The Prudent Investing of Trusts

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Cases and Materials

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This book is dedicated to
Peter J. Daly & Charles V. Antonicelli,
like to a grain of a mustard seed.
ROB

This book is also dedicated to
Isabella Claire Flannery,
for whom my love transcends all prudence.
MTF

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Note on Editing

Some text, footnotes, and citations have been edited to make the cases we have included more manageable and relevant to the teaching tools applicable to a two-, three-, or four-credit course. The footnotes that are included contain the original footnote numbers from the original source. All omissions are indicated with an appropriate ellipses or asterisk symbol to indicate that material has been omitted.

Introduction

The legal parameters of the prudent investment of trust assets parallel economic evolution in the United States. During the first decades of the nineteenth century, trust fiduciaries — often private individuals who were close business associates of wealthy individuals — invested in "safe" assets, items identified as such because they were included on a legal list of permissible investments. Utilization of legal lists mirrored the practice of British fiduciaries, upon which the American system was based. But by the middle of the nineteenth century, a new standard would make a tenuous debut. The new investment standard, on the one hand, advised against speculation, but on the other, required "sound discretion," probable income, and safety of capital. Thus was the prudent standard born. By the twentieth century, partially due to the stimulus provided by the first and second world wars, the American economy became increasingly industrial, far more multifaceted, and often enamored of equities to the exclusion of fixed income investments. Other changes emerged, fiduciary management appeared more corporate than individual, beneficiaries contested based on their status as "life tenant" or "remainderman," charitable and honorary trusts proliferated, and statutory reforms were introduced to supervise the investment powers of fiduciaries, now more often termed trustees.

The reforms, instituted to govern fiduciary conduct when options and beneficiaries became more diverse, were gradual and almost always initiated at the state level, either by statute or judicial opinion. These state reforms are documented in the first three Restatements of Trusts and the resulting Uniform Prudent Investor Act. These are continually amended but, even then, fail to address all of the economic permeations. There were additional uniform acts suggested by reformers, and states sometimes adopted them, or similar approaches, as trusts became increasingly interstate and then international. Eventually, federal rules emerged to supervise trustees. The most notable example of federal involvement in the supervision of trust management made a dramatic contribution with the enactment of the Employee Retirement Income Security Act (ERISA). This complex statute is meant to govern pension and disability benefits provided to all workers who contribute to approved plans. But there are additional federal regulations to include the assorted acts enforced by the Securities and Exchange Commission. Also, as this book goes to publication, Congress grapples with a means by which to regulate the burgeoning national and international hedge fund industry — a certainty of the twenty-first century. This corresponds with the Wall Street Crisis of 2008 — a part of the twelfth official recession since the death of Franklin Delano Roosevelt on April 12, 1945, and a particularly severe recession that is certain to spur many changes in prudent trust investing.

Teaching, learning, and using the lessons to be derived from nearly two hundred years of fiduciary trust management is cumbersome. Professors have benefitted from prescient scholars such as Harold M. Markowitz — the Nobel laureate catalyst behind modern portfolio theory, practitioners such as Mayo Adams Shattuck, and titans in legal scholarship such as John H. Langbein, Jesse Dukeminier, and Edward C. Halbach, Jr. Most often,

students are introduced to the topic of prudent investing as a very small part of a basic course on decedents' estates. Issues such as diversification, risk and return, loyalty, delegation, portfolio theory, or income versus remainder beneficiaries become lost amidst concerns over the proper execution of a Last Will and Testament and the Rule Against Perpetuities. But it is apparent that a separate course of study in fiduciary management—prudent investing of trusts—is warranted, both for students of the law and for those employed in the complex and rapidly evolving world of wealth management.

For most trustees, whether they are in private practice or part of a corporate group of trustees, the parameters of what is now termed "prudent investing" lack historical grounding, cohesion, and insight into "what the fuss was all about." It is the goal of this book to provide a structure by which to teach, understand, and practice the complex assembly of mostly default rules governing the prudent investing of trusts by individual and corporate trustees. For those to whom delegation of trust responsibility is made—wealth managers—this book is also a tool. By no means is this book a complete summary of the vast resources and options available and required for prudent investing. Such a panoply would, of necessity, include federal and state taxation, extensive discussion of all of the options available in alpha and beta investing, plus volumes of cases and statutes detailing the regulations governed by ERISA and the Securities and Exchange Commission. This is beyond the scope of this book, but nonetheless, this book is meant to be a good start in the right direction of understanding the complexities of a dynamic area of law.

Undoubtedly, as the Chinese curse states, we live in exciting times. In the rapidly evolving economic arena that now includes international investing, hedge funds, computerization of investing, derivatives, alpha and beta investment goals, and emerging markets that only hint at the opportunities to come in the future, limited space can only offer direction and perspective. But an effort to provide cases and materials is warranted and even demanded. We can be certain that private settlors, pension funds, and charitable institutions will all wish to invest assets—however these may be classified—for the benefit of beneficiaries, present and future. And furthermore, we can be certain that these beneficiaries will not be shy in demanding, through internal review, industry review, and judicial review, accountability of the trustees managing the assets. By offering, through cases, statutes, and quotations, a discrete and illustrated perspective of the evolution of prudent trust investment, this book seeks to educate and, as in all good learning, suggest future resources and direction.

This book contains ten chapters. Chapter One provides an introduction to the evolution of prudent investing. That is, how the earliest trustees avoided speculation and sought to obtain the highest rate of return with the lowest possible risk. It is in this chapter that we discover the underpinnings of the modern portfolio theory of investing and benefitting the beneficiaries. Students and practitioners should not avoid a discussion of the travails brought on by legal lists or attempts at a more broad-based common law standard of prudence.

Chapter Two offers an opportunity to discuss the Second Restatement of Trusts (1959) and the innovations it introduced to prudent investing of trust assets. The relative maturity of today's economic gains made by individuals and businesses in the United States—or by foreign nationals investing in this country—is reflected in requirements and opportunities that have become standard to modern investing: diversification, delegation, objective factors at the time of the investment, loyalty, reasonableness, and the possible conflict between a settlor's intent, the beneficiary's consent, and the often-adverse consequences of investment decisions. When assessed in the context of the twenty-first century, the Second Restatement of Trusts may seem antiquated. Yet it remains a part of state law and judicial enforcement as precedent and guide.

Chapter Three details the significant changes envisioned by the Third Restatement of Trusts (1992) and the Uniform Prudent Investor Act (1994), which followed as a direct consequence. The same issues that arose in the Second Restatement are revisited, but now are evaluated in the context of portfolio management of diverse assets. That is, investment in each asset is viewed in the context of the entire portfolio, one investment balanced against the other. Under a portfolio theory, no one asset is imprudent as long as it may be balanced against another. Cases and comments by renowned scholars offer insight into the impact of the Third Restatement of Trusts upon prudent investing and the challenges that economic expansion pose for investors.

Chapter Four provides a brief glimpse into federal, international, and computerized investing strategies and reforms. Since the bulk of investment supervision occurs at the state level, the majority of this book is concerned with state interpretations, their adoption of the Restatements, or various other enactments requiring prudence of its wealth managers. Nonetheless, federal supervision of trusts and the statutes that allow for compliance measures are an important feature of wealth management. For example, ERISA provided for delegation of trust responsibilities long before this was permitted at the state level. And some of the most notable breaches of prudence occurred because of the violation of provisions of various federal investment acts, all supervised by the Securities and Exchange Commission. Also, international investing—the global market—permitted by federal statute, is a reality and will become more prevalent as the world markets become increasingly more secure and increasingly accessible through technology. Finally, computerization of investments is one technological advancement that has benefitted many portfolio managers, but especially hedge funds—a bulwark of endowment and pension investments. Even in this century, which is a period of efficient market investing, computerization strategies provide advantages to some and may enhance the risk of others. Because it involves the changing landscape of prudent investing, this element of the picture deserves consideration and is included in this chapter.

Chapter Five illustrates the four types of trusts that most often are managed by professional trustees. The first type is the private trust. Obviously, we most often read judicial decisions involving private beneficiaries concerned over mismanagement of trust funds under terms most often drafted by a decedent settlor. These cases make dramatic headlines; they involve legal issues that include taxation, income and remainder competition, and the rise of a modern phenomenon—the perpetual or dynasty trust. Charitable trusts, the second type, involve specific mission issues, and of course the state attorney general is involved in the supervision of any charitable trust. The third type involves pension trusts, involving workers planning for retirement or seeking to derive wages through disability plans. Because of the public policy parameters and the investment of trillions of dollars of value, corporate and public trust supervision is the focus of many federal regulations, including, specifically for trust management, the ERISA provisions. The Supreme Court of the United States has made recent and significant pronouncements concerning ERISA enforcement, all in the context of fiduciary responsibility. Finally, this chapter discusses honorary and ethical trust investing, which is the fourth type of trust. Honorary trusts—now increasingly popular because of recent statutory establishments—benefit non-human beneficiaries, such as pets. These are serious trusts, illustrated by the testamentary trusts of such multi-millionaire notables as Doris Duke or Leona Helmsley. And as a part of this fourth type of trust, settlors are concerned about "social investing," which demands that a trustee takes into consideration special circumstances elucidated by the settlor based upon ethics, religion, or morality when investing the assets allocated to the trust.

Chapter Six highlights an issue litigated each day in state and federal courts, that is: how to interpret the intent of the settlor of the trust and the impact of that intent upon the

benefit due to the beneficiary. Most often, the trustee is guided by the general notions of prudence as defined in the Second Restatement of Trusts (1959), the Third Restatement of Trusts (1992), or the Uniform Prudent Investor Act (1994). These codes list factors for the trustee to consider, and this chapter discusses each with pertinent commentaries and case illustrations. One of the most vexing issues is the competition between income beneficiaries and remainder beneficiaries—how to preserve principal and make distributions of income prudently. Of course, the use of unitrusts is discussed in this context as a remedy, as well as the Uniform Principal and Income Act of 1997.

Chapter Seven explains the duties of the trustee, the skills demanded of a modern wealth manager, and the exculpation or removal of a non-performing trustee. Increasingly, trustees employ wealth management companies created for the primary purpose of serving as trustees, themselves, or being used by trustees under delegation rules. Banking institutions, serving in these capacities, often are the subject of judicial decisions in this chapter. Increasingly, these institutions are international, with offices based in locales such as the Grand Cayman, Hong Kong, and London. And, in part due to the Wall Street Crisis of 2008, independent, registered investment advisors have begun to attract clients from the wirehouse firms, but the larger investment institutions are illustrated in the litigation described in the cases discussed in this chapter. The notes speak to issues of loyalty, record-keeping, compensation, and cotrustees. All trustees—individual and corporate, large or small—are subject to the same standard of prudence demanded by the states and federal governments, but if a trustee purports to possess special skills, then the trustee is held to a higher standard.

Chapter Eight invites consideration of a modest selection of assets available to trustees and wealth managers during these modern times. When prudence was first considered, real estate was the major form of wealth, but as every student knows, this is certainly not true today. Thus, while cash, bonds, and equities are discussed as elements of a prudent strategy, there is also a listing of equities, plus mutual funds and index funds. These are considered as traditional investments. But non-traditional investments also form wealth, and as an opportunity for discussion, there are descriptions of such items as commercial real estate, derivatives, hedge funds, and global funds. These appear to be speculative investments among the nascent investors, but they have become traditional in some of the largest portfolios. Obviously, these and all investments must be managed with a view to inflation and deflation and to the various forms of taxation—state and federal. It is impossible to discuss investments at this stage of the book without considering portfolio management, especially in the present market environment where, following the Wall Street Crisis of 2008, United States markets lost $4.5 trillion in six weeks, world markets lost $16.3 trillion, and world bailouts by governments in Asia, the United States, Europe, and the Middle East totaled more than $4 trillion.

Chapter Nine offers insight into the bane of any trustee's existence—the necessity of systemic oversight and litigation if the trustee acts imprudently. Individual and corporate trustees have a process for an internal review of prudence, plus the nature of the wealth management business requires an industry review. Often this takes the form of licensing by associations, but most often this results from market analysis—a trustee's performance judged against that of his or her peers. Any beneficiary may evaluate any portfolio against many gauges provided by the Wall Street Journal or the New York Times business section each Sunday morning. And, of course, there are state causes of action based on imprudent investing, with the factors listed under the applicable Restatement, or causes of action for civil fraud, waste, breach of loyalty, or failure to supervise a delegated function. These elements are discussed in pertinent sections of the previous chapters, but they are offered in this chapter under the specific heading of Systemic Oversight.

Chapter Ten offers examples of how the systemic oversight discussed in the previous chapter, or the lessons of prudence learned in the other chapters, have interacted in a few of the more notorious failures in American investment history. Names such as Enron, WorldCom, or Bernie Madoff, offer insight into what is right and wrong about investment oversight and prudent investing. Federal rules forbid fraud and provide for prosecution under RICO standards, and there are a host of compliance details associated with ERISA and regulations enforced by the Securities and Exchange Commission. But in spite of massive regulation, private and corporate investors lost billions of dollars in fraudulent schemes. What can be done in the future?

In conclusion, while this book merely touches the surface of the vast and intricate issues that have arisen during the last two hundred and fifty years involving the sophisticated field of wealth management, it never would have come into being without the inspiration of professors and wealth managers such as John H. Langbein, Joel Dobris, Edward C. Halbach, Jr., Robert H. Sitkoff, Martin D. Begleiter, Robert Cooter, Bradley J. Freeman, Richard Posner, Maureen Bateman, Alyssa A. DiRusso, Kathleen M. Sablone, Maria O'Brien Hylton and, of course, Jesse Dukeminier. Throughout this book their published opinions have been presented in a manner that we hope fairly and accurately captures not only their analysis, but also their commitment to this field of law. Any errors in this book are those of the authors, but if any benefit to the profession occurs, it will be due to the inspiration and dedication of these aforementioned professors and authors. We are all beneficiaries of their prudent investment of time and analysis.

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