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Chasing Down the Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts

W. Brantley Phillips, Jr.

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I. Introduction

Be sober, be vigilant; because your adversary the devil, as a roaring lion, walketh about seeking whom he may devour.

— 1 *Peter* 5:8[1]

For more than one hundred years, protecting trust principal while generating the highest income possible marked the fundamental purpose of fiduciary investment standards.[2] In keeping with this purpose, trust doctrine evolved throughout the nineteenth and twentieth centuries to forbid speculative fiduciary investments.[3] Because traditional trust doctrine caused ultimate liability for losses to the trust to sit like a devil on the shoulder of every trustee, the threat of losses encouraged investments in low-risk ventures only.[4]

Today, however, it is the corrosive effects of inflation that create the greatest threat for trustees.[5] Increasingly, low-risk, interest-bearing securities fail to keep pace with inflation, and thus, inflation becomes the roaring lion, walking about, seeking to devour the trust.[6] Unfortunately, the traditional restrictions on fiduciary investment largely remain in place.[7] Such restrictions now hamper a trustee's ability to be vigilant against this new adversary — the devil of inflation.[8]

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1. King James version.

2. *See* Paul G. Haskell, *The Prudent Person Rule for Trustee Investment and Modern Portfolio Theory*, 69 N.C. L. REV 87, 93 (1990) (explaining that "prudent person rule" primarily focused on preservation of trust capital and production of income).

3. *See infra* notes 25-43 and accompanying text (discussing evolution of trustee investment standards).

4. *See* Loren C. Ipsen, *Trends in the Liability of Corporate Fiduciaries*, 24 IDAHO L. REV 443, 443 (1988) (describing traditional focus of trust law as avoidance of risk rather than maximization of return).

5. *See* RESTATEMENT (THIRD) OF TRUSTS, introduction (1992) (explaining that modern experience with inflation differs greatly from that in formative periods of trust investment law and now dictates greater sensitivity in trust management to competition between principal and income interests).

6. *See infra* note 52 (discussing limitations of interest-bearing investments).

7 *But see infra* notes 244-93 and accompanying text (comparing statutes that have adopted less restrictive fiduciary investment standards).

8. *See* Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, 27 REAL PROP PROB. & TR. J. 407, 412 (1992) (concluding that arbitrary restrictions on investment inhibit exercise of sound judgment by skilled trustees); *see also* Stephen P Johnson, Note, *Trustee Investment: The Prudent Person Rule or Modern Portfolio Theory, You Make the Choice*, 44 SYRACUSE L. REV 1175, 1177 (1993) (claiming that stricter views of prudent investment deter trustees from doing best possible job for beneficiaries); *cf.* David R. Levin et al., *Balancing Prudence and Risk: Under ERISA, Pension Plan Investors Must Focus on*

The *Restatement (Third) of Trusts* emerges in response to this challenge. Drawing heavily from current investment techniques, it seeks to reformulate trust doctrine so that trustees may be flexible enough to avoid the effects of inflation.[9] This effort takes shape in the form of the *Restatement (Third)*'s "prudent investor rule."[10] Given the importance of the investment function to fiduciary administration, an understanding of this new standard for prudent investing is essential.

In Part II, this Note provides a brief overview of the historical evolution of fiduciary investment standards.[11] Part III provides an introduction for laypersons to the central features of modern portfolio theory — the conceptual foundation of the prudent investor rule.[12] Part IV demonstrates the recent progression of trust doctrine by reviewing the fundamental changes made by the *Restatement (Third)*.[13] Part V.A considers the practical application of the prudent investor rule by using it to revisit three prominent fiduciary investment cases.[14] Part V.B assesses the effect of the new standard by reviewing the statutory response to the *Restatement (Third)* among the states.[15] Part VI concludes by discussing recent demographic trends that make the use of trusts more important than ever. Part VI then recommends that state legislatures quickly move to adopt legislation reflecting the standards of the prudent investor rule so that trustees have the flexibility needed to respond effectively to those trends.[16]

II. The Evolution of Fiduciary Investment Standards

A. Foundations of the Prudent Man Standard

England greatly influenced the development of "prudent" trustee investment practices in nineteenth-century America.[17] The English fiduciary

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Participants' Goals, 82 A.B.A. J. 76, 76 (1996) (noting that one goal of any investment program is to beat inflation); Mark Suzman, *Survey of Charity Fund Investment*, FIN. TIMES, Dec. 11, 1995, at 32 (explaining that, like other fiduciaries, trustees for charitable funds must protect assets against inflation and generate income for spending).

9. *See* RESTATEMENT (THIRD) OF TRUSTS, introduction (1992) (describing incorporation of modern portfolio theory into *Restatement (Third)*).

10. *See id.* § 227 (creating "General Standard of Prudent Investment," otherwise referred to as prudent investor rule).

11. *See infra* Part II.

12. *See infra* Part III.

13. *See infra* Part IV

14. *See infra* Part V.A.

15. *See infra* Part V.B.

16. *See infra* Part VI.

17 *See* Bruce Stone, *The Prudent Investor Rule: Conflux of the Prudent Man Rule with*

investment standard was the product of financial disaster, and it worked primarily to protect beneficiaries from losses caused by speculative trust investments.[18] By the early nineteenth century, the English standard centered on the notion that only government securities, such as British consols,[19] offered enough safety to merit investment by trustees.[20] As a developing nation, America could not successfully import this standard because it had no government-backed securities of equivalent rating to British securities.[21] Consequently, America initially experienced a shortage of investments like those considered appropriate for English fiduciaries.[22] This shortage encouraged the majority of American fiduciaries to direct their investments toward promoting nascent industrial enterprises instead.[23] As a result, it became necessary for American courts to consider whether

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Modern Portfolio Theory, EST. PLAN. & ADMIN. 1993, at 9, 11-12 (PLI Tax L. & Est. Plan. Course Handbook Series No. 229, 1993); *see also* Johnson, *supra* note 8, at 1175 (describing influence of England's historically conservative fiduciary rule in America).

18. *See* Bubble Act, 1719, 6 Geo., ch. 18 (Eng.) (enacting restrictions on fiduciary investments following collapse of South Sea Company); *see also* J. Alan Nelson, Comment, *The Prudent Person Rule: A Shield for the Professional Trustee*, 45 BAYLOR L. REV 933, 938 (1993) (recalling that English rule limiting trustees solely to investments backed by British government came in response to famous collapse of South Sea Company, "which ruined thousands of investors").

19. *Webster's* defines a consol as "a perpetual interest-bearing obligation first issued by the British government in 1751." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY UNABRIDGED 484 (1981). *Black's* defines a consol as a "bond that never matures but is redeemable on call." BLACK'S LAW DICTIONARY 308 (6th ed. 1990).

20. *See* Haskell, *supra* note 2, at 88 (contrasting American standard with early nineteenth-century British standard limiting trustees to investment in government securities); *see also* Nelson, *supra* note 18, at 938 (explaining that passage of Bubble Act limited English trustees to investments in securities backed by British government); Stone, *supra* note 17, at 11-12 (confirming that British rule approved only government-backed securities as investments for trust portfolios).

21. *See* Johnson, *supra* note 8, at 1175 (explaining that, in early nineteenth-century America, there were no government securities of equal rating to British consols); *see also* Nelson, *supra* note 18, at 938 (noting that American case law on fiduciary investment soon diverged from English case law because of high risks associated with investing in securities backed by American government).

22. *See* Ipsen, *supra* note 4, at 444 (noting how dearth of investment-grade government securities continued into post-Revolutionary War period); *see also* Mayo Adams Shattuck, *The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century*, 12 OHIO ST. L.J. 491, 493 (1951) (describing how economic conditions in America led to shortage of "safe" fiduciary investments commonly available in England).

23. *See* Johnson, *supra* note 8, at 1175 (explaining that majority of early nineteenth-century American fiduciaries invested funds in this nation's new industrial enterprises).

American trustees could participate in a more expansive range of trust investments.[24]

In *Harvard College v Amory*,[25] the Supreme Judicial Court of Massachusetts rejected the conservative British approach.[26] In so doing, the court formulated the "prudent man rule" for trust investments.[27] The *Harvard College* court concluded:

> All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.[28]

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24. *See* Stone, *supra* note 17, at 11-12 (explaining that lack of American equivalent to British government securities obligated American courts to consider whether trustees should enjoy more expansive range of trust investment options); *cf.* Johnson, *supra* note 8, at 1175 (concluding that shortage of "safe" fiduciary investments in America necessitated judicial definition of fiduciary investment standard).

25. 26 Mass. 446 (1830).

26. Harvard College v. Amory, 26 Mass. 446, 465 (1830) (finding that trustees acted prudently when investing in stocks of manufacturing and insurance companies). In *Harvard College*, the Supreme Judicial Court of Massachusetts considered whether trustees acted imprudently by investing portions of a trust fund, established for the maintenance of the decedent's wife during her life, in manufacturing and insurance company stocks. *Id.* at 446-53. According to the *Harvard College* court, these investments were not imprudent investments because all investments place capital at risk. *Id.* at 461. Consequently, "[a]ll that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion." *Id.* In *Harvard College*, the testator authorized the trustees to invest in "other stock." *Id.* (emphasis omitted). Given that shares in manufacturing and insurance corporations fell within that description, the contested investments were acceptable. *Id.* at 462. Despite the fact that those stocks later fell in value, the trustees were not liable to the legatees for any depreciation because neither beneficiary objected to the investments when originally made. *Id.* at 464-65. Consequently, the trustees did not act with gross neglect or willful mismanagement. *Id.* at 465; *see also* John A. Taylor, *Massachusetts' Influence in Shaping the Prudent Investor Rule for Trusts*, 78 MASS. L. REV 51, 53 (1993) (explaining that *Harvard College* court rejected conservative British approach in order to give American fiduciaries greater latitude in investment decisions).

27 *See* Leslie Joyner Bobo, Comment, *Nontraditional Investments of Fiduciaries: Re-examining the Prudent Investor Rule*, 33 EMORY L.J. 1067, 1072 (1984) (analyzing *Harvard College* decision). Bobo noted: "The [*Harvard College*] court, however, recognized that property management in America had always been necessarily speculative. In pronouncing there were no 'safe' investments, the court led the way toward fiduciary investments which could be imaginative yet fruitful." *Id.*, *see also* Taylor, *supra* note 26, at 53 (commenting that *Harvard College* decision enunciated prudent man rule for trustee investment and required that trustees act faithfully and with sound discretion).

28. *Harvard College*, 26 Mass. at 461.

The court premised this more flexible standard on the understanding that, regardless of a trustee's actions, the capital of a trust is always at risk.[29] Provided that a trustee used good judgment and care, he could employ any category of investment, including more speculative holdings like common stocks.[30] As a result, by 1830 American fiduciaries enjoyed greater latitude in investment decisions than did their British counterparts.[31]

This departure from trust doctrine's historical conservatism was not long lived. By the middle of the nineteenth century, the courts refined the prudent man rule, and in subsequent decisions, the broad principles established in *Harvard College* narrowed into unreasonably specific rules.[32] For example, in the landmark case of *King v Talbot*,[33] the New York Court of Appeals concluded that it was imprudent for trustees to invest in corporate stocks.[34] Concerned with the economic instability caused by the post-Civil

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29. *See* Stone, *supra* note 17, at 12 (observing that *Harvard College* decision recognized omnipresent threat of risk with respect to trust capital).

30. *See id.* (noting *Harvard College* court's recognition that more flexible standard of trustee action, embracing all forms of investment, could exist within bounds of good judgment and care).

31. *Cf.* Johnson, *supra* note 8, at 1176 (commenting that purpose behind adoption of prudent man rule was to give fiduciaries greater latitude in investment decisions).

32. *See* Stone, *supra* note 17, at 12-13 (illustrating how increase in litigation against trustees allowed American appellate courts to shape prudent man rule into more narrow and unreasonably specific rules than those that developed immediately after *Harvard College* decision); *cf.* Taylor, *supra* note 26, at 55 (noting that Massachusetts became minority view of prudent man rule as other states made their standards more rigid); James R. Wade, *The "New" Prudent Investor Rule*, 20 COLO. LAW. 713, 713 (1991) (noting that *Restatement (Third)* reflects idea that original prudent man rule became narrow and restrictive under prior trust doctrine and case law).

33. 40 N.Y. 76 (1869).

34. King v Talbot, 40 N.Y. 76, 88-91 (1869) (holding that speculative investing by trustees violates their primary duty). In *King v. Talbot*, the New York Court of Appeals considered whether the trustees overseeing a trust created for the benefit of the decedent's minor children were liable for losses caused by investments in certain stocks. *Id.* at 87 Following the testator's death, the trustees invested $45,000 in federal treasury notes and state bonds. *Id.* at 78. Later, the trustees took the profits from these investments and purchased canal company, railroad, and bank stocks. *Id.* The beneficiaries later rejected those stock investments. *Id.* at 80. In rendering its decision, the New York Court of Appeals explained that the duty of a trustee is to employ the same diligence and prudence as he would employ in his own affairs. *Id.* at 85-86. This duty necessarily excludes all speculative investments. *Id.* at 86. Investments in stocks remove the trust principal from the control and discretion of the trustees and thereby violate the trustees' primary responsibility. *Id.* at 88-89. Consequently, the court concluded that the trustees were not at liberty to invest in the canal company, railroad, and bank stocks. *Id.* at 89. From this conclusion, the court held that the beneficiaries had the right to reject the stock investments and to demand that the trustees pay over the whole amount of their legacies and the interest

War depression,[35] the *King* decision limited trustees to investments in government bonds and mortgage-backed corporate debts.[36] This view quickly spread throughout other states.[37]

By the 1880s, many state legislatures responded to *King* by adopting "legal list" regimes.[38] These lists codified permissible trust investments and generally limited trustees to choices among certain fixed income debt instruments or bonds.[39] Other investments, such as common stocks, became improper unless the trust instrument gave the fiduciary discretion to make such investments.[40] Over time, changes in business and economic conditions made the restrictive nature of these lists increasingly impractical.[41]

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thereon. *Id.* at 92. Accordingly, the court ordered the trustees to pay the beneficiaries an amount equal to a six percent annual return on the investments from the death of the testator. *Id.* at 93-96; *see also* Taylor, *supra* note 26, at 55 (explaining that *King* classified investments in shares of stock as imprudent and limited permissible trust investments to government bonds and mortgages).

35. *See* Austin Fleming, *Prudent Investments: The Varying Standards of Prudence*, 12 REAL PROP. PROB. & TR. J. 243, 244 (1977) (explaining that depression following Civil War decreased economic stability experienced in America during first half of nineteenth century and drastically devalued stocks).

36. *See* Taylor, *supra* note 26, at 55 (explaining that *King* decision found fiduciary investments in stocks to be imprudent); *cf.* Johnson, *supra* note 8, at 1176 (noting that 1889 New York statute prompted by *King* decision limited trust investments, unless otherwise directed by settlor, to government bonds and first mortgage debt securities).

37 *See* Haskell, *supra* note 2, at 90 (advancing notion that New York's restrictive position on trust investments soon became dominant among states). *But see* Taylor, *supra* note 26, at 55 (explaining that Massachusetts declined to join movement among states to adopt "legal lists").

38. *See* Stone, *supra* note 17, at 14-15 (concluding that passage of 1889 New York statute governing permissible trust investments began legislative trend toward legal lists). *Black's* defines a legal list as a "list of investments selected by various states in which certain institutions and fiduciaries, such as insurance companies and banks, may invest." BLACK'S LAW DICTIONARY 895 (6th ed. 1990). "Legal lists are often restricted to high quality securities meeting certain specifications." *Id.*

39. *See* Haskell, *supra* note 2, at 90 (noting that legal lists limited trustees to enumerated categories of debt instruments); *see also* Johnson, *supra* note 8, at 1176 (adding that many states had legal lists that limited trustees to investments in debt instruments and bonds).

40. *See* Haskell, *supra* note 2, at 90 (commenting that by 1900, unless trust instruments provided otherwise, only handful of states permitted trustees to invest in common stocks); *cf.* Stone, *supra* note 17, at 14 (emphasizing that testators in legal list jurisdictions that wanted their trustees to invest in equities and other types of property needed to make appropriate provisions in their wills or trust instruments).

41. *See* Fleming, *supra* note 35, at 244 (noting that legal lists failed to adapt to changing economic and business conditions); *see also* Taylor, *supra* note 26, at 55 (illustrating failure of legal list regimes by explaining that investment portfolios regulated under prudent man standards outperformed those under legal lists by two-to-one ratio).

Consequently, by the 1930s most states had replaced the legal list with a somewhat broader, more flexible standard commonly referred to as the "prudent person rule."[42] Although this transition allowed for a wider variety of investment options, including stocks and other property, it still did not fully embrace the adaptable approach put forward in *Harvard College*.[43]

B. Shortcomings of the Prudent Person Standard

Preservation of trust corpus and production of income embody the core goals of the prudent person rule.[44] However, given that the prudent person rule, as enunciated in the *Restatement (Second) of Trusts*, forbids any form of speculation, trustees have difficulty meeting these goals when confronted by rising inflation.[45] Consequently, the strict view of prudence taken by the prudent person rule inhibits truly effective trust management.[46]

The prudent person rule falls short of the vision in *Harvard College* in several respects. First, the analysis of each investment takes place in isolation from the overall portfolio.[47] Determinations of what is prudent occur without regard to any net gain to the portfolio as a whole or to the diversification of its assets.[48] This compartmentalization obstructs the development of an integrated investment plan designed to achieve the high-

42. *See* Stone, *supra* note 17, at 14-15 (observing that, as United States began to pull out of Depression, so too began movement away from restrictive legal lists in favor of broader, more flexible standards).

43. *See* Fleming, *supra* note 35, at 245 (commenting that modern interpretation of prudent person rule, particularly in *Restatement (Second) of Trusts*, points away from flexible approach promoted by *Harvard College* and toward more rigid standards of prudence found in English common law); *cf.* Haskell, *supra* note 2, at 90 (detailing limitations of current statutory restrictions on investment, including those that now specifically provide for investment in common stock and other property).

44. *See* Haskell, *supra* note 2, at 93 (explaining that prudent person rule principally aimed to preserve trust capital and produce trust income).

45. *See id.* at 92 (referring to prudent person rule as misnomer because it does not allow for speculative capital investments in keeping with modern notions of prudent investment practices).

46. *See* Halbach, *supra* note 8, at 412 (claiming that arbitrary restrictions inhibit exercise of sound judgment by skilled trustees); *see also* Johnson, *supra* note 8, at 1177 (pointing out that stricter view of prudence deters trustees from doing best possible job for beneficiaries).

47 *See* Haskell, *supra* note 2, at 93 (explaining that current investment rule looks at investments in isolation when measuring prudence); *see also* Johnson, *supra* note 8, at 1178 (noting that determinations of trustee's prudence come by analyzing each investment in isolation).

48. *See* Fleming, *supra* note 35, at 248-49 (explaining that trustees face strict liability for imprudent investments despite sufficient diversification or net gain by entire portfolio).

est possible yield.[49] Rather, courts tend to apply the prudent person rule in a way that encourages an over-reliance on "safe" investments, such as government bonds. These safer investments often have only modest returns that barely exceed the rate of inflation.[50]

Second, the *Restatement (Second)* imposes no duty on the trustee to protect the trust principal from inflation.[51] Considering that, historically, inflation has outpaced the returns available from interest-bearing assets,[52]

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49. *See* Samuel David Cheris, *Making Responsible Investment Decisions in Light of the Prudent Person Rule*, 14 EST. PLAN. 338, 339-40 (1987) (criticizing effects of compartmentalization as impediment to trustee's ability to achieve optimal economic results because each investment is not part of overall investment plan designed for profit and growth).

50. *See id.* at 340 (concluding that resulting tendency to invest in only those investments considered prudent or safe causes underdiversification in portfolio and thereby increases overall risk because resulting low rates of return cannot keep pace with inflation).

51. *See* BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 14 (1986) (commenting that, while some courts respond positively to inflation-conscious investment strategies, no court imposes duty to guard against depreciation in purchasing power); *see also* Haskell, *supra* note 2, at 93 (noting that trustee has no duty to guard against inflation); Johnson, *supra* note 8, at 1181 (explaining that prudent person rule places trustee "under no duty to protect trust principal from inflation").

52. *See* Robert T. Willis, Jr., *Prudent Investor Rule Gives Trustees New Guidelines*, 19 EST. PLAN. 338, 339 (1992) (explaining that historical evidence supports conclusion that inflation typically exceeds returns from interest-bearing investments). Willis observed:

> The following historical data demonstrate the effect of inflation on the return provided by interest bearing instruments over long periods of time.

Annualized Total Returns

	1926-1991	1950-1991
U.S. Treasury Bills	3.7%	5.3%
U.S. Government Bonds	5.1%	6.1%
Inflation (CPI)	3.1%	4.3%

Inflation Erosion

Inflation/Bills	84%	80%
Inflation/Bonds	61%	70%

> The above table shows that average annual rates of return from U.S. Treasury bills and U.S. Government bonds (average five-year maturities) for two time periods, as well as the average annual inflation rates. The undeniable historical facts are that the investment returns of interest bearing instruments have been largely offset by inflation. The last two lines of the above table show that inflation erased an average of 75% of the total returns provided by bonds and T-bills during the two periods. The data for CDs would be very similar to the data for Treasury bills. The result is actually worse when taxes are considered, as shown below:

this oversight jeopardizes virtually every portfolio.[53] Naturally, if the rate of inflation consistently exceeds a portfolio's rate of return, then over time it will deplete the trust principal.[54]

Third, the prudent person rule requires active asset management by the trustee.[55] This duty exists despite the fact that active management techniques rarely outperform comparable passive investment strategies, such as portfolios composed of stock index funds.[56] In this regard, the prudent person rule wholly contradicts current economic theory on asset management.[57]

Average historical return for bonds (1950-1991)	6.10%
Minus inflation (1950-1991)	(4.30)
Minus income tax at 25%	(1.53)
Net return to trust	0.27%

> The income tax is calculated on the pre-inflation (nominal) return (which for bonds is 90% interest income). The above example indicates that both the remainderman's principal and the income beneficiary's income have eroded in purchasing power. If principal does not grow to offset inflation, income likewise cannot grow. The above example results in essentially no (only 0.27%) principal growth.

Id. at 339-40.

53. *See* Cheris, *supra* note 49, at 339 ("Loss of purchasing power through inflation is a serious threat to every investment portfolio.").

54. *See* Johnson, *supra* note 8, at 1181 ("When inflation exceeds the rate of return on the trust investments erosion of the principal is bound to occur.").

55. *See* Cheris, *supra* note 49, at 340 (citing requirement of active portfolio management as major criticism of prudent person rule).

56. *See* Halbach, *supra* note 8, at 426 (asserting that current assessments of market efficiency clearly support adoption of passive investment strategies including use of index funds); *see also* Johnson, *supra* note 8, at 1182 (explaining that costs associated with active portfolio management practices generally exceed benefits such that active portfolios rarely outperform passive portfolios); John H. Langbein & Richard A. Posner, *The Revolution in Trust Investment Law*, 62 A.B.A. J. 887, 887 (1976) (confirming nearly 20 years ago that actively managed institutional funds consistently underperform broad market averages, like Standard & Poor's 500 Stock Index); Ted C. Fishman, *The Bull Market in Fear*, HARPER'S, Oct. 1995, at 55, 61 (illustrating that "only one in three fund managers beats broad market average for given year, and that very few do so year in and year out"). Fishman explained:

> Even more telling is the fact that half the top ten funds in a given year number among the *worst* funds within ten years. In fact, statisticians would tell us that it would take 105 years of data to know if a manager who consistently beat the market by 2 percent were really smarter than anyone else.

Id.

57 *See* Haskell, *supra* note 2, at 94 (asserting that prudent person rule is wholly inconsistent with contemporary economic learning about portfolio management); *cf.* R.A. BREALEY, AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS 55 (1983) (noting that, under concept of efficient markets, no portfolio manager can consistently outperform market).

Finally, the prudent person rule disfavors innovative investments.[58] For example, unless authorized by the governing instrument, a trustee may not invest in "speculative" assets, such as futures contracts, foreign stocks, or precious metals.[59] This constraint runs counter to the adaptability promised in the development of the prudent person rule.[60]

C. An Introduction to the Prudent Investor Rule

The rigidity of the prudent person rule has not gone unrecognized.[61] The desire among academics and professionals alike has been to bring both modern economic theory and common sense to contemporary trust management.[62] As a result, the *Restatement (Third)*, adopted by the American Law Institute (ALI) in 1992, relies on modern portfolio theory to anchor the new prudent investor rule.[63]

The ALI revised the *Restatement (Second)* standard for three reasons. First, the ALI wanted to undo restrictive judicial precedent.[64] Following the decision in *Harvard College*, many cases gradually limited the flexibility once thought available to trustees.[65] These subsequent cases essentially

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58. *See* Robert A. Levy, *The Prudent Investor Rule: Theories and Evidence*, 1 GEO. MASON L. REV 1, 3 (1994) (noting that prudent person rule prohibits purchasing securities on margin, purchasing real property for resale, making venture capital commitments, and questions safety of investments in precious metals, collectibles, deep discount bonds, options, futures, repurchase agreements, and second mortgages).

59. *See* Haskell, *supra* note 2, at 93 (detailing how newer forms of investment, such as options and futures, appear too speculative to receive acceptance under prudent person rule).

60. *See* Johnson, *supra* note 8, at 1182 (commenting that rigid exclusion of new types of investment runs counter to notion of adaptability thought to be original virtue of prudent person rule).

61. *See* Stone, *supra* note 17, at 18 (revealing that, with high inflation during 1970s, scholars and legislative bodies gradually began to realize inadequacy of prudent person standard).

62. *Cf. id.* (noting that passage of Employee Retirement Income Security Act of 1974 (ERISA) reflects recognition of need for increased reliance on sound economic theory and common sense in trust management).

63. *See* Willis, *supra* note 52, at 338 (distinguishing *Restatement (Third)* from its predecessor by highlighting *Restatement (Third)*'s focus on educating courts and practitioners about modern portfolio theory and investment practices).

64. *See id.* at 338-39 (identifying desire to reverse trend in judicial decisions favoring inflexible guidelines for trustees as major reason for move to prudent investor rule); *see also supra* notes 32-43 and accompanying text (discussing development of case law following *Harvard College* decision).

65. *See* Halbach, *supra* note 8, at 410 (illustrating how prudent person rule tended to lose much of its adaptability as generalizations regarding investment guidelines for trustees developed).

fossilized trust asset management practices in outdated principles.[66] In light of an increasingly complex economy, this rigid approach to fiduciary investment became imprudent in its own right.[67]

Second, the rules needed modernization to reflect current asset management techniques.[68] Passage of the Employee Retirement Income Security Act of 1974 (ERISA) prompted this modernization effort.[69] In addition to federalizing the common law of trusts,[70] ERISA incorporates several key features of modern portfolio theory Most importantly, ERISA considers no investment imprudent per se and links investment selection to an overall investment strategy, rather than to individual asset performance.[71] The

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66. *See* Willis, *supra* note 52, at 339 (characterizing intent of *Restatement (Third)* as desire to release trustees from former doctrines that crystallized rules concerning permissible investments).

67 *See* Stone, *supra* note 17, at 14-15 (citing how strictures on possible portfolio investments prevent trustees from acting conscientiously or making optimal management decisions).

68. *See* Halbach, *supra* note 8, at 412 (promoting idea that recent trends in state and federal legislation encouraged push for modernization and clarification of prudent man rule); *see also* Willis, *supra* note 52; at 339 (citing passage of ERISA and recent updating of state statutes to include principles of modern portfolio theory as major reason to advocate for revision of prudent person rule).

69. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001-1461 (1994 & Supp. I 1995)); *see also* Robert J. Aalberts & Percy S. Poon, *The New Prudent Investor Rule and the Modern Portfolio Theory: A New Direction for Fiduciaries*, 34 AM. BUS. L.J. 39, 45-46 (1996) (calling ERISA's enactment "[i]nfluential development" because it advanced "prudent expert rule"); Johnson, *supra* note 8, at 1184 (identifying ERISA as first legislation to apply modern portfolio theory to fiduciary investments); *cf.* Cheris, *supra* note 49, at 340 (explaining that Congress adopted ERISA after hearing extensive testimony demonstrating that prudent person rule was far too rigid for regulating managers of employee benefit funds). Cheris observed: "Currently, the ERISA standards are the most liberal enunciation of the prudent person rule." *Id.*

70. *See* Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101, 110-11 (1989) (explaining that ERISA codifies common law of trusts). The Supreme Court said that "ERISA's legislative history confirms that the Act's fiduciary responsibility provisions 'codif[y] and mak[e] applicable to [ERISA] fiduciaries certain principles developed in the evolution of the common law of trusts.'" *Id.* (quoting H.R. REP No. 533, 93d Cong., 2d Sess. 11 (1973), *reprinted in* 1974 U.S.C.C.A.N. 4639, 4649); *cf.* Willis, *supra* note 52, at 339 (concluding that legislative history of ERISA inextricably links law governing pensions to common law of trusts).

71. *See* Aalberts & Poon, *supra* note 69, at 46 (noting that ERISA impliedly sanctioned use of modern portfolio theory and "encouraged [consideration of] total return and total portfolio performance in governing pension plans"); *see also* Johnson, *supra* note 8, at 1185 (implying that government regulations regarding ERISA do not use relative riskiness of specific investments to characterize whether investment is per se prudent or imprudent;

ERISA approach allows fiduciaries to structure pension portfolios in a way that takes advantage of market fluctuation, rather than in a way that merely avoids it.[72]

Last, and perhaps most important, modern portfolio theory[73] now receives wide acceptance throughout both the academic and investment communities.[74] Whereas the prudent person rule required trustees to bypass risky investments unless otherwise authorized by the trust, modern portfolio theory, as embodied in the prudent investor rule, seeks to benefit from such investments.[75] As a result, trustees may now utilize a wider array of mod-

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rather, relationship of specific investment to overall investment strategy determines prudence). ERISA regulations explain:

> (b) Investment duties (1) With regard to an investment or investment course of action taken by a fiduciary the requirements of section 404(a)(1)(B) are satisfied if the fiduciary·
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> (i) Has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio and
>
> (ii) Has acted accordingly
>
> (2) For purposes of paragraph (b)(1) of this section, "appropriate consideration" shall include, but is not necessarily limited to
>
> (i) A determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain associated with the investment or investment course of action

29 C.F.R. § 2550.404a-1(b) (1996); Willis, *supra* note 52, at 339 (elaborating on fact that ERISA endorses concept of total return and total portfolio performance rather than mere income yield and performance of single asset).

72. *See* Johnson, *supra* note 8, at 1186 (claiming that prudent investor approach allows trustees to construct portfolios using securities that react differently to market events so that upward turn in one part of portfolio offsets downward turn in another part).

73. *See* 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, 424 (1993) (noting progress in using academic investment research as legal basis of fiduciary standards). *See generally* Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 81 (1952) (introducing concept of portfolio theory for which Markowitz received 1990 Nobel Prize in Economic Sciences).

74. *See* RESTATEMENT (THIRD) OF TRUSTS, introduction (1992) (explaining that modern portfolio theory encouraged revision of fiduciary investment standards); *see also* Willis, *supra* note 52, at 338 (commenting that drive toward prudent investor rule comes from empirical research in investment management generally referred to as modern portfolio theory).

75. *Cf.* Johnson, *supra* note 8, at 1183 (clarifying that prudent investor rule empowers trustees to embrace investment strategies that contain more risk than allowed under prudent person rule).

ern investments and, consequently, can better respond to the ever-changing market conditions that they face.[76] To aid the reader in understanding the full impact of modern portfolio theory on contemporary trust management, a discussion of the theory's basic features follows in Part III.

III. An Overview of Modern Portfolio Theory

Acceptance of modern portfolio theory came slowly[77] Given that, in part, the theory combines speculative and "safe" investments in an effort to generate consistent portfolio gains, it can appear counterintuitive when compared with previous standards of prudence.[78] Nevertheless, decades of empirical research now support modern portfolio theory and establish it firmly in the mainstream.[79]

Current economic thinking broadly defines risk as the potential for an investment to underperform its expected rate of return.[80] The focus of this

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76. *See id.* at 1184 (explaining how modern portfolio theory provides trustees with greater leeway to determine what investments trusts should hold, thereby allowing for strategies that preserve capital funds while increasing returns and trust growth during economic downturns).

77 *See* Willis, *supra* note 52, at 338 (showing slow acceptance of modern portfolio theory). Willis observed:

> Modern portfolio theory is a body of knowledge concerning investment analysis and portfolio management that is creditable and thoroughly documented. Empirical research has been conducted by leading universities and the results debated in scholarly journals. Some of the cornerstones of portfolio management date back to the 1930s. The 1990 Nobel Prize in Economic Sciences was awarded for research in investment analysis and portfolio management. The foundation for [the] award was research done in the 1950s and 1960s. It has taken 50 years for legal scholars to acknowledge that this body of knowledge is substantive, but that slow course of recognition was probably wise.

Id., *see also* Fishman, *supra* note 56, at 61 (noting that although developed in 1950s, Harry Markowitz's "portfolio theory" did not receive careful consideration until 1976).

78. *See* Haskell, *supra* note 2, at 103 (finding justification for some measure of skepticism with respect to modern portfolio theory because of its counterintuitive logic).

79 *See* Dobris, *supra* note 73, at 424 (concluding that, while trust law incorporates academic research at glacial pace, research on investments from 1950s, 1960s, and 1970s is now gaining acceptance in legal circles); *cf.* Richard M. Todd, *The Prudent Investor: New Trust Management Rules*, 22 COLO. LAW. 281, 281 (1993) (commenting that *Restatement (Third)* incorporates investment strategies of modern portfolio theory derived from work of 1990 Nobel laureates Harry Markowitz and William Sharpe).

80. *See* Halbach, *supra* note 8, at 423 (explaining that projected returns from investment involve assessments not only of average anticipated investment returns but also of risk that follows from "variance," or departure from that average); *see also* Haskell, *supra* note 2, at 100 (noting that risk reflects possibility that investments will perform below expected returns).

thinking is the relationship between the risk of an individual investment and the entire investment portfolio.[81] Modern portfolio theory recognizes that managing an asset's potential for underperformance can reward prudent investors.[82] By dividing risk into its various components, the theory seeks to aid an investor in understanding how to balance the opportunity for gain against the degree of risk undertaken.[83]

Essentially, two types of risk threaten most investments.[84] The first type of risk rises and falls in direct response to general economic conditions that affect the entire market.[85] Modern portfolio theory describes this type of risk as "systematic" or "market" risk.[86] Because market risk mirrors the fluctuations in the overall market, such risk is unavoidable. Nevertheless, because a rising market compensates an investor in the form of higher returns, incurring greater market risk is not inherently detrimental to an investment strategy [87]

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81. *See* Haskell, *supra* note 2, at 100 (identifying importance of interrelationship between individual investments and overall portfolio to modern economic theory); *cf.* Todd, *supra* note 79, at 281 (noting that diversification requires spreading trust assets among several classes of assets so that portfolio "includes assets that perform differently in various economic climates").

82. *Cf.* Wade, *supra* note 32, at 714 (suggesting that there are market risks for which market pricing offers rewards that prudent investors should take into account).

83. *See* Levy, *supra* note 58, at 7 (asserting that modern portfolio theory offers an instructive framework for separating risk into market and nonmarket components); *cf.* Wade, *supra* note 32, at 714 (commenting that trustees must consider degree of compensated risk when analyzing investment objectives and designing portfolio to ensure balance between opportunities for gain and degree of risk).

84. *See* Haskell, *supra* note 2, at 100-01 (stating that investments experience two basic forms of risk).

85. *See id.* (explaining that market risk represents response by all securities to changes in general economic conditions).

86. *See id.* (referring to risk experienced in response to changes in general economic conditions as "systematic" or "market" risk).

87 *See id.* (noting that marketplace compensates buyers for systematic risks). Haskell observed:

> A fundamental principle of contemporary economic thinking is that the marketplace compensates the buyer for systematic risk but does not compensate the buyer for specific risk. Systematic risk is unavoidable; almost all stock covary positively, albeit in different degrees, in relation to that risk. Expected return is the riskless rate (short-term U.S. government debt) plus a rate determined in accordance with the degree of systematic risk.

Id., *see also* Levy, *supra* note 58, at 7 (emphasizing that market risks are not inherently bad because investors receive compensation for such risks in form of higher returns).

Modern portfolio theory describes the second form of risk as "specific" or "residual" risk.[88] This type of risk represents those market forces that negatively affect a specific investment or industry [89] Specific risk also measures how the variability in the rate of return for an individual investment impacts the whole portfolio.[90] However, given that specific risk does not precisely imitate market fluctuations, increases in the market do not necessarily compensate an investor with higher returns when he assumes the additional specific risk because of a particular asset.[91] Nevertheless, investors can take steps to avoid specific risk.[92] Diversification effectively

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88. *Cf.* Levy, *supra* note 58, at 7 (labeling diversifiable risks as "specific" or "residual" risks).

89. *See* Haskell, *supra* note 2, at 101 (defining specific risk). Haskell observed:

> The other form of risk is that which peculiarly affects a particular investment or industry, as climate affects an agriculturally related investment, as Japanese imports affect the American auto companies, and as the federal budget affects the aerospace industry This risk is referred to as "specific," "unsystematic" or "residual" risk. A risk that affects one stock negatively may affect another stock positively, in which case the stocks are said to "covary negatively" with respect to that risk; if they are affected in the same way by the same risk, they "covary positively" with respect to that risk.

Id., *cf.* Wade, *supra* note 32, at 714 (noting that every security possesses certain risks unrelated to overall market conditions).

90. *See* Langbein & Posner, *supra* note 56, at 889 (illustrating counterbalancing effect of diversification). Professors Langbein and Posner illustrated:

> The 1973 Arab oil embargo damaged the fortunes of all automobile makers, motel chains, and makers of recreational vehicles but benefited domestic oil producers, the coal industry, and oil exploration service companies. Owning shares in the last three groups of stocks would have enabled an investor to offset, in part anyway, the losses he would have incurred on his holdings in the first three groups.

Id., *see also* Levy, *supra* note 58, at 7 (explaining that specific risks represent variability in rate of return that mitigates with proper portfolio diversification).

91. *See* Halbach, *supra* note 8, at 424 (noting failure of market to compensate for specific risk); *see also* Haskell, *supra* note 2, at 101 (concluding that market does not compensate investor for specific risk); Langbein & Posner, *supra* note 56, at 889 (extolling virtues of diversification). Langbein and Posner added: "Although an investment policy that achieves optimal diversification cannot eliminate nondiversifiable risk, it can eliminate the uncompensated diversifiable risk, which represents a deadweight loss for the investor who dislikes risk when it does not produce a higher return." *Id.*, Levy, *supra* note 58, at 7 (explaining that higher market returns do not automatically compensate investors for diversifiable risks).

92. *Cf.* Haskell, *supra* note 2, at 101 (suggesting that investors can avoid specific risk). Haskell explained:

> The marketplace does not compensate the buyer for specific (unsystematic) risk. This is because the investor can balance the specific risk to one stock with

ties portfolio returns to general market conditions and thereby dilutes the volatility associated with any one investment.[93] Therefore, by maintaining a broad portfolio, one can better hold specific risk to a relatively low level.[94]

In addition to comparing risks, modern portfolio theory also suggests that the investment markets are reasonably efficient.[95] This means that, at any given time, the price of an investment reflects virtually all information available for that investment.[96] More importantly, however, a reasonably efficient market means that the price of an investment closely corresponds to its degree of specific risk.[97] As a result, attempts to identify undervalued investments in order to earn above average returns are rarely successful because the market correctly prices every investment.[98] The fact that the

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> the purchase of another stock that is affected positively by the same factor which adversely affects the first stock. In other words, through diversification specific risk can be virtually eliminated. If the investor can avoid the effect of specific risk, there is no reason for the marketplace to compensate him for the risk.

Id.

93. *See* Halbach, *supra* note 8, at 423 (observing that reductions in portfolio volatility come from increasing number of assets held and by considering reactions those assets have to various economic events); *cf.* Haskell, *supra* note 2, at 102 (concluding that investors with portfolios that contain negatively covarying stocks experience expected returns that adequately reflect systematic risks for each asset and thereby cause substantially all specific risks to cancel out).

94. *See* Haskell, *supra* note 2, at 102 (using notion that contemporary economic theory supports position that investors should maintain broad portfolios to reduce specific risk to low levels).

95. *See id.* at 103 (stating that most economic theorists view pricing of publicly traded stocks as reasonably efficient).

96. *See* Halbach, *supra* note 8, at 425 (noting that economic research shows that major capital markets tend to be highly efficient because market prices for securities generally reflect all available information); *see also* Wade, *supra* note 32, at 714 (explaining that efficient market theory postulates that, in markets in which market analysts know all basic information about investments, market forces — through purchases and sales — assign realistic values to those securities); *cf.* Langbein & Posner, *supra* note 56, at 888 (describing price of security as present value of its future earnings).

97 *Cf.* Halbach, *supra* note 8, at 423 (explaining that lower market prices for risky securities express prospects for extra rewards to those investors who accept more volatile returns); Haskell, *supra* note 2, at 103 (suggesting that, if stock prices reflect virtually all available information, pricing of publicly traded stocks is reasonably efficient).

98. *See* Haskell, *supra* note 2, at 103 (contending that, if one accepts efficient market theory, attempts to outperform market by selecting undervalued stocks are futile because no such stocks exist); *see also* Langbein & Posner, *supra* note 56, at 888 (presuming that current trading price correctly values every stock).

majority of professional investment managers consistently fail to match the performance of the market supports this view [99]

The ultimate goal of modern portfolio theory is to balance portfolio risks and returns through diversification of the assets held.[100] Relying on efficient market principles, the theory concludes that, by using a wide range of investments to build a portfolio that more closely resembles the overall market, higher returns are possible.[101] A diversified portfolio is prudent because, by incurring mostly market risk, it minimizes the specific risk associated with any one investment.[102] Using a broad spectrum of investments, including those once regarded as speculative, an investor can improve the portfolio's expected rate of return without inherently increasing its exposure to uncompensated risks.[103] Thus, under modern portfolio theory, the use of more volatile investments becomes prudent.[104] Obviously, modern portfolio theory stands in sharp contrast to the notions of safe investment followed under the prudent person standard. To aid the reader in understanding how trust doctrine expects to benefit from this theory, a discussion of the central features of the *Restatement (Third)* follows in Part IV

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99. *See* Halbach, *supra* note 8, at 425 (noting that empirical research supporting efficient market theory reveals that, in such markets, skilled professionals can rarely identify underpriced securities or predict market forces affecting future return on investments); *see also* Wade, *supra* note 32, at 714 (pointing to studies indicating that, even when discounting for management fees, substantial majority of professional investment managers fail to match market performance).

100. *Cf.* Halbach, *supra* note 8, at 433 (asserting that goal of diminishing uncompensated risk through diversification should be pervasive consideration in prudent investment management despite presence of specialized investment objectives).

101. *See id.* at 433-34 (identifying increases in degree of market risk as primary means for increasing diversified portfolio's expected return); *see also* Haskell, *supra* note 2, at 103 (observing that, within efficient market, increased returns only occur through increased risks).

102. *Cf.* Haskell, *supra* note 2, at 103 (confirming that, when pricing is reasonably efficient, passive strategy of investing broadly in market is both prudent and conservative investment policy). *But see id.* (commenting that passive investment by trustees would be questionable under prudent person rule because portfolio would include "speculative" stocks unsuitable for trustee investment).

103. *See* Halbach, *supra* note 8, at 424 (concluding that diversified portfolios benefit from reductions in firm-specific or diversifiable elements of risk with no impairment of average expected returns); *see also* Haskell, *supra* note 2, at 102 (advocating maintenance of broad portfolios to reduce specific risk to insignificance and to maximize benefits of systematic risk).

104. *See* Halbach, *supra* note 8, at 435 (concluding that trustees can prudently employ risky assets in manner reasonably designed to reduce overall risk or to achieve higher returns in appropriate circumstances without disproportionate increases in overall risk or expense).

IV Advancements Made Under the Restatement (Third) of Trusts

Section 227 of the *Restatement (Third)*, commonly referred to as the "prudent investor rule,"[105] integrates the investment functions associated with fiduciary administration in a unique way This integration combines contemporary portfolio management techniques with established trust doctrine and, in the process, works to make the limits of prudent investment less restrictive.[106] Likewise, this combination clarifies the traditional duties that a trustee must continue to perform in dealing with the complex modern economy [107] The following discussion examines how the *Restatement (Third)* redefines several fundamental fiduciary duties.

A. The Duty to Balance Risks Against Total Returns

Whereas the *Restatement (Second)* condemned trustees for speculative investment practices, the prudent investor rule acknowledges that excessive conservatism can prove equally harmful to trust beneficiaries.[108] This latter viewpoint rests on the notion that the degree of market risk assumed and higher portfolio returns share a direct relationship.[109] As such, the prudent

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105. *See generally* RESTATEMENT (THIRD) OF TRUSTS § 227 (1992) (stating "General Standard of Prudent Investment").

106. *See* Halbach, *supra* note 8, at 435 (lauding *Restatement (Third)* and its advocacy of relatively flexible principles of prudent investing as guide for trustees, trust counsel, and courts).

107 *Cf. id.* (identifying considerations that trustees should make when analyzing investment decisions). Professor Halbach noted:

> [A] trustee should analyze any investment or action by considering the contributions it can be expected to make to the trust's diversification needs, to fulfilling the trustee's duty of impartiality, and to achieving a desired overall level of risk and expected return for the trust estate, or perhaps otherwise in terms of a suitable portfolio and strategy for the trust in question.

Id.

108. *Compare* RESTATEMENT (SECOND) OF TRUSTS § 227 cmt. e (1959) (noting that speculation results in improper trust investment) *with* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. e (1992) (explaining that speculation can assist trustees in complying with requirement of caution); *see also* Halbach, *supra* note 8, at 437 (suggesting that excessive conservatism, like excessive risk taking, may harm trust beneficiaries); Willis, *supra* note 52, at 341 (re-emphasizing that undue conservatism can undermine beneficial trust interests); *cf.* GIW Indus. v. Trevor, Stewart, Burton & Jacobsen, Inc., 895 F.2d 729, 733 (11th Cir. 1990) (finding prominent investment manager liable for investing almost all of pension plan's assets in U.S. Treasury bonds).

109. *See* Halbach, *supra* note 8, at 436 (identifying direct relationship between market risk and portfolio returns); *cf.* Willis, *supra* note 52, at 341 (explaining that "only by accepting a reasonable and appropriate amount of market risk can any portfolio grow at a rate meaningfully greater than inflation").

investor rule demands that the trustee make reasonable decisions regarding the amount of risk that is appropriate to the objectives of the portfolio.[110]

This duty requires balancing the opportunities for gain that come from using more speculative investments against the trust's capacity to withstand the losses that will occur occasionally because of those investments.[111] Unfortunately, the prudent investor rule fails to identify where the appropriate balance lies.[112] Instead, the *Restatement (Third)* explains that trustees should consider the overall risk tolerance of a particular trust in relation to its distribution requirements, specific terms, and general purposes.[113] Ultimately, the degree of conservatism required for a particular trust is a matter for the trustee's reasonable interpretation and judgment.[114]

Despite the lack of specific guidance offered by the *Restatement (Third)* concerning the proper mix between risk and returns, the prudent investor rule does provide trustees with two important guidelines for determining that mix. First, no investment or investment strategy is inherently impermissible.[115] This view differs significantly from previous trust

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110. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. b (1992) (commenting that trustee's duties apply not only in making investment decisions but also in monitoring and reviewing investments and that trustee should perform duties in manner that is reasonable and appropriate to particular investments, courses of action, and strategies involved); *see also* Halbach, *supra* note 8, at 436 (noting that reasonable decisions about acceptable degree of market risk are integral part of decisions regarding trustee's ongoing investment strategy).

111. *See* Halbach, *supra* note 8, at 437 (insisting that trustees balance trust requirements and potential gains against trust's capacity to absorb hazards created by adverse investment outcomes).

112. *See* Willis, *supra* note 52, at 341 (recognizing that *Restatement (Third)* does not state objective or general legal standard for degree of risk that is or is not prudent).

113. *See* RESTATEMENT (THIRD) OF TRUSTS § 227(a) (1992) (describing duty to balance portfolio risks and returns). The *Restatement (Third)* states:

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

Id., *see also* Halbach, *supra* note 8, at 436 (recommending that trustee's judgment reflect assessment of particular trust's distribution requirements and risk tolerance together with consideration of its pertinent terms and specific circumstances).

114. *See* Halbach, *supra* note 8, at 437 (concluding that, although general requirement of conservatism in investment continues to flow from duty to use caution, ultimately trustee must make reasonable interpretations and judgments about degree of conservatism required and overall degree of risk permitted for particular trust).

115. *See* Willis, *supra* note 52, at 341 (noting that prudent investor rule has one clear message — that no investment or course of action is inherently prudent or imprudent).

doctrine, which categorically excluded certain investments as imprudent per se.[116] Consequently, under the prudent investor rule, trustees are free to utilize nearly any type of investment in creating a desirable balance between risk and return for a given trust.[117]

Second, the prudent investor rule defines what constitutes a reasonable return using the concept of "total return."[118] Total return is the sum of portfolio income plus capital appreciation or depreciation.[119] Whereas trust doctrine formerly characterized return as income yield alone, the prudent investor rule considers increases in market value as part of the trust's return as well.[120] This significant change gives trustees greater flexibility in assessing tradeoffs between risk and reward by providing a much broader view of what constitutes return and, consequently, what justifies increased risks for the portfolio.[121]

B. The Duty to Diversify

Risk always accompanies one's entrance into the marketplace.[122] By offering a response to this problem, sound diversification becomes fundamental to the effective management of trust assets.[123] To this end, the

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116. *See id.* (concluding that *Restatement (Third)* position represents departure from previous trust doctrine that considered certain investments necessarily imprudent).

117 *Cf.* Stone, *supra* note 17, at 12 (observing that *Harvard College* decision recognized that capital of trust is always at risk and that more flexible standard of trustee action, embracing all forms of investment, could exist within bounds of good judgment and care).

118. *See* Willis, *supra* note 52, at 341 (noting that, because *Restatement (Third)* explicitly adopts investment industry's standard definition of "total return," duties of skill and prudence generally require trustees to secure reasonable returns).

119. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. e (1992) (defining reasonable return as "total return, including capital appreciation and gain as well as trust accounting income"); *see also* Willis, *supra* note 52, at 341 (defining total return as "income plus capital appreciation or depreciation").

120. *See* Willis, *supra* note 52, at 341 (noting that prior trust doctrine emphasized income yield when considering return).

121. *Cf. id.* (explaining that total return concept allows trustees to seek economic benefits for beneficiaries without artificially limiting those economic benefits with classifications such as income or appreciation).

122. *See* Halbach, *supra* note 8, at 436 (noting that risk, while not inherently bad, is unavoidable in trust investing); *see also* Willis, *supra* note 52, at 341 (using illustration of market volatility associated with U.S. Treasury securities and CDs to assert that no investment is risk free).

123. *See* Halbach, *supra* note 8, at 437 (re-emphasizing that "[s]ound diversification is fundamental to management of uncompensated risk"); *cf.* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. g (1992) (commenting that asset allocation decisions are fundamental aspect of investment strategies and serve as starting point for diversification plans). *But cf.* GIW

prudent investor rule places great importance on the duty to diversify [124] This duty also is found in the *Restatement (Second)*.[125] However, the *Restatement (Third)* modifies this duty by allowing greater managerial discretion. Whereas the *Restatement (Second)* mandated diversification without exception, the prudent investor rule relaxes this duty in the rare instances when the trust instrument, applicable statutes, or general economic conditions make it wiser to maintain a less diversified portfolio.[126]

This change recognizes that the economy does not affect the value of all investments in the same way [127] To strike an efficient counterbalance within the portfolio, a trustee must consider not only the variety of assets held, but also the manner in which each asset's response to economic

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Indus. v Trevor, Stewart, Burton & Jacobsen, Inc., 895 F.2d 729, 733 (11th Cir. 1990) (finding prominent investment manager liable for investing nearly all of pension plan's assets in U.S. Treasury bonds); Estate of Knipp, 414 A.2d 1007, 1009 (Pa. 1980) (finding that trustee acted within accepted standards of care, skill, and judgment required of fiduciary and that there was no duty to diversify portfolio).

124. *See* RESTATEMENT (THIRD) OF TRUSTS § 227(b) (1992) (defining duty to diversify). The *Restatement (Third)* states that "[i]n making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so." *Id.*, *see also* Halbach, *supra* note 8, at 438-39 (describing adverse tax considerations, inability to realize full value from sale of property, or unique character of asset as special circumstances when diversification is imprudent).

125. *Compare* RESTATEMENT (SECOND) OF TRUSTS § 228 (1959) (requiring portfolio diversification in order to distribute risk of loss), *with* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. g (1992) (discussing requirement of portfolio diversification); *see also* Halbach, *supra* note 8, at 438 (explaining that, given central role of diversification in modern concepts of prudence, *Restatement (Third)* incorporates duty to diversify into basic text and commentary of prudent investor rule).

126. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. g (1992) (commenting that duty to diversify does not prohibit favoring one class of investment). The *Restatement (Third)* explains:

> In fact, given the variety of defensible investment strategies and the wide variations in trust purposes, terms, obligations, and other circumstances, diversification concerns do not necessarily preclude an asset allocation plan that emphasizes a single category of investments as long as the requirements of both caution and impartiality are accommodated in a manner suitable to the objectives of the particular trust.

Id., *see also* Levy, *supra* note 58, at 6 (highlighting fact that Section 228 of *Restatement (Third)* exculpates trustee if trustee refrains from diversifying in compliance with terms of trust or any applicable statute).

127 *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. g (1992) (noting that events affecting economy do not affect value of all investments in same way); *see also* Halbach, *supra* note 8, at 424 (illustrating that economic trends do not affect value of all investments in same way).

changes impacts the other holdings.[128] As noted above, proper diversification enables a trustee to use varied investments to manage uncompensated risks more effectively and, thus, to increase returns.[129]

Fortunately, the heightened importance that the prudent investor rule places on diversification corresponds to other developments that make this objective easier to achieve.[130] As pooled investment vehicles, such as mutual funds, proliferate and grow to include nearly every type of investment, thorough diversification becomes eminently practical for virtually all trustees.[131] The result — a more prudent form of risk taking — enables

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128. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. g (1992) (commenting that effective diversification depends not only on number of assets held in trust portfolio, but also on whether assets' responses to economic events tend to cancel or neutralize one another); *see also* Halbach, *supra* note 8, at 440 (restating understanding of effective diversification put forward by *Restatement (Third)*).

129. *See* Halbach, *supra* note 8, at 440 (agreeing that otherwise volatile investment can make major contribution to risk management if shifts in returns tend not to correlate with movements of other investments in portfolio); *see also* Levy, *supra* note 58, at 13-14 (providing example of advantage offered by mix of investment grades). Professor Levy observed:

> The correlation coefficient between long-term government bonds and small capitalization stocks over the 10-year period ended June 30, 1992 was 0.155; the respective annualized standard deviations for the two assets were 11.8% and 21.4% (i.e., small cap stocks were nearly twice as volatile as long-term government bonds). Since the correlation is fairly low, combining the assets should stabilize return. In fact, the standard deviation of a portfolio allocated 2/3 to long-term government bonds and 1/3 to small cap stocks would be 11.2% — lower than the 11.8% for the long-term government bonds standing alone. Thus, by adding a relatively high-risk asset like small cap stocks to a low-risk asset like long-term government bonds, one can produce a portfolio with a lower standard deviation than either of the individual assets. The combined portfolio is more efficient than a 100% investment in long-term governments; the expected rate of return would be enhanced by adding equities, and the risk as measured by standard deviation is lower.

Id.

130. *Cf.* Halbach, *supra* note 8, at 440 (elaborating on possibility of thorough diversification for virtually all trustees due to wide offering of pooled investments).

131. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. g (1992) (noting practicality of diversification for most trustees). The *Restatement (Third)* states:

> Broadened diversification may lead to additional transaction costs, at least initially, but the constraining effect of these costs can generally be dealt with quite effectively through pooled investing. Hence, thorough diversification is practical for nearly all trustees. The ultimate goal of diversification would be to achieve a portfolio with only the rewarded or "market" element of risk.

Id. But see Langbein & Posner, *supra* note 56, at 889 (questioning ease of diversification).

> The point has been made that if one carefully selects about thirty stocks, the port-

trustees to use speculation to benefit the portfolio without completely sacrificing the caution that tradition demands.[132]

C. The Duty of Impartiality

The duty to treat trust beneficiaries impartially[133] requires a trustee to balance the competing needs of life tenants and remaindermen.[134] However, by eroding the trust principal, the effects of inflation frustrate a trustee's ability to treat income beneficiaries and future interests equally.[135] The

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> folio will be as much as 90 to 95 per cent correlated with the movements of the market. But a 90 or even 95 per cent correlation by no means eliminates all or even 90 to 95 per cent of the diversifiable risk. If the market as a whole rose in value (including dividends and appreciation) by 10 per cent in one year, there would be a good chance that the thirty-stock portfolio would rise by as little as 5.5 per cent. It is only when the portfolio reaches about *two hundred stocks* that the range within which its return can be expected to fall is reduced to 1 per cent on either side of the market's expected return.

Id. (emphasis added).

132. *Cf.* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. g (1992) (suggesting that diversification allows trustees to balance conservatism against needs of portfolio). The *Restatement (Third)* explains that "[t]he rationale of the trust law's requirement of diversification is more than conservatism or a duty of caution, which admonishes trustees not to take excessive risks — that is, not to take risks higher than suitable to a trust's purposes, return requirements, and other circumstances." *Id.*, *see also* Halbach, *supra* note 8, at 441 (confirming that forbidding or placing arbitrary limits on risk taking is unrealistic and that fiduciary prudence ordinarily requires reasonable efforts to reduce uncompensated elements of risk through diversification).

133. *Compare* RESTATEMENT (SECOND) OF TRUSTS § 227 cmt. y (1959) (noting that improper trust investment includes assets that unduly favor one beneficiary over another), *with* RESTATEMENT (THIRD) OF TRUSTS §§ 183, 227(c)(1) (1992) (adding duty of impartiality to other fiduciary duties). The *Restatement (Third)* states that "[i]n addition, the trustee must conform to fundamental fiduciary duties of loyalty (§ 170) and impartiality (§ 183)." *Id.* § 227(c)(1). The *Restatement (Third)* also states that "[w]hen there are two or more beneficiaries of a trust, the trustee is under a duty to deal impartially with them." *Id.* § 183.

134. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. c (1992) (commenting that duty of impartiality requires trustee to balance competing interests of differently situated beneficiaries in fair and reasonable manner); *see also* Robert T. Willis, Jr., *Steps to Protect the Fiduciary from Liability for Investment Decisions*, 16 EST. PLAN. 228, 230 (1989) (describing divergent objectives of life tenants and remainder beneficiaries). Willis stated: "Life tenants usually prefer high-income investments with little emphasis on growth while remainder beneficiaries prefer low-income investments with the emphasis on growth in order to maintain the purchasing power (i.e., inflation adjusted) of the remainder." *Id.*

135. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. c (1992) (noting that interests of life income beneficiaries almost inherently compete with those of remainder beneficiaries, especially in light of inflation risks; likewise, differing tax circumstances of various classes of beneficiaries frequently create competing investment preferences); *see also* Willis, *supra*

prudent investor rule facilitates the duty of impartiality through a more flexible standard and seeks to clarify the trustee's obligations to conflicting interests in the trust.[136]

The prudent investor rule recognizes that income production is more a function of the portfolio's overall productivity than of the productivity of each investment.[137] Likewise, the *Restatement (Third)* recognizes that, because the relationships among trust beneficiaries vary, the proper amount of income production also will vary considerably for each trust.[138] Therefore, the prudent investor rule encourages trustees to balance the market forces that affect each of those beneficial relationships.[139]

To this end, the prudent investor rule enlarges the concept of trust preservation to include the protection of trust capital and its purchasing power from the threat of inflation.[140] To illustrate this point, the *Restatement (Third)* explains how an investment strategy that seeks maximum income yield may minimize growth of the trust corpus.[141] Although such

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note 52, at 340 (concluding that erosion from inflation affects trustee's duty to treat income and remainder beneficiaries impartially). Willis illustrated:

> A trust requires payment of income to Roberta for life, with remainder to Richard on Roberta's death. The trustee invests the trust funds primarily in CDs and Government bonds. In the absence of sound reasons for this investment strategy, it appears to favor Roberta with high income yield at the expense of the value of Richard's future principal due to erosion of the trust principal from inflation.

Id.

136. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. c (1992) (commenting that conflicting fiduciary obligations result in necessarily flexible and somewhat indefinite duty of impartiality); *see also* Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV 52, 56 (1987) (concluding that only significant clash between portfolio theory and trust doctrine arises in allocation of returns between life beneficiaries and remaindermen); Halbach, *supra* note 8, at 441 (noting that prudent investor rule includes flexible and more comprehensive duty of impartiality).

137 *See* Halbach, *supra* note 8, at 442 (commenting that *Restatement (Third)* evaluates productivity of income in relation to productivity of trust portfolio as whole, rather than in relation to productivity of each investment).

138. *See id.* (noting *Restatement (Third)*'s recognition that appropriate overall degree of income productivity will vary considerably from trust to trust because of differences in trust purposes and relationships among beneficiaries).

139. *See id.* (encouraging trustees to take reasonable and balanced account of potential and differing impacts that factors such as taxation and inflation impose on beneficiaries).

140. *See id.* at 443 (viewing objective of "safety" or "preservation" of trust capital within prudent investor rule to include protecting trust's purchasing power from risks of inflation).

141. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. c, illus. 7 (1992) (demonstrating how maximizing income yield may minimize corpus growth). For example, the *Restatement (Third)* illustrates:

a strategy satisfies the income beneficiaries' interest, it leaves any remaindermen with diminished real purchasing power and, therefore, violates the duty of impartiality by favoring one group's interest over another group's interest.[142] In response, the prudent investor rule recognizes the need for investment strategies that aim to increase, and not merely to preserve, real purchasing power.[143]

Obviously, any strategy that pursues higher returns necessarily involves taking increased risks that may not succeed.[144] Regardless of the degree of care and skill used by the trustee, the prudent investor rule accepts the potential for losses as a virtual certainty [145] Consequently, the *Restatement (Third)* excuses trustees from liability for periodic losses that occur in the attempt to preserve portfolio purchasing power.[146] This leniency suggests a greater appreciation for the often opposing demands made by the duty of

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> T is trustee of a trust to pay income to A for life, remainder to B if then living and if not then by right of representation to B's issue who are then living. T invests the trust funds in investments of a type that, despite the broad range of yields that might be appropriate to particular trusts, appear unduly to favor A's interest in receiving a high income at the expense of the B family's interest in having corpus protected against loss of purchasing power. This constitutes a breach of T's duty of impartiality in the absence of satisfactory explanation.

Id., *see also* Willis, *supra* note 52, at 340 (noting that *Restatement (Third)* advises trustees to understand that investment strategies which focus primarily on maximizing income yield will minimize or ignore possibilities for growth).

142. *See* Willis, *supra* note 52, at 340 (admonishing trustees to recognize that maximizing income yield at expense of growth may force invasions of corpus to support income beneficiaries and may suggest violation of impartiality); *cf.* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. c (1992) (warning that trustees should recognize that, in inflationary times, high-yield and low-growth investment strategies, adhered to over long periods, pose risks with respect to life beneficiary's future security and have effects comparable to regular practice of invading principal).

143. *See* Halbach, *supra* note 8, at 443 (justifying, under some circumstances, investment strategies that seek to enhance and not merely preserve real value of trust capital).

144. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. e (1992) (accepting notion that objective of preserving portfolio purchasing power carries with it some increases in risk); *see also* Halbach, *supra* note 8, at 443 (recognizing that goal of higher returns carries some increases in risk that will not always pay off, especially in short run).

145. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. e (1992) (recognizing that, in some periods, trustees cannot succeed in preserving portfolio purchasing power); *see also* Halbach, *supra* note 8, at 443 (noting *Restatement (Third)*'s acceptance that, despite exercise of due skill and care, trustees cannot always maintain portfolio purchasing power).

146. *See* Halbach, *supra* note 8, at 443 (explaining that, if trustee has used due care and skill, liability does not attach when trustee fails to preserve purchasing power of portfolio).

impartiality[147] Overall, the prudent investor rule allows trustees more flexibility in balancing the competing needs found within multiparty and multigenerational trusts. This flexibility also recognizes the idea that prudent trust investing varies according to the nature, purposes, and circumstances of the respective trust.[148]

D The Authority to Delegate

The *Restatement (Second)* limited a trustee's delegation authority to "ministerial"[149] functions only[150] In contrast, the *Restatement (Third)* greatly expands a trustee's delegation authority,[151] particularly with respect to investment matters.[152] The prudent investor rule allows a trustee to

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147 *Cf. id.* at 443-44 (praising *Restatement (Third)*'s elaborate discussion of investment implications created by duty of impartiality as effort to increase, or at least to clarify, both flexibility of that duty and concerns duty addresses).

148. *Cf. id.* at 443 (recommending that rules governing trust investment activities be sensitive to (1) competition between needs of present and future interests in trust and (2) fact that degrees of productivity requirements will differ significantly depending on nature, purposes, and circumstances of different trusts).

149. *See* RESTATEMENT (SECOND) OF TRUSTS § 171 (1959) (characterizing "ministerial" functions as those functions that it is not reasonable to require trustee to perform); *see also* John H. Langbein, *Reversing the Nondelegation Rule of Trust-Investment Law*, 59 MO. L. REV 105, 108 (1994) (describing fiduciary's obligation to perform ministerial functions). Professor Langbein illustrated:

> When a piece of residential real estate is held in trust for family members, the list of agents whom the trustee may employ can lengthen to include the panoply of household providers — gardeners, plumbers, cleaning staff, house painters, and so forth. The trustee does not have to take out the garbage or paint the house in person.

Id.

150. *See* Willis, *supra* note 52, at 341-42 (explaining that prior trust doctrines and treatises permitted delegation of administrative duties only).

151. *See* RESTATEMENT (THIRD) OF TRUSTS §§ 171, 227(c)(2) (1992). Section 227(c)(2) of the *Restatement (Third)* requires trustees to "act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents (§ 171)." Section 171 states:

> A trustee has a duty personally to perform the responsibilities of the trusteeship except as a prudent person might delegate those responsibilities to others. In deciding whether, to whom and in what manner to delegate fiduciary authority in the administration of a trust, and thereafter in supervising agents, the trustee is under a duty to the beneficiaries to exercise fiduciary discretion and to act as a prudent person would act in similar circumstances.

Id. § 171, *see also* Willis, *supra* note 52, at 342 (concluding that *Restatement (Third)* completely eliminates former prohibition on delegation of discretionary authority previously advanced in trust doctrine).

152. *See* Halbach, *supra* note 8, at 445 (mentioning that, as compared with its predeces-

assign broad decision-making responsibilities for the trust to others[153] and, in the case of nonprofessional fiduciaries, may impose a duty to delegate to investment professionals.[154] This revision seeks to widen efficient trust management practices by allowing, and even sometimes requiring, trustees to use outside expertise to identify available risk-reward tradeoffs and opportunities for additional diversification.[155] Nevertheless, this increased latitude to delegate does not relieve a trustee from personally defining, or at least approving, the trust's investment strategies and objectives.[156]

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sors, *Restatement (Third)* takes nearly opposite view of trustee's duty with respect to delegation in investment matters); *cf.* Langbein, *supra* note 149, at 106 (suggesting that, by making it easier to externalize investment functions, prudent investor rule will encourage persons who lack investment expertise, such as family members and lawyers, to serve as trustees).

153. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. j (1992) (discussing duty with respect to delegation). The *Restatement (Third)* states:

> The trustee's authority to delegate is not confined to acts that might reasonably be described as "ministerial." Nor is delegation precluded because the act in question calls for the exercise of considerable judgment or discretion. The trustee's decisions with regard to delegation are themselves matters of fiduciary judgment and responsibility falling within the sound discretion of the trustee.

Id., *see* Willis, *supra* note 52, at 342 (explaining that trustees can now delegate broad decision-making responsibilities under *Restatement (Third)*).

154. *See* Wade, *supra* note 32, at 715 (suggesting that, for nonprofessional fiduciaries, *Restatement (Third)* may impose duty to obtain informed investment assistance); *cf.* Langbein, *supra* note 149, at 110 (concluding that well-intentioned trustees will seek out and rely upon outside advisors in performing investment function). *See generally* Richard Korman, *Time to Trust Your Trust Fund to a Pro?*, BUS. WK., Dec. 5, 1994, at 114 (praising authority to appoint professional trustee to handle investment duties).

155. *Cf.* Langbein, *supra* note 149, at 110 (explaining why it is more efficient to delegate investment functions). Professor Langbein commented:

> Today financial instruments have become the typical asset of the trust, and these assets require active fiduciary administration. Managing a portfolio of marketable securities is as demanding a specialty as stomach surgery or nuclear engineering. There is no more reason to expect the ordinary individual serving as a trustee to possess the requisite investment expertise than to expect ordinary citizens to possess expertise in gastroenterology or atomic science.

Id., Wade, *supra* note 32, at 715 (stating that duty to delegate involves seeking professional assistance to clarify objectives and analyze risk/reward tradeoffs with respect to compensated risk).

156. *See* Halbach, *supra* note 8, at 445-46 (clarifying that, despite reliance on professional advice as needed, trustees should personally define or approve trust's investment strategies and objectives). *But cf.* Taylor, *supra* note 26, at 60 (arguing that delegation authority has defensive component that protects trustee against allegation that trustee was too unsophisticated or too busy to manage portfolio without assistance).

Likewise, the prudent investor rule does not relax the trustee's duty to act with care, skill, and caution when delegating authority [157]

As a part of the duty to delegate, the prudent investor rule emphasizes the trustee's obligation to invest in a cost-conscious manner. This emphasis builds on traditional trust doctrine and requires trustees to avoid unwarranted expenses when administering trusts.[158] Under the prudent investor rule, a trustee must consider such expenses in light of efficient market principles.[159] Accordingly, the trustee should balance the transaction costs associated with outside advice, investment fees and commissions, and additional capital gains taxation against the prospect that these activities will lead to increased returns.[160] Although this view necessarily favors passive investment strategies, the duty to be cost-conscious does not foreclose more active approaches when appropriate.[161] In short, the prudent investor rule continues to encourage reasonable attention to the costs of administering the trust.

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157 *See* Halbach, *supra* note 8, at 447 (warning that increased acceptance of delegation by trustees generally does not alter trustee's duty to act with care, skill, and caution in delegating investment authority); *cf.* Langbein, *supra* note 149, at 110 (criticizing traditional rule prohibiting delegation as disservice to trust beneficiaries because prohibition prevents open discussion of standards and safeguards appropriate to delegation).

158. *See* Halbach, *supra* note 8, at 447 (noting that trustee traditionally has "duty to avoid incurring unwarranted expenses" in administering trust).

159. *See id.* (suggesting that cost-conscious administration should consider market efficiency information and concepts, but should also recognize presence of "different degrees of efficiency in different markets"); *cf.* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. g (1992) (explaining that significant diversification advantages are possible with small number of well-selected securities representing different industries and having other qualitative differences). *But cf.* Langbein & Posner, *supra* note 56, at 889 (suggesting effective diversification requires investments in 200 or more securities).

160. *See* Halbach, *supra* note 8, at 447 (advising trustees to compare any additional transaction costs, including capital gains taxation, resulting from particular management strategy or course of action with realistically appraised prospects of increased returns from transaction); *see also* Willis, *supra* note 52, at 342 (concluding that trustees should justify costs of investment advisor, mutual fund sales charges and fees, and real estate management fees in terms of expected return and necessity of services purchased).

161. *See* Halbach, *supra* note 8, at 447-48 (noting that, although commentary of prudent investor rule encourages relatively passive investment and indexing techniques, it avoids suggesting that active strategies are impermissible); *cf.* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. e (1992) (explaining that prudent investor rule's emphasis on long-term investing does not prevent use of active management strategies, including use of investments or techniques heretofore characterized as risky or speculative). *But cf.* Langbein, *supra* note 149, at 110 (concluding that, because securities have become typical asset in modern trust, active fiduciary administration is necessary).

E. Expanding Liability for Trustees

The prudent investor rule makes it more difficult for the trustee who neglects a fiduciary obligation to avoid liability[162] In a complete departure from historical practices,[163] the prudent investor rule now measures a trustee's liability by comparing the portfolio's total return,[164] whether positive or negative, with what the portfolio reasonably could expect to earn under an "appropriate" investment program.[165] In addition, this standard potentially increases the amount of a trustee's liability in an action for breach of fiduciary duty

The adoption of this standard reflects, in part, the ready availability of the investment performance data needed for accurate comparisons of total return.[166] For example, in an action for breach of fiduciary duty, a court could use a similar trust portfolio or a recognized securities index as a benchmark when comparing a given portfolio's total return.[167] More importantly, the total returns approach maintains the traditional goal of damage awards for breach — to place beneficiaries where proper trust management would have placed them.[168] On balance, the total return concept

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162. *Cf.* Halbach, *supra* note 8, at 459 (commenting that major objective of prudent investor rule was to insure that trustees who ignored their fiduciary obligations by using inadequate investment strategies could not avoid liability merely because investment program escaped loss of dollar value during periods of significantly rising markets in which trusts should have but did not fully benefit).

163. *Cf.* Halbach, *supra* note 8, at 458 (looking at prudent investor rule as dramatic break with past doctrine in use of total returns, whether positive or negative, as new measure of trustee liability for improper investment).

164. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. e (1992) (linking concept of reasonable return with concept of total return — including capital appreciation and gain, as well as trust accounting income); Willis, *supra* note 52, at 341 (defining total return as "income plus capital appreciation or depreciation").

165. *See* RESTATEMENT (THIRD) OF TRUSTS § 205 cmt. a (1992) (explaining that recovery for improper investment by trustee ordinarily is difference between (1) value of investment and its income at time of surcharge and (2) amount of funds expended in making investment, increased or decreased by amount of total return that would have accrued to trust if properly invested); *see also* Halbach, *supra* note 8, at 459 (noting that prudent investor rule allows surcharges to reflect gains and losses reasonably expected from appropriate investment program).

166. *Cf.* Halbach, *supra* note 8, at 460 (crediting extension of total return approach to damages to ready availability of fair and relevant performance data in today's financial world).

167 *See id.* (identifying possible units of comparison available when applying total return approach to damages).

168. *See id.* (asserting appropriateness of total return measure of damages in light of objectives of traditional trust doctrine — to restore trust estate to position possible through

represents a very practical approach to measuring the damages resulting from fiduciary mismanagement.[169]

In keeping with traditional trust doctrine, the prudent investor rule limits a trustee's ability to offset losses caused by one asset in the portfolio with profits from other assets.[170] This limitation — called the "anti-netting" rule — exists despite considerable criticism that it inhibits the use of modern portfolio theory by encouraging the exclusive use of low-risk investments to avoid losses entirely[171] However, because the *Restatement (Third)*'s anti-netting provision triggers only after a breach has occurred, such criticism arguably is without merit.[172] To facilitate the use of the anti-netting rule in assessing damages, the prudent investor rule more carefully defines profit and loss.[173]

proper administration); *cf.* RESTATEMENT (THIRD) OF TRUSTS § 213 cmt. b (1992) (defining loss from breach of trust as amount necessary to restore value of beneficial interest to value possible through proper administration).

169. *See* Halbach, *supra* note 8, at 461 (listing recent state court decisions involving underdiversification or inadequate impartiality in asset allocation to illustrate practicality of total return measure of damages); *cf. In re* Estate of Anderson, 196 Cal. Rptr. 782, 795 (Ct. App. 1983) (finding appreciation damages appropriate when executor breached duty of loyalty); *In re* Estate of Rothko, 372 N.E.2d 291, 296 (N.Y 1977) (same); Baker Boyer Nat'l Bank v. Garver, 719 P.2d 583, 591 (Wash. Ct. App. 1986) (finding that damages for trustee's failure to diversify include lost appreciation in equity securities that properly diversified portfolio would produce).

170. *See* RESTATEMENT (THIRD) OF TRUSTS § 213 (1992) (outlining so-called "anti-netting rule"). Section 213 states:

> A trustee who is liable for a loss caused by a breach of trust may not reduce the amount of liability by deducting the amount of a profit that accrued through another and distinct breach of trust; but if the breaches of trust are not separate and distinct, the trustee is accountable only for the net gain or chargeable only with the net loss resulting therefrom.

Id.

171. *See* LONGSTRETH, *supra* note 51, at 60 (criticizing anti-netting rule for assessing prudence of each investment separately and thereby barring fiduciaries from employing modern techniques of risk management to detriment of beneficiaries). *But see* Halbach, *supra* note 8, at 420 (debunking criticisms of anti-netting rule).

172. *See* Halbach, *supra* note 8, at 420 (emphasizing that anti-netting rule serves only to measure damages; anti-netting rule does not measure prudence).

173. *See* RESTATEMENT (THIRD) OF TRUSTS § 213 cmt. b (1992) (clarifying meaning of "loss" and "profit" within Section 213). "Loss" is amount necessary to restore trust to value it would achieve with proper administration. *Id.* "Profit" is amount by which beneficial interests exceed value of trust otherwise possible with proper administration. *Id.*

V *The Practical Effects of the Prudent Investor Rule*

A. *A Current Perspective on Past Cases*

Harvard College v Amory established that trustees could invest in a wide range of securities.[174] The *Restatement (Third)* advocates a return to the lesson of *Harvard College.*[175] However, because that lesson differs so greatly from current fiduciary investment practices,[176] many judges and trustees may lack the perspective necessary to appreciate fully the fundamental changes proposed by the prudent investor rule.[177] The absence of cases that explore the question of investment prudence under the *Restatement (Third)* hampers any attempt to inform judges and trustees in this regard.[178] Until such guidance arrives, a reconsideration of significant past cases may address this problem. By understanding whether the outcomes of earlier cases change in light of the *Restatement (Third)*, judges and trustees can make reasonable predictions about how courts will apply the prudent investor rule. The following sections examine three cases for this purpose.

1. Estate of Knipp

Estate of Knipp[179] provides an opportunity to study the duty to diversify found under the prudent investor rule.[180] In *Knipp*, the Pennsylvania Supreme Court considered whether to surcharge a corporate fiduciary,

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174. *See* Harvard College v Amory, 26 Mass. 446, 465 (1830) (finding that trustees acted prudently when trustees invested in stocks of manufacturing and insurance companies).

175. *See* RESTATEMENT (THIRD) OF TRUSTS, introduction (1992) (expressing desire to return to flexible approach announced in *Harvard College*).

176. *See supra* notes 44-60 and accompanying text (discussing failures of prudent person standard).

177 *Cf.* Gordon, *supra* note 136, at 66 (criticizing modern courts). Professor Gordon stated: "It is striking to see contemporary courts, citing the Restatement, the Treatise, or authority derived from those two sources, haul professional trustees over the coals for investment policies that few financial economists would find exceptionable." *Id.*

178. *See id.* at 75 (decrying lack of recently decided cases that address question of contemporary investment prudence). Professor Gordon complained that "there are perhaps [only] ten cases after 1965 giving serious consideration to the trustee's investment management." *Id.* at 66 n.50; *see also* Langbein & Posner, *supra* note 56, at 890 (noting that most case law interpreting trustee's duty of prudence dates from 1930s or earlier).

179. 414 A.2d 1007 (Pa. 1980).

180. Estate of Knipp, 414 A.2d 1007, 1007-10 (Pa. 1980) (considering fiduciary's failure to diversify estate's stock holdings); *cf.* John W Church & Edward L. Snitzer, *Diversification, Risk, and Modern Portfolio Theory*, TR. & EST., Oct. 1985, at 32, 33 (using *Knipp* to compare results of broad versus narrow diversification).

Central Penn National Bank, for its failure to diversify the assets of an estate.[181] At the decedent's death, the estate contained 4314 shares of Sears Roebuck & Co. common stock valued at $470,000.[182] This investment constituted 97% of the estate's stock portfolio and over 70% of its total assets.[183] The bank sold four hundred shares during the first year of administration to cover costs.[184]

Over the next few years, the price of the stock declined precipitously; however, the bank retained the stock in the hope that it would rebound.[185] Under a provision in the will, the bank had absolute discretion to retain or sell the stock.[186] Despite dramatic losses, the state supreme court affirmed the lower court's refusal to surcharge the bank.[187] In so doing, the court stressed that a testamentary provision authorizing the retention of portfolio assets did not excuse the bank from making prudent investment decisions.[188] Nevertheless, the Pennsylvania court found that Sears Roebuck & Co. was a sound investment[189] and that the bank had no duty to diversify.[190]

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181. *Knipp*, 414 A.2d at 1008 (finding that corporate executor exercised degree of care, skill, and judgment required of corporate fiduciary despite executor's failure to diversify assets).

182. *Id.*

183. *Id.*

184. *Id.*

185. *Id.* Between November 1972 and February 1974, the price of the stock dropped from $117 to $88 per share. *Id.* Unfortunately, it continued to decline thereafter. *Id.*

186. *Id.*

187. *Id.* at 1009.

188. *See id.* (qualifying authorization to retain assets). The court stated: "On the other hand, we are not prepared to say that authorization to retain assets gives an executor or trustee an absolute and unbridled discretion to sit idly by while those assets depreciate in value." *Id.* *But see* First Alabama Bank v. Spragins, 515 So. 2d 962, 964 (Ala. 1987) (holding trustee liable for breach of fiduciary duty when trustee failed to diversify trust investments and to dispose of stock that composed more than 70% of trust estate); Ipsen, *supra* note 4, at 462 (discussing *Spragins*). Ipsen noted: "The language of the trust provided that the trustee could ... change investments from time to time as it thought necessary or desirable, regardless of any lack of diversification, risk or non-productivity .... The holding of this case is difficult to rationalize on anything other than a result-oriented basis." *Id.*

189. *See Knipp*, 414 A.2d at 1008 (assessing prudence of Sears Roebuck & Co. investment). The court explained that "[t]he evidence establishes that Sears stock was, during the period in question, reasonably believed to be a sound, national, broad-based stock worthy of investment by a fiduciary." *Id.*

190. *See id.* at 1009 (concluding that duty to diversify did not exist). The court reasoned:

> Although many financial authorities advocate diversity of investment as a desirable course for trust management, a judicial decision declaring non-diversification to be presumptively imprudent would arbitrarily foreclose executors and trustees

Clearly, *Knipp* stands in sharp contrast to the duty to diversify found under the prudent investor rule.[191] As noted above, modern portfolio theory focuses, in part, on diversification and, therefore, suggests that underdiversification is imprudent.[192] Consequently, under the prudent investor rule, the *Knipp* court likely would reach an opposite result.

Two considerations support this view First, the prudent investor rule requires diversification unless certain factors, such as adverse tax consequences or the unique character of the asset, make diversification less desirable.[193] Apparently, no special circumstances existed in *Knipp* Instead, the evidence suggested that the corporate fiduciary retained the stock in the hope that its declining price might recover.[194] Modern portfolio theory assesses each investment in relation to its effect on the entire portfolio, not in isolation.[195] Given that this deteriorating investment represented more than two-thirds of the portfolio, it is difficult to justify the bank's retention of the stock under the new standard, arguably making it liable for the surcharge.

Second, the prudent investor rule requires that a fiduciary determine if the risk being undertaken is appropriate for the beneficiaries.[196] Using

> from opportunities to retain beneficial holdings. The preferable approach, therefore, is to determine on a case by case basis whether the particular investment approach meets the standard Here we cannot say that the record does not adequately support the determination of the court below that retention of the Sears stock, without diversification, was not imprudent.

Id. But see Baker Boyer Nat'l Bank v Garver, 719 P.2d 583, 588 (Wash. Ct. App. 1986) (standing for proposition that fiduciary duty requires diversification of investments unless special circumstances excuse failure to diversify).

191. *Cf.* Haskell, *supra* note 2, at 99 (asserting that failure to see diversification as independent duty is "radically inconsistent with contemporary economic theory").

192. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. g (1992) (explaining duty to diversify); *see also supra* notes 122-32 and accompanying text (discussing function of diversification in portfolio theory).

193. *See* Halbach, *supra* note 8, at 438-39 (identifying adverse tax considerations, inability to realize full value of property, or unique character of asset as among special circumstances rendering diversification potentially imprudent).

194. *Cf.* Estate of Knipp, 414 A.2d 1007, 1009-10 (Pa. 1980) (Nix, J., dissenting) (objecting to trustee's retention of stock in continuing hope for its market recovery despite steadily increasing losses). Justice Nix observed that "[t]hese circumstances should have forced the conclusion that some diversification was required to attempt to offset the possible loss." *Id.* (Nix, J., dissenting).

195. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. g (1992) (explaining that modern portfolio theory assesses prudence of trustee's investment by considering investment's role in trust portfolio as whole, not in isolation).

196. *See id.* § 227(a) (articulating trustee's duty to incorporate risk and return objectives that are reasonably suitable to trust as part of basic standard of care, skill, and caution).

modern financial analysis, a trustee can quantify the level of risk associated with a given asset.[197] From these measurements, trustees can counterbalance trust assets so as to virtually eliminate uncompensated risks.[198] Conversely, a lack of adequate diversification can expose trust assets to unnecessary risk.[199]

By failing to diversify the portfolio in *Knipp*, the trustee adopted an extremely risky investment posture and, therefore, acted imprudently A comparison of the Sears stock and the Standard & Poor's 500 Stock Index supports this contention.[200] This comparison reveals that, during the relevant period, the Sears stock was 60% riskier than the overall market.[201] In short, retaining the Sears stock as the dominant portfolio asset exposed the overall portfolio to an alarming degree of uncompensated risk.[202] Under the prudent investor rule, a court likely would find this strategy inappropriate given the purpose behind Mr. Knipp's will and, thus, would impose the surcharge.[203]

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197 *See* Levy, *supra* note 58, at 13 (outlining techniques for measuring security's risk as variability from its expected return).

198. *Cf.* Haskell, *supra* note 2, at 101 (remarking that diversification can virtually eliminate specific risk); *supra* notes 122-132 and accompanying text (detailing role of portfolio diversification).

199. *See* Levy, *supra* note 58, at 13-14 (demonstrating how portfolio composed exclusively of government bonds possesses higher risk element than one that mixes bonds with small capitalization stocks). *But cf.* Gordon, *supra* note 136, at 98 (advocating diversification as means for avoiding risk of loss and increasing expected return at chosen risk level).

200. *Cf.* Church & Snitzer, *supra* note 180, at 33 (comparing performance of Sears Roebuck & Co. stock with Standard & Poor's 500 Stock Index from January 1961 to December 1972).

201. *See id.* (explaining that, on total return basis, Sears stock was 60% riskier than Standard & Poor's 500 Stock Index from January 1961 to December 1972).

202. *Cf.* Levy, *supra* note 58, at 16 (explaining that beta coefficient measures covariation between asset and market and that beta represents risk that diversification cannot eliminate). Professor Levy explained that higher returns require a beta greater than 1.00. *Id.* at 16 n.60. The difference between the beta coefficient and 1.00 would equal uncompensated risk. *Id.* In *Knipp*, the difference between the beta coefficient and 1.00 was .60; therefore, 60% of the returns on the Sears Roebuck & Co. stock were uncompensated. *Cf.* Church & Snitzer, *supra* note 180, at 33 (describing higher risk associated with Sears stock).

203. *See* Church & Snitzer, *supra* note 180, at 33 (criticizing *Knipp* decision). Church and Snitzer stated: "It is not often that a fiduciary for widows and children takes 60 percent greater risk than market, a risk comparable to *the* most aggressive portfolio managers." *Id.* Accordingly, "it should be gross negligence, subject to surcharge, for a fiduciary to assume the risk of *Knipp*, (i.e., 60 percent more risk than market), a risk level higher than the most aggressive portfolios." *Id.* at 36.

2. First Alabama Bank v Martin

First Alabama Bank v Martin[204] provides an opportunity to consider how the *Restatement (Third)* assesses the prudence of a trustee's investment strategy.[205] In this case, the Supreme Court of Alabama considered the prudence of certain investments made by a corporate trustee, First Alabama Bank, on behalf of 1250 individual trusts.[206] The trustee used assets from those trusts to invest in two common trust funds — a bond fund and an equity fund.[207] The plaintiffs objected to investments in several publicly traded "growth" stocks and the bonds of six highly leveraged real estate investment trusts (REITs).[208] At trial, the court found each of these investments to be imprudent, either with respect to the purchase or the sale of the investments, and surcharged the bank over $2.6 million plus interest.[209]

The state supreme court affirmed the trial court's ruling.[210] In so doing, the court assessed each investment using a rigid security-by-security approach advanced by the plaintiffs.[211] At trial, expert testimony confirmed

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204. 425 So. 2d 415 (Ala. 1982).

205. First Alabama Bank v Martin, 425 So. 2d 415, 417-29 (Ala. 1982) (analyzing several investments made in two common trust funds).

206. *Id.* at 417

207 *Id.*

208. *See id.* at 418 (listing challenged investments and lower court's determination on each investment). The challenged bond fund holdings included debentures of ATICO Mortgage Investors, Barnett Mortgage Trust, Guardian Mortgage Investors, Justice Mortgage Investors, Midland Mortgage Investors, and Security Mortgage Investors. *Id.* The challenged equity fund holdings included American Garden Products, Ames Department Stores, Beverage Canners, CNA Financial, Elixir Industries, First Mortgage Investors, Hav-A-Tampa, Kinney Services, Loomis Corporation, Mortgage Associates, Transamerica Corporation, Universal Oil Products, Wynn Oil Co., Associated Coca-Cola Bottling Co., Cox Broadcasting, Rust Craft Greeting Cards, and Sealed Power. *Id.*

209. *Id.* The court ordered the bank to pay $1,226,798.00 into the bond fund and $1,426,354.88 into the equity fund. *Id.* The court also ordered interest on these sums. *Id.* at 419.

210. *Id.* at 429.

211. *Id.* at 420. In evaluating each security, the court considered the following criteria:

> (1) a minimum of $100 million in annual sales; (2) a current ratio of at least two to one (current assets should be twice current liabilities); (3) a net working capital to long-term debt ratio of at least one to one (net working capital being current assets less current liabilities and long-term debt meaning obligations that mature in more than one year); (4) earnings stability (positive earnings for the last ten years); (5) a good dividend record; (6) an earnings growth measure of at least one-third per share over a ten-year period, averaging the first three years and the last three years to remove extremes; (7) a moderate price earnings ratio

that this approach would disqualify most publicly traded securities as imprudent investments.[212] Nevertheless, the Alabama court found that, although the REIT bonds paid high rates of interest, they carried an inordinate degree of risk[213] and that such risk taking clearly violated the prudent person rule.[214] Likewise, the court found the stocks to be unnecessarily risky.[215] The court characterized these investments as speculative because, as growth company stocks, each focused solely on increased returns.[216] Thus, despite the potential for higher income, the trustee breached its duty of caution by failing to preserve the trust corpus.[217]

Arguably, applying the prudent investor rule would alter this outcome.[218] In *Martin*, the court seemed indifferent to both the percentage of the portfolio devoted to the challenged investments and the overall composition of the portfolio.[219] Rather, the court considered each investment in isolation.[220] The prudent investor rule rejects this method.[221]

> of no more than fifteen to one; and (8) a moderate ratio of price to assets of no more than one and one half to one.

Id. at 419-20. In contrast, the bank used the following criteria to evaluate each purchase: (1) a rating of B+ or better by Standard & Poor's (B+ is an average rating and B is a speculative rating); (2) a minimum of 1.5 million shares of stock in the hands of the public; and (3) annual sales of at least $100 million. *Id.* at 419.

212. *See id.* at 419-21 (describing respective investment standards used by parties). The plaintiffs' expert witness, Dr. Robert Johnston, conceded on cross-examination that only five of the thirty stocks in the Dow Jones Industrial Average would meet the criteria employed by the court in considering the challenged investments. *Id.* at 420.

213. *Id.* at 421.

214. *See id.* at 429 (finding no error in lower court's holding against trustee for six REIT purchases).

215. *Id.* at 427-28.

216. *See id.* at 427 (concluding that trustee did not consistently use long-term investment standards in making stock purchases); *cf.* Willis, *supra* note 134, at 229 (indicating that investments held for long period of time to produce income are not imprudent).

217 *Martin*, 425 So. 2d at 429.

218. *See* Aalberts & Poon, *supra* note 69, at 51-52 (discussing *Martin* decision and concluding that "it is highly unlikely that under [the *Restatement (Third)*] the foregoing cases [including the *Martin* decision] would be treated as they were").

219. *See* Gordon, *supra* note 136, at 71 (remarking on *Martin* court's indifference to proportion of challenged investments in portfolio and to makeup of portfolio as whole).

220. *See Martin*, 425 So. 2d at 420 (reviewing several common trust fund investments by corporate trustee and finding each to be too speculative).

221. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. b (1992) (explaining that use of trust's performance or hindsight is inappropriate when judging trustee's investment conduct). The *Restatement (Third)* states that "[t]he trustee is not a guarantor of the trust's investment performance." *Id.*, *see also* Donovan v Walton, 609 F Supp. 1221, 1228

The logic of the prudent investor rule is simple: The burden imposed by requiring trustees to monitor each investment individually prompts trustees to limit the number of holdings.[222] Such underdiversification creates greater overall risk and lower rates of return for the portfolio.[223] Under the prudent investor rule, the *Martin* court would have considered how the decisions surrounding the purchases of the challenged investments fit into the larger strategy of the two common trust funds. From this broader perspective, the court would have seen that some of the investments were both prudent and reasonable.[224] In all likelihood, then, the Alabama court would have reduced the surcharge.

3. *In re* Bank of New York (Spitzer)

In re Bank of New York (Spitzer)[225] illustrates how a court might apply the prudent investor rule's anti-netting provision.[226] In this case, the New York Court of Appeals considered a challenge to four investments held in a common trust fund.[227] During the four-year accounting period in question, the fund as a whole experienced a gross gain of $1.7 million with losses of $238,000.[228] The Surrogate[229] granted summary judgment for the

(S.D. Fla. 1985) (deciding that imprudent conduct, not poor investment result, is basis for trustee liability); Stark v United States Trust Co., 445 F Supp. 670, 678 (S.D.N.Y 1978) (same).

222. *See* Cheris, *supra* note 49, at 340 (criticizing requirement that trustees monitor investments separately as leading to underdiversification).

223. *Cf.* Levy, *supra* note 58, at 13-14 (illustrating dangers of underdiversification).

224. *Cf.* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. k, reporter's notes (1992) (explaining that, even within total portfolio context, *Martin* court correctly found some of challenged investments too risky; however, court's findings as to remaining investments depended exclusively on rigid and arbitrary criteria).

225. 323 N.E.2d 700 (N.Y 1974).

226. *In re* Bank of New York (Spitzer), 323 N.E.2d 700, 701-04 (N.Y 1974) (considering losses sustained with respect to four investments by fiduciary); *cf.* Gordon, *supra* note 136, at 97 (pointing to *Bank of New York (Spitzer)* as possible application of prudent investor rule's anti-netting standard).

227 *Bank of New York*, 323 N.E.2d at 701.

228. *Id.* at 702.

229. "Surrogate" is "[t]he name given in some of the states to the judge or judicial officer who has jurisdiction over the administration of probate matters, guardianships, etc." BLACK'S LAW DICTIONARY 1445 (6th ed. 1990). With respect to New York, *Black's* adds:

> In New York the Surrogate's Court has jurisdiction over all actions and proceedings related to the affairs of decedents, probate of wills, administration of estates and actions and proceedings arising thereunder or pertaining thereto, guardian-

bank on only two of the challenged investments.[230] However, the appellate division held for the bank on all four investments,[231] and the court of appeals affirmed.[232]

In deciding that the bank acted prudently, the court of appeals rejected the basis for the appellate division's ruling — that the net gain to the trust precluded any need for a surcharge.[233] The court of appeals explained that net increases should not insulate the trustee from being held accountable for all of its investment decisions.[234] The court reasoned that if trustees had this kind of immunity in rising markets, it might encourage unwarranted risk taking in an effort to recover other losses.[235] Ironically, this reasoning cultivated wider judicial acceptance of portfolio theory by recognizing that any determination of the safety of a specific investment decision must consider that investment in relation to the portfolio as a whole.[236]

> ship of the property of minors, and such other actions and proceedings, not within the exclusive jurisdiction of the supreme court, as may be provided by law.

Id.

230. *Bank of New York*, 323 N.E.2d at 702. The Surrogate granted summary judgment for the bank in regard to investments in Harcourt, Brace & World, Inc. and Mercantile Stores Company, Inc. and denied summary judgment as to the investments in Boeing Company and Parke, Davis & Company *Id.*

231. *Id.*

232. *Id.* at 704. The court of appeals observed that, for each investment, "the trustee acted in good faith and cannot be said to have failed to exercise 'such diligence and such prudence in the care and management of the fund, as in general, prudent men of discretion and intelligence employ in their own like affairs.'" *Id.* (citations omitted).

233. *Id.* at 703.

234. *Id.* The court of appeals observed:

> The fact that this portfolio showed substantial overall increase in total value during the accounting period does not insulate the trustee from responsibility for imprudence with respect to individual investments for which it would otherwise be surcharged. To hold to the contrary would in effect be to assure fiduciary immunity in an advancing market

Id., *cf.* Gordon, *supra* note 136, at 97 (agreeing with court's decision not to insulate trustees from liability despite overall increases in portfolio value).

235. *See* Gordon, *supra* note 136, at 97 (commenting that if *Bank of New York* had held otherwise it would have encouraged unwarranted risk taking by trustees to recoup from errors); *cf.* Halbach, *supra* note 8, at 458 (noting policy concern that allowing losses to be offset with profits could encourage multiple breaches of trust).

236. *See In re* Bank of New York (Spitzer), 323 N.E.2d 700, 703 (N.Y 1974) (warning against assessing investments as if segregated from rest of portfolio). The court stated:

> The record of any individual investment is not to be viewed exclusively, of course, as though it were in its own watertight compartment, since to some extent individual investment decisions may properly be affected by considerations

Despite criticism that it impedes the use of modern portfolio theory,[237] the anti-netting approach to damages suggested by the *Bank of New York* decision appears as a part of the prudent investor rule.[238] However, the prudent investor rule modifies the anti-netting approach to avoid unnecessary harshness in dealing with good faith breaches.[239] For example, a trustee arguably could commit a good faith breach by purchasing an unusually risky investment for purposes of diversification.[240] Yet, the prudent investor rule encourages trustees to make such purchases regularly to enhance portfolio performance.[241] By focusing its decision on whether the trustee acted in good faith, and not on whether the gain exceeded the loss, the *Bank of New York* decision likely would remain undisturbed under the prudent investor rule.[242] Moreover, the prudent investor rule would facili-

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> of the performance of the fund as an entity, as in this instance, for example, of individual security decisions based in part on considerations of diversification of the fund or of capital transactions to achieve sound tax planning for the fund as a whole. The focus of inquiry, however, is nonetheless 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.

Id., *cf.* Cheris, *supra* note 49, at 340 (referring to *Bank of NewYork* as first decision to hint at applicability of modern portfolio theory to fiduciary investment responsibilities).

237 *See* Ipsen, *supra* note 4, at 450 (commenting that anti-netting rule is at odds with modern portfolio theory). *But see* Gordon, *supra* note 136, at 97 (concluding that anti-netting rule is not inconsistent with modern portfolio theory); Halbach, *supra* note 8, at 457 (contesting belief that anti-netting rule inhibits reliance on modern portfolio theory).

238. *See* RESTATEMENT (THIRD) OF TRUSTS § 213 (1992) (continuing traditional support for anti-netting rule with some modifications).

239. *See* Halbach, *supra* note 8, at 458 (finding that revised anti-netting rule avoids being overly punitive in dealing with good faith breaches).

240. *See* Gordon, *supra* note 136, at 97 (concluding that breach of trust does not occur with purchase of security or instrument that appears particularly volatile when viewed in isolation).

241. *See id.* (noting that rational portfolio strategy requires diversification). Professor Gordon commented:

> A misapplied anti-netting rule would make portfolio theory impossible to use, for the very essence of a portfolio strategy is diversification such that losses will be balanced out by gains in a way that makes the overall portfolio less risky and the overall returns more dependable. It is a rational portfolio strategy to include some securities whose expected returns are negative, if, for example, in unusually difficult economic times their returns are positive and will balance out losses on the rest of the portfolio.

Id.

242. *Cf. In re* Bank of New York (Spitzer), 323 N.E.2d 700, 701-04 (N.Y 1974) (concluding that trustee acted in good faith with respect to purchase, retention, and sale of challenged investments); Gordon, *supra* note 136, at 67 (noting that application of prudent

tate this result by clarifying the means for determining the prudence of a particular investment under similar circumstances.[243]

B. The Response Among the States

Prior to the adoption of the *Restatement (Third)* in 1992, several states amended their fiduciary administration statutes to incorporate modern investment principles. These revisions generally enable, but do not require, trustees to follow the tenets of modern portfolio theory [244] The statutes also emphasize a total-portfolio standard of care similar to that described in Sections 227-229 of the *Restatement (Third)*.[245] The states that have amended their fiduciary administration statutes in advance of the Restatement (Third) include Delaware,[246] Georgia,[247] Minnesota,[248] and Tennessee.[249]

Beginning in 1991, four other states modified their statutes to reflect the new standards found in both the draft and final versions of the *Restatement (Third)*.[250] These states include Florida,[251] Illinois,[252] New

investor rule does not require courts to overrule past cases, but merely to re-interpret them in light of new standard).

243. *See* Taylor, *supra* note 26, at 63 (noting that new version of anti-netting rule offers considerable assurance of no penalties for trustees who commit modest portions of portfolio to high risk or underproductive ventures so long as such investments fit reasonably into diversified overall strategy when made); *cf.* Chase v. Pevear, 383 Mass. 350, 362-70 (1981) (supporting, in dicta, principles underlying revised anti-netting standard); Gordon, *supra* note 136, at 97 (citing revised anti-netting rule as means for deciding prudence of particular investment).

244. *See* RESTATEMENT (THIRD) OF TRUSTS § 227, reporter's note (1992) (introducing discussion of recent state legislation updating rules of prudent investing).

245. *See id.* (comparing several state statutes passed prior to ALI's adoption of *Restatement (Third)*).

246. *See* DEL. CODE ANN. tit. 12, § 3302 (1986) (describing state's prudent investment standards for fiduciaries).

247 *See* GA. CODE ANN. § 53-8-2 (1995 & Supp. 1996) (describing state's prudent investment standards for executors and trustees).

248. *See* MINN. STAT. ANN. § 501B.10 (West 1990) (describing state's prudent investment standards for trustees). As of January 1, 1997, Minnesota repealed the foregoing statute and adopted the Uniform Prudent Investor Act (UPIA). *Id.* § 501B.151 (West Supp. 1997) (codifying UPIA).

249. *See* TENN. CODE ANN. § 35-3-117 (1996) (describing state's prudent investment standards for fiduciaries).

250. *See* Langbein, *supra* note 149, at 116 (noting that, in 1991, Illinois loosely patterned its prudent investor rule on *Restatement (Third)*).

251. *See* FLA. STAT. ANN. § 518.11 (West 1988 & Supp. 1997) (describing state's prudent investment standards for fiduciaries).

252. *See* 760 ILL. COMP. STAT. ANN. 5/5-5/5.1 (West 1992) (describing state's prudent

York,[253] and Virginia.[254] Given that these statutes are the first codifications of the prudent investor rule, they merit close consideration.

Of these four statutes, the Illinois and Florida versions are most similar.[255] Although each statute differs considerably from the language of the *Restatement (Third)*, each carefully mimics its substance.[256] However, both of these statutes contain two important distinctions that set their versions of the prudent investor rule apart from the *Restatement (Third)*.

First, both Florida and Illinois require a fiduciary to notify the beneficiaries in writing prior to any delegation of the investment functions.[257] The *Restatement (Third)* mandates no such requirement.[258] With respect to these notification provisions, the statutes also differ from one another. Florida asks for notification "within 30 days of the delegation," whereas Illinois requires notice "at least 30 days before the delegation."[259] This difference makes the Florida notice requirement somewhat more permissive.

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investment standards for trustees). Illinois recently amended this statute to empower trustees to invest in mutual funds. *Id.* § 5/5.2 (West Supp. 1996).

253. *See* N.Y. EST. POWERS & TRUSTS LAW § 11-2.3 (McKinney Supp. 1997) (describing state's prudent investment standards for trustees).

254. *See* VA. CODE ANN. § 26-45.1 (Michie 1992) (describing state's prudent investment standards for fiduciaries).

255. *See* Jerold I. Horn, *Prudent Investor Rule: Impact on Drafting and Administration of Trusts*, C891 A.L.I.-A.B.A. 235, 244 (1994) (concluding that Florida and Illinois versions of prudent investor rule are more similar to each other than to *Restatement (Third)*). *See generally* Philip N. Hablutzel, *May an Attorney in Illinois Be a Trustee?*, 83 ILL. B.J. 22 (1995) (offering overview of Illinois prudent investor legislation).

256. *See* Horn, *supra* note 255, at 244 (noting that Florida and Illinois versions of prudent investor rule are similar in substance to *Restatement (Third)*; however, each statute's language differs considerably from language of *Restatement (Third)*).

257 *See* FLA. STAT. ANN. § 518.112(2)(c) (West Supp. 1997) (requiring written notice to beneficiaries before delegation of investment functions); *see also* 760 ILL. COMP. STAT. ANN. 5/5.1(b)(6) (West 1992) (requiring written notice to beneficiaries prior to delegation of investment functions); *cf.* Allard v Pacific Nat'l Bank, 663 P.2d 104, 110 (Wash. 1983) (finding that fiduciary's overall conduct, including failure to inform beneficiaries prior to sale of sole trust asset, constituted breach of fiduciary duty), *amended by* 773 P.2d 420 (Wash. 1989).

258. *See* RESTATEMENT (THIRD) OF TRUSTS § 171 cmt a (1992) (explaining that decisions by trustees concerning delegation are matters of fiduciary judgment and discretion).

259. *Compare* FLA. STAT. ANN. § 518.112(2)(c) (West Supp. 1997) (requiring written notice to beneficiaries *within* 30 days of delegation of investment functions), *with* 760 ILL. COMP. STAT. ANN. 5/5.1(b)(6) (West 1992) (requiring written notice to beneficiaries *at least* 30 days prior to delegation of investment functions).

Second, the Florida and Illinois versions arguably impose a weaker duty to diversify than does the *Restatement (Third)*.[260] The *Restatement (Third)* requires diversification unless special circumstances make diversification imprudent.[261] Given that modern portfolio theory considers diversification essential to prudent investing,[262] such special circumstances rarely exist.[263] In contrast, both Florida and Illinois dispense with the duty to diversify if the fiduciary possesses a reasonable belief that nondiversification is in the trust's best interest.[264] This curious distinction appears to create a more subjective standard regarding the trustee's decision to diversify.[265]

Compared to Florida and Illinois, Virginia adopted only modest revisions to its prudent investor statute.[266] Most notably, aside from requiring a fiduciary to consider individual investments within the context of the whole portfolio, the Virginia statute offers little guidance as to other investment considerations.[267] Nor does it make any express provision for the

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260. *See* Horn, *supra* note 255, at 245 (suggesting that Florida and Illinois versions of prudent investor rule may impose weaker duty of diversification than *Restatement (Third)* imposes).

261. *See* RESTATEMENT (THIRD) OF TRUSTS § 227(b) (1992) (mandating diversification of trust assets unless, under certain circumstances, it is prudent not to do so).

262. *See id.* § 227 cmt. g (identifying reduction of uncompensated risk through diversification as central feature of prudence).

263. *Cf. id.* (explaining that justifying drastic departures from reasonable degree of diversification requires sound basis, such as unusual investment objectives needing major commitment of trust assets for particular enterprise).

264. *See* FLA. STAT. ANN. § 518.11(1)(c) (West Supp. 1997) (imposing duty to diversify unless fiduciary reasonably believes it is in best interest of beneficiaries and furthers purposes of trust not to diversify); 760 ILL. COMP. STAT. ANN. 5/5(a)(3) (West 1992) (same).

265. *Cf.* Horn, *supra* note 255, at 245 (calling possibly lesser duty to diversify in Florida and Illinois "curious" departure from main themes of prudent investor rule).

266. *Cf.* Langbein, *supra* note 149, at 116 (characterizing Virginia's 1992 revision of its prudent investor statute as modest).

267 *See* FLA. STAT. ANN. § 518.11(1)(f) (West Supp. 1997) (allowing fiduciary to consider general economic conditions, possible effects of inflation, expected tax consequences, expected total return, and duty to incur only reasonable costs when making investment decisions); 760 ILL. COMP. STAT. ANN. 5/5(a)(6) (West 1992) (same); N.Y EST. POWERS & TRUSTS LAW § 11-2.3(b)(3)(B) (McKinney Supp. 1997) (requiring consideration of size of portfolio, nature and estimated duration of fiduciary relationship, liquidity and distribution requirements of governing instrument, general economic conditions, possible effects of inflation or deflation, expected tax consequences, expected total returns, and needs of beneficiaries for present and future distributions as part of investment decisions). *But see* VA. CODE ANN. § 26-45.1(A) (Michie 1992) (requiring only consideration of individual investments in context of investment portfolio as whole).

delegation of investment functions. This omission stands in sharp contrast to the Florida, Illinois, and New York statutes.[268] Finally, although the Virginia statute authorizes the fiduciary to acquire and retain every type of property and investment that a prudent person would,[269] it does not impose any duty with respect to the original assets of the trust. Again, the absence of this feature distinguishes the Virginia statute from the other three statutes.[270] Thus, although the Virginia prudent investor statute now incorporates portfolio theory, it fails to include several key features of the *Restatement (Third)* that facilitate the application of the theory As a result, the Virginia statute represents only nominal progress over the prudent person standard that it replaces.

The New York statute[271] is the most comprehensive of the four statutes.[272] This specificity stems from its relatively late enactment[273] and the resultant ability to draw on both the *Restatement (Third)* and the then-proposed Uniform Prudent Investor Act (UPIA)[274] for its structure.[275] As

268. *See* FLA. STAT. ANN. § 518.112(1) (West Supp. 1997) (allowing delegation of investment functions when prudent investor of comparable skills would delegate); *see also* 760 ILL. COMP STAT. ANN. 5/5.1(a) (West 1992) (imposing duty not to delegate except for investment functions that prudent investor of comparable skills would delegate under same circumstances); N.Y. EST. POWERS & TRUSTS LAW § 11-2.3(b)(4)(C) (McKinney Supp. 1997) (authorizing delegation of investment and management functions if consistent with trustee's duty to exercise skill).

269. *See* VA. CODE ANN. § 26-45.1(A) (Michie 1992) (authorizing fiduciary to acquire and retain every kind of property — real, personal, or mixed — and every kind of investment that persons of prudence, discretion, and intelligence would acquire and retain for their own account under same circumstances).

270. *See* FLA. STAT. ANN. § 518.11(1)(d) (West Supp. 1997) (imposing duty on fiduciary to review investment portfolio and to make and implement decisions concerning retention and disposition of pre-existing investments); 760 ILL. COMP STAT. ANN. 5/5(a)(4) (West 1992) (same); N.Y. EST. POWERS & TRUSTS LAW § 11-2.3(b)(3)(D) (McKinney Supp. 1997) (requiring trustee to determine whether to retain or dispose of initial assets within reasonable time after creation of fiduciary relationship).

271. *See* N.Y. EST. POWERS & TRUSTS LAW § 11-2.3 (McKinney Supp. 1997) (describing state's prudent investment standards for trustees).

272. *See generally* Joshua S. Rubenstein, *1994 New York State Legislative Changes Affecting Estate Planning*, 67 N.Y. ST. B.J. 37 (1995) (describing passage of New York prudent investor statute).

273. *See* N.Y. EST. POWERS & TRUSTS LAW § 11-2.3(a) (McKinney Supp. 1997) (making statute applicable to any investment made or held by trustee on or after January 1, 1995). The Florida, Illinois, and Virginia prudent investor statutes took effect in 1993, 1991, and 1992, respectively. *See* UNIF PRUDENT INVESTOR ACT, 7B U.L.A. 18 (Supp. 1996) (listing dates Florida, Illinois, and Virginia enacted prudent investor statutes).

274. *See generally* UNIF PRUDENT INVESTOR ACT, 7B U.L.A. 18 (Supp. 1996) (making available complete text of proposed UPIA).

275. *See* Sanford J. Schlesinger & Arlene Harris, *Prudent Investor Act Becomes Law*,

a result, the statute eases fiduciaries into the role of "investors" of trust property with very explicit standards and language.[276]

In so doing, the New York version differs from its three companion statutes in several significant respects. First, unlike Florida and Illinois, the New York statute holds fiduciaries with special investment skills to a higher standard of care and diligence.[277] This provision flows directly from standards for professional fiduciaries set out in the *Restatement (Third)*.[278] Second, unlike the other states, New York codifies the requirement of cost-consciousness with respect to both trust investments and administration.[279] Finally, New York does not insulate a fiduciary from the actions and decisions of a delegate, as do Florida and Illinois.[280] Instead, the New York statute imposes on the delegate a fiduciary duty to the trustee and invalidates any attempt to exonerate the delegate from that duty.[281] Generally speaking, these differences allow the New York statute to reflect more accurately the full spirit of the *Restatement (Third)*. These differences also make the statute slightly more stringent than its counterparts with respect to the fiduciary's duties.

N.Y.L.J., Aug. 4, 1994, at 1 (explaining that New York statute draws on *Restatement (Third)*, recent Illinois legislation, and preliminary version of UPIA).

276. *Cf.* Edward V Atnally, *Prudent Investor Act: Its Effect on Executors*, 67 N.Y. ST. B.J. 12, 12 (1995) (noting that new statute moves executors away from traditional role as conservators of estate assets and into role as investors).

277 *Compare* N.Y. EST. POWERS & TRUSTS LAW § 11-2.3(b)(5) (McKinney Supp. 1997) (requiring fiduciaries with special investment skills to exercise those skills in investing and managing assets), *with* FLA. STAT. ANN. § 518.11(1)(a) (West Supp. 1997) (imposing duty on fiduciaries with special investment skills to use those skills). *See generally* Rubenstein, *supra* note 272, at 37 (noting that 1995 New York Prudent Investor Act holds fiduciaries with special investment skills to higher standard).

278. *Cf.* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. d (1992) (explaining that, if trustee possesses degree of skill greater than that of individual of ordinary intelligence, trustee is liable for loss that results from failure to make reasonably diligent use of that skill).

279. *See* N.Y. EST. POWERS & TRUSTS LAW § 11-2.3(b)(4)(D) (McKinney Supp. 1997) (authorizing fiduciary to incur costs only to extent it is appropriate and reasonable in relation to purposes of governing instrument, assets held by trustee, and skill of trustee).

280. *See* Schlesinger & Harris, *supra* note 275, at 7 (noting that provision was controversial late amendment to legislation requested by state attorney general for protection of beneficiaries). *But cf.* FLA. STAT. ANN. § 518.112(3) (West Supp. 1997) (releasing fiduciary from responsibility for agent's investment decisions or actions if fiduciary meets general requirements for delegation); 760 ILL. COMP STAT. ANN. 5/5.1(c) (West 1992) (releasing trustee from liability for investment decisions or actions of investment agent after satisfying all requirements for delegation).

281. *See* N.Y EST. POWERS & TRUSTS LAW § 11-2.3(c)(2) (McKinney Supp. 1997) (imposing on delegate duty to exercise delegated function with reasonable care, skill, and caution, and calling any attempt to exonerate delegate from liability for failure to meet duty as contrary to public policy and void).

The UPIA is the most recent statutory development to address the general concern about rigid fiduciary investment practices.[282] The National Conference of Commissioners on Uniform State Laws approved the UPIA in 1994.[283] The American Bar Association approved the UPIA in February 1995[284] By standardizing five fundamental alterations to the criteria for prudent investing,[285] the UPIA facilitates the implementation of the *Restatement (Third)*'s main principles.[286]

Section 2 is the heart of the UPIA.[287] In general, the language in this section loosely follows that of Section 227 of the *Restatement (Third)*, the Illinois statute, and Section 7-302 of the Uniform Probate Code.[288] In providing a uniform standard of care, Section 2 stresses that different beneficiaries have different needs and, therefore, that the risk level of each investment strategy should correspond to the individual purposes of the trust.[289] Similarly, Section 2 draws a distinction between amateur and professional trusteeship and sets the standard for professionals higher than that for nonprofessionals.[290] As a result, Section 2 attempts to be sensitive to the needs of every trust, regardless of its size.[291]

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282. *See generally* UNIF PRUDENT INVESTOR ACT, 7B U.L.A. 18 (Supp. 1996) (setting forth complete text, prefatory note, and comments).

283. *See id.* (listing date of approval by National Conference of Commissioners on Uniform State Laws).

284. *See* John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV 641, 641 (1996) (reporting February 1995 adoption of UPIA by American Bar Association).

285. *See* UNIF PRUDENT INVESTOR ACT, 7B U.L.A. 19 (Supp. 1996) (stating the objectives of UPIA). The UPIA identifies the criteria for prudent investing as (1) the use of a total portfolio rather than an individual investment process; (2) an appreciation for tradeoffs between risks and returns; (3) the removal of restrictions that bar certain types of investments; (4) an enhanced duty to diversify investments; and (5) the elimination of the former prohibition on delegation. *Id.*

286. *See* Langbein, *supra* note 149, at 116 (noting that UPIA seeks to implement main principles of *Restatement (Third)*).

287 *See* UNIF PRUDENT INVESTOR ACT § 2 cmt., 7B U.L.A. 22 (Supp. 1996) (highlighting overall importance of UPIA Section 2).

288. *See id.* (identifying similarity between language of UPIA Section 2 and several other authorities relating to prudent investing).

289. *See id.* (stressing that risk level of investment strategy should correspond with both needs of beneficiary and purposes of trust). The comment to Section 2 of the UPIA notes that a "trust whose main purpose is to support an elderly widow of modest means will have a lower risk tolerance than a trust to accumulate for a young scion of great wealth." *Id.*

290. *See id.* (concluding that, because standard of prudence is relative, it follows that standard for professionals is that of prudent professionals; for amateurs, it is that of prudent amateurs).

291. *Cf. id.* (commenting that UPIA emphasizes factors that are sensitive to traits of small trusts, including needs for varying risk-return objectives and levels of expertise among trustees).

As noted above, several states already have taken steps to benefit from the current perspective on prudent fiduciary investment found in the *Restatement (Third)*. However, given that a large majority of states continue to rely on the prudent person rule, these states are the exception. Nevertheless, as of 1996, several states have enacted the UPIA.[292] Those states include Arizona, California, Colorado, New Mexico, Oklahoma, Utah, and Washington.[293] Hopefully, by distilling the principles of the *Restatement (Third)* into a succinct working model, the UPIA will enable the remaining states to move more easily to this improved investment standard.

VI. Conclusion

Under the prudent investor rule, trust doctrine returns to the flexible standard advanced in *Harvard College*.[294] In so doing, the prudent investor rule tries to monitor fiduciary investments closely without restricting the trustee's ability to respond effectively to the uncertainty of a dynamic economy.[295] With trusts beginning to play an increasingly important role in our society, those states without such a fiduciary investment standard should immediately

292. *See* Langbein, *supra* note 284, at 641-42 (listing states that adopted UPIA in 1995).

293. *See* ARIZ. REV. STAT. ANN. §§ 14-7601 to -7611 (West Supp. 1996) (adopting several sections of UPIA); CAL. PROB. CODE §§ 16045-16054 (West Supp. 1996) (same); COLO. REV. STAT. ANN. §§ 15-1.1-101 to -115 (West Supp. 1995) (same); N.M. STAT. ANN. §§ 45-7-601 to -612 (Michie 1978 & Supp. 1995) (same); OKLA. STAT. ANN. tit. 60, §§ 175.60-.72 (West Supp. 1997) (same); UTAH CODE ANN. §§ 75-7-302 to -303 (Supp. 1996) (same); WASH. REV. CODE ANN. § 11.100.010-.130 (West Supp. 1997) (same).

294. *See* RESTATEMENT (THIRD) OF TRUSTS, introduction (1992) (describing prudent investor rule as modest reformulation of original *Harvard College* standard).

295. *But see* Haskell, *supra* note 2, at 110-11 (arguing that uncertain economic times caution against expanding use of modern portfolio theory under prudent investor rule to private trusts). Professor Haskell warned:

> At the present time the economic landscape is a mine field. There are large perennial federal budget deficits and an enormous federal debt. There are large perennial trade deficits. There is a huge and growing foreign investment in our federal debt and in our economy. Our major banks have huge loans of questionable value to third world countries. Some of our major industries have great difficulty competing with foreign products. The economic impact of the European Community remains to be seen. Elementary and secondary education in this country is a disaster area. Many of our older cities have rotting infrastructures (bridges, sewer lines, water mains, gas lines). The social pathology of our urban centers worsens. Unless the business cycle is obsolete, a recession is long overdue. When this nation decides to face up to the reality of its situation, it will be enormously expensive, with uncertain consequences. I would suggest that anyone who is daring with another's money in these circumstances is not acting responsibly.

Id. at 110.

implement legislation reflecting the wisdom of the *Restatement (Third)*.[296]

Fueling the urgency of this recommendation are several ongoing demographic shifts that increase the need for flexible trust management.[297] First, private wealth in this country has increased dramatically in recent years.[298] Moreover, this newer wealth differs considerably in form from private wealth of the past.[299] Whereas previous generations had wealth comprised primarily of tangible property — like farms — people today invest their money in financial assets[300] — like stocks and bonds.[301] In fact, for many Americans, pension plan benefits — a form of wealth composed almost entirely of marketable securities[302] — constitute their largest asset.[303]

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296. *Cf.* UNIF. PRUDENT INVESTOR ACT, 7B U.L.A. 19 (Supp. 1996) (discussing adoption of prudent investor statutes in several states both before and after issuance of *Restatement (Third)*); J. Timothy Ritchie, *Is the Prudent Person Rule Obsolete?*, TR. & EST., Jan. 1989, at 28, 65 (concluding that it is time to update prudent person rule to enable fiduciaries to maximize returns for all beneficiaries).

297 *Cf.* JESSE DUKEMINIER & STANLEY M. JOHANSON, WILLS, TRUSTS, AND ESTATES 571 (5th ed. 1995) (concluding that increasing personal wealth creates increasing needs for property management); Carolyn T. Geer, *Trust a Trust*, FORBES, Aug. 14, 1995, at 168, 168 (calling trust necessity for middle class). *See generally* John H. Langbein, *The Twentieth-Century Revolution in Family Wealth Transmission*, 86 MICH. L. REV 722 (1988) (discussing enormous demographic shifts over last century affecting estate planning for persons with middle and upper-middle incomes).

298. *See* DUKEMINIER & JOHANSON, *supra* note 297, at 571 (illustrating recent increase in private wealth with Federal Reserve data). In 1991, American banks held more than $450 billion in some 900,000 irrevocable trusts, with individual trustees managing billions more. *Id.*, *cf.* Cristina Merrill, *N.Y. Law Seen Widening Trust Market for Banks*, AM. BANKER, May 15, 1995, at 17 (citing estimates that $6 to $10 trillion will pass from older to younger generation in next 25 years).

299. *See* John H. Langbein, *The Nonprobate Revolution and the Future of the Law of Succession*, 97 HARV L. REV 1108, 1119 (1984) (concluding that "bulk of modern wealth takes form of contract rights rather than rights in rem"). Professor Langbein observed: "Promissory instruments — stocks, bonds, mutual funds, bank deposits, and pension and insurance rights — are dominant component of today's private wealth." *Id.*

300. *Cf.* Langbein, *supra* note 297, at 729 (explaining how movement to complex industrial economy encourages today's family to invest its wealth in financial instruments); *id.* at 739 (describing financial assets as "distinctly modern form of property that was still of peripheral importance in last century").

301. *See* Kathy L. Anderson & Brian W Smith, *Banks Explore Options on Trust Conversions as Congress Deliberates*, 21 BANKING POL'Y REP 19, 19 (1993) (reporting growth of mutual funds). A recent count revealed that there are approximately four thousand mutual funds in the United States, with total assets approaching $2 trillion. *Id.*

302. *See* Langbein, *supra* note 297, at 739 (noting that financial assets comprise majority of pension funds); *cf. id.* at 740 (illustrating that, as of 1984, pension funds owned 22.8% of U.S. equity securities and about half of all corporate debt in United States).

303. *See id.* at 740 (revealing that pension wealth is largest asset for many middle and upper-middle class families).

Second, the average life expectancy is significantly greater than ever before.[304] Whereas shorter lifetimes formerly obviated the need for a stream of retirement income, our increasing longevity makes such income crucial today.[305] Similarly, with longer life also has come the fear of prolonged incapacity and its attendant medical expenses.[306] Together, these trends signal a fundamental change in the needs of many trust beneficiaries.

Historically, trusts worked to accumulate and transfer wealth from one generation to the next using "dynastic" estate plans.[307] Today, however, the trends described above encourage estate planning that uses private wealth to provide the income needed to guard against premature death, old age, or incapacity.[308] As the considerable growth in trust management suggests,[309] trusts play an increasingly central role in such planning.[310] However, as the needs of beneficiaries become more oriented toward income,[311] inflation's

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304. *See id.* (describing advances in medicine and sanitation as reason for 66% increase in average life expectancy since 1900). In fact, some researchers believe that the eventual norm of the human life span will be approximately 85 years. *Id.*

305. *See id.* (explaining that, in previous century, life expectancy was such that one was not likely to need much retirement income).

306. *Cf.* DUKEMINIER & JOHANSON, *supra* note 297, at 641 (discussing increasing necessity for use of support trusts in dealing with incapacity).

307 *See generally* Jerry A. Kasner, *A Trust Law Professor's Perspective*, TR. & EST., May 1995, at 58 (expressing opinion that most clients do not use trusts to effect "dynastic" estate plans that accumulate large amounts of wealth for succeeding generations).

308. *See* Langbein, *supra* note 297, at 750 (concluding that estate planning services for middle and upper-middle class persons resemble contingency planning in which client's primary concern is to make arrangement for client's family in unlikely event of premature death); *see also* Todd, *supra* note 79, at 281 (stating that "virtually all estate and tax attorneys have clients who rely on trusts to grow and preserve assets for their heirs or to provide sufficient retirement income").

309. *See* Langbein, *supra* note 297, at 740 (estimating total assets of nonfederal pension plans at approximately $2 trillion); *see also* Geer, *supra* note 297, at 168 (illustrating middle class's increased use of trusts by pointing to formation of 60 independent trust companies since 1990, including several by discount brokers and fund operators such as PaineWebber and Fidelity Investments). Emphasizing the growing use of trusts, Geer noted that "[f]rom a standing start five years ago, [Charles Schwab & Co.] now has $23 billion in personal trust assets." *Id.*

310. *See* Edward C. Halbach, Jr., *Trusts in Estate Planning*, 2 PROB. LAW 1, 1 (1975) (noting utility of trusts). Professor Halbach concluded:

> Thus, the trust plays a central role in modern estate planning and has utility in nearly every family situation. It is indeed a rare client who should not at least seriously consider the use of a trust for some circumstances, even if only to cover certain contingencies that ought to be anticipated.

Id.

311. *See* Dobris, *supra* note 73, at 400 (using results of focus group meetings conducted by American Association of Retired Persons to illustrate that most investors favor safety and income above all else).

potentially corrosive effect on the trust corpus needed to generate that income poses greater concern.[312] Therefore, to fulfill their fiduciary obligations, trustees must have the managerial flexibility needed to address this concern.[313]

To this end, every state should enact legislation that adopts the primary elements of the prudent investor rule as described in the *Restatement (Third)*. However, given that the complex features of this new standard are, in part, counterintuitive to traditional notions of prudence,[314] legislatures must carefully consider the policy implications raised by such a transition.[315] To aid in this effort, lawmakers should draw upon three resources.

First, the UPIA offers foundational guidance in the practical application of the complexities underlying the prudent investor rule. Consequently, the UPIA provides an excellent framework from which to begin structuring a move to a modern fiduciary investment standard. Second, by looking to statutes already passed in other states, legislators may gain an understanding of how those states addressed localized concerns not reflected in the more general language of the UPIA. Where states share those concerns, such an understanding will assist legislators in tailoring a prudent investor standard that better fits local interests.

Finally, each state should consider the model provided by ERISA.[316] Passed in 1974, ERISA predates both the *Restatement (Third)* and the UPIA. As such, it represents the first attempt to use modern portfolio theory in combating the detrimental effects of inflation on pension trust funds.[317]

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312. *See supra* notes 52-54 and accompanying text (discussing effects of inflation on interest-bearing investments).

313. *See* RESTATEMENT (THIRD) OF TRUSTS, introduction (1992) (stating that rules governing fiduciary investments must be flexible and general enough to adapt to changes in financial world); *cf.* Cheris, *supra* note 49, at 342 (contending that today's fiduciary is usually sophisticated investment manager who possesses talent, knowledge, and skill and, therefore, requires less judicial paternalism).

314. *See* Haskell, *supra* note 2, at 103 (describing logic of modern portfolio theory as "counterintuitive"); *cf.* Gordon, *supra* note 136, at 90 (arguing that complexity of modern portfolio model has slowed its acceptance by judiciary).

315. *Cf.* Gordon, *supra* note 136, at 93 (describing how uncertainty over propriety of investments under prudent investor standard will make monitoring of trustee performance more problematic); Ritchie, *supra* note 296, at 65 (suggesting that prudent investor's conduct may be significantly different from conduct of prudent person under prudent person rule).

316. *Cf.* Sharon Reece & Mary Beth Navin, *Regulating Public Pension Fund Investments: The Role of Federal Legislation*, 6 B.Y.U. J. PUB. L. 101, 107 (1992) (noting that several statutes have already incorporated fiduciary rules of ERISA).

317 *See supra* notes 69-72 and accompanying text (discussing influence of ERISA); *cf.* Bobo, *supra* note 27, at 1077 (linking ERISA standard of prudence to common-law prudent investor rule); Ron Kilgard, *Lord Jim Faces Up to the Employee Retirement Income Security Act of 1974*, ARIZ. ATT'Y, Aug.-Sept. 1995, at 16, 18 (attributing standard of prudence found in ERISA § 404(a) to *Harvard College* holding).

Moreover, ERISA expresses perhaps the most sophisticated statement of the prudent investor standard.[318] As the rising demand for retirement income causes the needs of pension and trust beneficiaries to merge,[319] so too will the responsibilities of their respective fiduciaries.[320] Therefore, lawmakers should understand the interplay that exists between the theory underlying ERISA and the prudent investor rule advanced in both the *Restatement (Third)* and the UPIA.[321]

By developing standards of prudent investment that reflect the latest thinking on the subject, the *Restatement (Third)* considerably advances conventional trust doctrine. With this advance, fiduciaries are now free to safeguard trust portfolios against the fluctuations that attend the increasingly global marketplace.[322] More importantly, by instituting the *Restatement (Third)* and its prudent investor rule as a common feature in fiduciary investment standards, trustees can post a more vigilant watch for those devils that may lurk in the century ahead.

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318. *See* Arthur H. Kroll, *Nontraditional Investments Under ERISA: Panning for Gold*, PROB. & PROP., Jan.-Feb. 1995, at 23 (commenting that ERISA plan fiduciaries are subject to review under "the most sophisticated expression of prudence to have attained the force of law" (quoting LONGSTRETH, *supra* note 51, at 34)). *But see* Kilgard, *supra* note 317, at 17 (placing ERISA among most complicated American statutes ever enacted).

319. *Cf.* Bobo, *supra* note 27, at 1098 (concluding that, with respect to investment concerns, personal trusts and employee pension plans have few differences); Sherwin P Simmons, *Irrevocable Life Insurance Trusts: A Current Perspective*, C966 A.L.I.-A.B.A. 1, 13 (1994) (suggesting that, in light of prudent investor standard, ERISA fiduciary litigation decisions will influence case law governing personal trusts). *But see* Johnson, *supra* note 8, at 1185 (stating that ERISA fiduciaries and personal trust fiduciaries deal with two different types of investment vehicles).

320. *See* Bobo, *supra* note 27, at 1098 (comparing pension and trust beneficiaries). Bobo observed:

> [T]here is a distinct analogy to be drawn between income beneficiaries and retired employees on the one hand and between remaindermen and active employees on the other. The life beneficiary of a personal trust and retiree beneficiary of a [pension] plan are stereotypically only interested in a steady, unchanging return; the remaindermen of a personal trust and the employee presently contributing to the [pension] plan place a higher priority on increasing the principal. Thus, the differences among various fiduciaries regarding the basic principles that govern their investment decisions are not so great

Id.

321. *See id.* at 1099 (noting that current interpretation of prudent investor rule could apply generally to all fiduciary investments by incorporating flexible aspects and extracting inflexible aspects of common and statutory law).

322. *Cf.* Ritchie, *supra* note 296, at 65 (suggesting that recent volatility in stock and bond markets drives professional investors to explore different investment techniques to hedge against loss in value as well as to obtain enhanced yield).

SYMPOSIUM