Dept)

[X] fiscal note(s) DOA

[ ] zero fiscal note(s) _____

APPROVES PREVIOUS: (Dept/Date)

[ ] fiscal note(s) _____

[ ] zero fiscal note(s) _____

SIGNING WITH RECOMMENDATIONS	DP	DNP	NR	AM
John Cowdery	✓			
Kevin Brice	✓			
Joe Ryan	✓			
Gene Kosbeni	✓			
Bill Hudson	✓			
Norm Rokeberg	✓			

CHAIR'S SIGNATURE Norm Rokeberg _____

ALASKA STATE LEGISLATURE
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Labor and Commerce Committee

MEMORANDUM

TO: Representative John Cowdery
Representative Bill Hudson
Representative Joe Ryan
Representative Jerry Sanders
Representative Tom Brice
Representative Gene Kubina

FROM: Shirley Armstrong, Staff
House Labor & Commerce Committee

DATE: April 21, 1998

SUBJECT: **Additional Backup For Committee Bill Packet - HB 323**

Attached is information that has come to the House Labor and Commerce Committee since our committee hearing.

Please insert in your HL&C, HB 323 committee packet.

Attachment

Bill History/Action Display

BILL: HB 323 SHORT TITLE: PERS CREDIT FOR NONCERTIFICATED EMPLOYEES
BILL VERSION:
SPONSOR(S): REPRESENTATIVES(S) BRICE, Kubina

CURRENT STATUS: (H) L&C STATUS DATE: 1/15/98
THEN HES

TITLE: "An Act relating to the calculation of credited service in the public employees' retirement system for noncertificated employees of school districts, regional educational attendance areas, and state boarding schools; and providing for an effective date."

Full Text No Fiscal Information for Bill/Resolution

ill History

Jrn-Date	Jrn-Page		Action
1/15/98	2054	(H)	READ THE FIRST TIME - REFERRAL(S)
1/15/98	2054	(H)	LABOR & COMMERCE, HES
2/11/98	Text	(H)	L&C AT 3:15 PM CAPITOL 17
2/11/98	Text	(H)	MINUTE(L&C)

Similar Subject Match or Exact Subject Match
EDUCATION
EMPLOYMENT
RETIREMENT
SALARIES & ALLOWANCES
SCHOOL DISTRICTS

Bill Root: Display History/Action Clear Bill Root

Return to BASIS Main Menu(20th Legislature)
BASIS Last Updated 4/20/93 4:43 PM

0-LS1350\E
Cramer
4/21/98

CS FOR HOUSE BILL NO. 323( )

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTIETH LEGISLATURE - SECOND SESSION

BY

Offered:
Referred:

Sponsor(s): REPRESENTATIVES BRICE, Kubina

A BILL

FOR AN ACT ENTITLED

"An Act relating to the calculation of employee contributions and credited service in the public employees' retirement system for noncertificated employees of school districts, regional educational attendance areas, and state boarding schools; and providing for an effective date."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

*** Section 1.** AS 39.35.160 is amended by adding a new subsection to read:

(c) Beginning July 1, 1998, a noncertificated employee of a state boarding school or of a school district or regional educational attendance area shall pay a contribution surcharge. The amount of the surcharge is the difference between the amount the employer would have had to contribute under AS 39.35.250 - 39.35.290 for the employee when treating the employee's credited service as service earned under AS 39.35.300(c) or 39.35.310(c) less the amount the employer would have had to contribute under AS 39.35.250 - 39.35.290 without treating the employee's credited service as service earned under AS 39.35.300(c) or AS 39.35.310(c).

* **Sec. 2.** AS 39.35.300 is amended by adding a new subsection to read:

(c) In calculating the credited service of a noncertificated employee of a state boarding school earned on or after July 1, 1998, the employee's years of service shall be determined using the table for service on or after July 1, 1969, set out in the definition of year of service in AS 14.25.220. A noncertificated employee is entitled to credit for service performed on a part-time basis as set out in that definition.

* **Sec. 3.** AS 39.35.310 is amended by adding a new subsection to read:

(c) In calculating the credited service of a noncertificated employee of a school district or regional educational attendance area earned on or after July 1, 1998, the employee's years of service shall be determined using the table for service on or after July 1, 1969, set out in the definition of year of service in AS 14.25.220. A noncertificated employee is entitled to credit for service performed on a part-time basis as set out in that definition.

* **Sec. 4.** This Act takes effect July 1, 1998.

ALASKA STATE LEGISLATURE
House of Representatives

COMMITTEE ASSIGNMENTS:

LABOR & COMMERCE COMMITTEE, CHAIRMAN
SPECIAL COMMITTEE ON OIL & GAS, MEMBER
JUDICIARY COMMITTEE, MEMBER
CORRECTIONS BUDGET SUBCOMMITTEE, MEMBER
ADMINISTRATION BUDGET SUBCOMMITTEE ,MEMBER
HESS BUDGET SUBCOMMITTEE, MEMBER

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Representative Norman Rokeberg

April 7, 1998

Mr. Steve Kortie
1128 Jackson Drive
Anchorage, AK 99518

Dear Mr. Kortie:

Thank you for your recent message. I am always pleased to know the views of my constituents.

HB 323 currently lacks the support of Alaska's school districts. However, as Chairman of the Labor & Commerce, I have sent a letter to the Anchorage School District to ask if the ASD could support the bill, if the employees had the option to fund the interim period themselves.

I support the concept that employees should enjoy typical retirement benefits by increasing their own contributions.

I appreciate you taking the time to contact me. If you would like to speak directly to a staff person, please feel free to give my office a call at 1-800-773-4968 or e-mail me at: Representative_Norman_Rokeberg@legis.state.ak.us.

Please keep me advised of your concerns.

Sincerely,

Representative Norman Rokeberg

NEA-ALASKA

Affiliated with the National Education Association

NEA-Alaska Position Paper

HB 323

NEA-Alaska supports House Bill 323.

NEA-Alaska seeks legislation to cause equitable treatment between teachers and school employees. After twenty years of service in an Alaska school district a teacher receives twenty years of credit for purposes of retirement. In contrast a school secretary, a janitor, or school bus driver working the same 20 years receives only 15 years of service credit. For a support employee working a nine month school term it takes 40 years to get 30 years of retirement service credit. It takes the same employee 6.8 years to vest in the retirement system instead of five.

Legislative changes last year have made it harder for school support staff members to vest in order to qualify for health insurance at retirement. A newly employed school support employee working on a nine month contract must work 13.3 years instead of the 10 year requirement.

It's not difficult to understand why retirement incentives have not been made available to school support employees. For a school district to RIF a nine month employee, the district must pay a twelve month retirement credit and the savings that would accrue are lost in the purchasing of the extra year. To provide a three year incentive, a school district would have to purchase four work years.

Meanwhile a support employee has limited opportunities to seek summer employment in many communities in Alaska. In particular jobs that allow the employee to add to their PERS time during the summer months are non-existent.

We seek a degree of equity. We realize the importance of the work provided by support staff who work shoulder to shoulder with teachers and administrators. The pressures associated with the job are similar for support staff as they are for teachers. Increasing student enrollment causes increased worked demands on support staff. They work to do more with less each year. The stress of work is as prevalent with them as with teachers.

In 1997 Alaska schools hired the highest number of new teachers ever. We do not have statistics on support staff turn over. Support staff generally represents a more stable work

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FAIRBANKS REGIONAL OFFICE • 2118 Cushman Street • Fairbanks, Alaska 99701 • (907) 456-4435 • FAX: (907) 456-2159

force within schools and communities. But if teacher turn-over statistics are any indicator of possible support turn-over, we face a developing hiring crisis. Alaska must initiate efforts now to attract and retain teachers and support staff so that we can maintain excellent schools for children.

HB 323 is the right step in establishing a degree of equity with other employees and elected officials of school districts. School board members who participate in PERS receive a year's credit for attendance and work related to their duties as members of the board. It is only fair to provide the same for school support employees who work more hours for the school.

School employees have heard others argue that they are treated no differently than seasonal workers. School support employees are treated different in ways other than retirement and those listed above. For example, seasonal workers are entitled to unemployment benefits during non-work time. School support staff are specifically excluded from unemployment benefits during non-work time.

In addition school support employees have seen benefits and hours reduced. In the public sector, they have become among the lowest paid. They too are required to make ends meet. The retirement system that school employees currently have punishes those who can least afford to save for their future.

We urge the Legislature to pass House Bill 323.

ALASKA STATE LEGISLATURE
House of Representatives

COMMITTEE MEMBERS.

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REPRESENTATIVE JOHN COWDERY, VICE CHAIRMAN
REPRESENTATIVE BILL HUDSON
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Labor and Commerce Committee

MEMORANDUM

TO: Representative John Cowdery
Representative Bill Hudson
Representative Joe Ryan
Representative Jerry Sanders
Representative Tom Brice
Representative Gene Kubina

FROM: Representative Norman Rokeberg, Chairman
House Labor & Commerce Committee

DATE: March 7, 1998

SUBJECT: **Additional Bill Information -** HB323

Attached is information that has come to he House Labor and Commerce Committee since our committee hearing.

Attachments

February 12, 1998

Please enter into record my testimony to the House Labor and Commerce Committee concerning HB 323.

All school district employees, whether certified teachers or classified support personnel, are working toward the same goal: that of providing a quality education for Alaska's children.

The support of the classified work force is vital to the success of the entire process of education. As such, I feel that our service is of equal value to that of the certified staff.

Therefore an equitable retirement credit needs to be established for 9 and 10 month classified employees.

I urge you to support the passage of this bill, which would give 12 month retirement credit for partial year employees.

Thank you for your consideration and support.

Mary Beth Hunn

Mary Beth Hunn
1212 B Halibut Pt Rd
Sitka, Alaska 99835
907-747-5340

2/12/98

To Whom It May Concern:

Please enter into record my testimony to the House Labor and Commerce Committee concerning HB 323, February 11, 1998.

I support HB 323. for the following reasons:

1. We need equity for ALL school district employees. Certified staff already receive the full 12 months credit for 9 months of service. Classified should be treated the same.

2. Unlike other "seasonal" employees, school district employees are not eligible for unemployment benefits during the summer months.

3. Elected officials receive 12 months credit. They clearly do NOT put in as many hours per day that classified employees do, yet they receive the full credit toward their retirement.

Please, let's make this equitable.

Thank you for the opportunity to voice our opinions and concerns.

Sincerely,

Cherie Creek
101 Winchester Way
Sitka, AK 99835
907-747-3290

Feb 12, 1998

Please enter into record my testimony to the House Labor and Commerce Committee concerning HB 323 February 11, 1998

As a classified employee I would encourage the passage of HB 323. Classified school personnel work in several different job classifications. Some employees work 12, 10, and 9 months. We should not discriminate towards the 10 and 9 month classified employees. We need equity for all district school employees and not show that one is more deserving than the other employee.

Also classified school district employees are not eligible to collect unemployment, unlike other "seasonal" employees.

Our local elected officials receive full yearly credit towards retirement, and yet do not put in as many days or hours as school district classified 10 and 9 months employees. Equity is needed statewide for classified employees.

Rebecca A. Charlton
February 12, 1998
301 Islander Dr.
Sitka, Ak 99835
(907) 747-6565

2-12-98

Please enter my testimony into record to the house labor and commerce committee concerning HB323. February 11, 1998.

I feel we need equity for all school district employees.

Faye Nutting
708 Biorka
Sitka, AK. 99835
907-747-8746