

IS YOUR TRUSTEE A PRUDE? BECAUSE YOU WANT HIM TO BE.

Although the Uniform Prudent Investor Act became effective in Texas in 2004, the “Prudent Investor” standard has been a topic of litigation in American courts since the 19th century. To truly understand the purpose of the Act, one should not only understand the standard’s origin, but also its evolution and subsequent impact on trustees, attorneys, and financial planners.

I. Origins of the Prudence Standards for Trusts

A. Landmark Cases

(1) The Act’s historical background begins in 1719. This was the first time the rule was mentioned in Common Law courts in England. In response to a catastrophic collapse of a large private investment, the courts required fiduciaries to invest solely in securities backed by the British Government.

(2) In an 1830 Massachusetts case: *Harvard College v. Amory*. 26 Mass (9 Pick.) 446 (1831), American courts rejected the strict common law standard and adopted a more prudent standard. The following are the facts of that case:

- The Decedent, John M’Lean, died on October 23, 1823. He left a will which established a Trust for his spouse, Ann M’Lean. The Trust totaled \$50,000 and the income and profits were to be “received and collected by the said trustees and paid over to my said wife, Ann M’Lean, in quarterly or semi-annual payments . . . for and during the term of her natural life.” *Id.* at 446.
- Upon Ann’s death, the remainder of the Trust was to be divided equally between Harvard College and Massachusetts General Hospital.
- The Decedent’s estate totaled \$228,120. \$100,800 consisted of manufacturing stock, \$48,000 consisted of insurance stock, and \$24,700 consisted of bank stock.
- By October of 1828, the manufacturing stock’s book of value had decreased by more than 30%.
- The remaindermen of the testamentary trust brought action against the Trustees and alleged that the Trustees had invested in corporate stocks that were financially risky and, in so doing, had abused the power given to them as Trustees.
- The court eventually held that the “Trustees are not to be made chargeable but for gross neglect and willful mismanagement.” *Id.* at 461.
- The court also observed that

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.
Id. at 461.

The foregoing statement has been accepted and implemented in courts around the United States and was incorporated into Texas statute in 1971. *See, e.g.* Doss v. United States, 326 F. Supp. 1320, 1325 (N.D. Tex. 1971).

(3) Following *Harvard College v. Amory*, the New York Court of Appeals overturned the prudent man rule, and reverted to the more strict standard advocated by the common law courts. In *King v. Talbot*, 40 N.Y. 76 (1869) three children brought action against the executor of their father's estate. The following are the facts of that case:

- Charles W. King, the Decedent, died on a voyage from Ceylon to Suez on September 26, 1845, leaving behind a widow and three children: William Vernon King, Anna Henrietta King, and Arthur King.
- The Decedent's will, prepared in Macao, bequeathed \$15,000 to each of his children, "the interest on the same, so far as required, to be applied to their maintenance and education, and the principal, with any accumulations thereon, to be paid to them severally on their majority." *Id.* at 78.
- On December 31, 1849, the executors filed an inventory which totaled more than \$106,000.
- Between March 5, 1847 and December 19, 1847, the executors invested more than \$45,000 in United States treasury notes and Ohio State bonds.
- Between August 1, 1848 and November 10, 1849, they sold \$41,986 of the above investments for a profit of \$1,312.77. They proceeded to reinvest the profits in canal company stocks, railroad company stocks, and Bank of Commerce stock, for the children's benefit.
- The executors set apart \$45,390.45 from those investments for the Decedent's children, opened an account with the children and debited it with the \$45,320.45 as well as the income derived from those investments. Payments from the account were made to the children for their support and maintenance.
- The Decedent's children rejected the stock investments made by the executors and brought an action against them for "all the moneys invested in those stocks, with interest from the death of the testator, and for all profits resulting from their dealings with such moneys . . ." *Id.* at 80.
- Judge Woodruff, writing for the *King* court, stated that:

There is no underlying principal or rule of conduct in the administration of a trust, which calls for obedience. Whether it has been declared by the courts or not, whether it has been enacted in statutes or not, whether it is in familiar recognition in the affairs of life, there appertains to the relation of trustee and *cestui que trust*, a duty to be faithful, to be diligent, to be prudent in an administration entrusted to the former, in confidence in his fidelity, diligence and prudence. *Id.* at 84.

Although the *King* court adopted the Prudent Man Rule promulgated by the *Harvard* court, it restricted the investment options available to trustees in an effort to protect trust beneficiaries. In his opinion, Judge Woodruff added the following requirement for fiduciaries: “the fund . . . should always be subject to future recall for the benefit of the *cestui que trust*.” *Id.* at 88. This recallability requirement eliminated bank, insurance, and private stocks from the class of prudent investments available to executors and trustees. The court further warned that speculative investments would not be accepted. *Id.* at 86.

B. Legal List

In 1889, following the *Harvard* and *King* cases, the New York legislature codified the investment standard in an attempt to protect trust beneficiaries. The fiduciary investment act was the original “legal list” of permissible fiduciary investments. *See* Restatement (Second) of Trusts §227, Comment p (1959). Between the 1890s and the 1930s, a majority of states adopted the legal list rule and only a handful of states adopted the Harvard College rule. Beginning in the early 1930s, fiduciaries began to fight the legal list approach due to the fact that states utilizing the Harvard College Rule realized a higher rate of return on investments than states implementing the legal list. Since the 1940s, the trend has been to discard the legal list in favor of statutes containing the prudent man rule. *See* Restatement (Second) of Trusts §227, Comment p (1959).

C. Return to the Prudent Man Standard

During the Great Depression, bond values collapsed. This collapse led to a nationwide reconsideration of the Prudent Man Rule. In fact, one commentator stated that: “[s]ince the legislature cannot be omniscient, legal lists cannot be perfect; thus the prudent-man rule seems preferable since it is better able to adjust to changing market conditions and business practices.” Ward & Shockney, *The Texas Trust Act: Investment Powers of a Trustee*, 37 Tx. L. Rev. 66, 70(1958). In 1959, the Restatement (Second) of Trusts added the requirement that a trustee “must use caution in making investments which are used by prudent men who have primarily in view of the preservation of their property, of men who are safeguarding property for others.” The Restatement also established a set of universally acceptable investments.

II. Uniform Prudent Investor Act

A. Development of the Uniform Prudent Investor Act

In 1994, the National Conference of Commissioners on Uniform State Laws developed the Uniform Prudent Investors Act (UPIA). The Uniform Law Commissions Summary of the Act states that the “adoption of this act by the state legislatures will correct the rules, based on false and damaging premises, that now govern the actions of trustees.” The Summary further states that the “UPIA does not encourage irresponsible, speculative behavior, but requires careful assessment of investment goals, careful analysis of risk versus return, and diversification of assets to protect them.”

Although the UPIA is a step away from the Prudent Man Rule, it still offers trustees the flexibility to choose from a wider array of investments while outlining factors every trustee must consider before making investment choices. According to the Summary, the “act takes a truly holistic approach to investment practices.”

B. Five Alterations Made by the Prudent Investor Act

The UPIA makes five fundamental changes to the former criteria for prudent investing. *See* Restatement (Third) of Trusts: Prudent Investor Rule.

- (1) The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting the term “portfolio” embraces all of the trust’s assets. UPIA § 2(b). [Texas Trust Code § 117.004(b)].
- (2) The tradeoff in all investing between risk and return is identified as the fiduciary’s central consideration. UPIA § 2(b). [Texas Trust Code § 117.004(b)]
- (3) All categoric restrictions on types of investments have been abrogated; the trustee can invest in anything that plans an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing. UPIA § 2(e). [Texas Trust Code § 117.004(e)]
- (4) The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing. UPIA § 3. [Texas Trust Code § 117.005]
- (5) The much criticized former rule of trust law forbidding the trustee to delegate investment and management functions has been reversed. Delegation is now permitted, subject to safeguards. UPIA § 9. [Texas Trust Code § 117.011]

C. The Uniform Prudent Investor Act of Texas

The 78th Texas Legislature enacted a Texas version of the Uniform Prudent Investor Act in 2003 and House Bill 2240 became effective on January 1, 2004. The Texas Bar Comment from the Real Estate, Probate, and Trust Law Section of the State Bar of Texas says that “The adoption of the prudent investor rule reflects a significant departure from prior Texas law. The prudent investor rule is the majority rule among the states, so its adoption brings Texas in line with the national trend.”

Sections 2 through 9 of the Texas Act [Texas Trust Code §§ 117.004 to 117.011] delineate the main factors that apply to prudent investment behavior. However, the adoption of the UPIA has caused a divergence from previous Texas law.

(1) Section 117.006 Duties at Inception of Trusteeship

Section 117.006 states:

Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and

implement decisions concerning the retention and disposition of asset, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances for the trust, and with the requirements of this chapter.

The 1959 Restatement of Trusts says that “[o]rdinarily any time within a year is reasonable, but under some circumstances a year may be too long a time and under other circumstances a trustee is not liable although he fails to effect the conversion for more than a year.” Restatement of Trusts 2d § 230, comment *b* (1959). However, the 1992 restatement does not concur with that definition and instead states that “No positive rule can be stated with respect to what constitutes a reasonable time for the sale or exchange of securities.” Restatement of Trusts 3d: Prudent Investor Rule §229, comment *b* (1992).

For trustees in Texas, this departure could prove challenging. Prior Texas law “allowed the trustee to retain the initial trust estate without diversification and without liability for loss or depreciation.” *See* Texas Bar Comment of the Uniform Prudent Investor Act of Texas pg. 18. Trustees must now be cognizant of the amount of time they hold a trust estate and, although there is not a set standard for such a time frame, trustees must strive to diversify.

(2) Section 117.011 Delegation of Investment and Management Functions

Section 117.011 states:

- (a) A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:
 - (1) selecting an agent;
 - (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and
 - (3) periodically reviewing the agent’s actions in order to monitor the agent’s performance and compliance with the terms of the delegation.
- (b) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.
- (c) A trustee who complies with the requirements of Subsection (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated, unless:
 - (1) the agent is an affiliate of the trustee; or
 - (2) under the terms of the delegation:
 - a. the trustee or beneficiary of the trust is required to arbitrate disputes with the agent; or

- b. the period for bringing an action by the trustee or a beneficiary of the trust with respect to an agent's actions is shortened from that which is applicable to trustees under the law of this state.
- (d) By accepting delegation of a trust function from the trustee of a trust that is subject to the law of this state, an agent submits to the jurisdiction of the courts of this state.

Subsection (b) is a significant departure from prior Texas law. Previous Texas held the agent to the Texas trust investment standard and was required to assume liability for failing to follow that standard. Now, the agent only owes a duty to the trust to “exercise reasonable care to comply with the terms of the delegation.” This could be dangerous for trustees who may agree to delegation terms that do not require that the agent be held to the same trust standards. In that case, the agent only has to meet the terms of the delegation and the trustee becomes liable for the actions of such agent.

Additionally, subsections (c)(1) – (2)(a) and (b) were added by the Texas legislature and do not appear in the original act.

III. Duties and Liabilities of Trustees

A. Attorney Considerations

Attorneys, while drafting trusts of any kind, be conscious of the following section of the prudent investor rule:

Section 117.003 states:

(b) The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust.

Although the rule clearly states that it can be overridden, attorneys drafting trusts of any kind must be aware of certain considerations. For one, the prudent investor act requires trustees to diversify a trust's investments. If a trustee has a trust with concentrations of investments it is possible such investments will violate Section 117.005. Attorneys drafting such trusts must include language that specifically states the trustee may retain or invest property in the trust without the need to diversify. For example, the following provision is included in our boilerplate trust powers:

[The trustee is specifically authorized] to retain, in the discretion of the Trustee, any property transferred to the Trustee by the Settlor without regard to the duty to diversify investments under the laws governing a trust created hereunder, and without liability for any depreciation or loss occasioned by such retention

This language is more than likely sufficient to allow a trustee to retain concentrations of investments, but trustees should not rely on such a provision to avoid diversification if it is prudent to diversify. A trustee must still be “investing and managing the trust assets as a prudent investor.” Including such a clause, however, does not absolve a trustee of liability for acts of willful misconduct, gross negligence, or abuse of discretion.

B. Financial Advisor Considerations

Financial advisors should be aware of the following issues when working with trusts:

- If a group of financial advisors has offices in multiple states, be aware of any nuances in different versions of the act;
- Be aware of the kind of investments your clients would like to include in the trust initially, there could be potential diversity issues. Specifically take note of trusts including life insurance policies, real estate, and any oil and gas interests.

C. Trustee Considerations

Section 117.004(a) through (f) delineate the factors that must be considered by a trustee:

- (a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.
- (b) A trustee’s investment and management decisions respecting individual assets must be evaluated not in isolation but in context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.
- (c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:
 - (1) general economic conditions;
 - (2) the possible effect of inflation or deflation;
 - (3) the expected tax consequences of investment decisions or strategies;
 - (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;
 - (5) the expected total return from income and the appreciation of capital;
 - (6) other resources of the beneficiaries;
 - (7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and
 - (8) an asset’s special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.
- (d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.

(e) Except as otherwise provided by and subject to this subtitle, a trustee may invest in any kind of property or type of investment consistent with the standards of this chapter.

(f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.

First, trustees should take notice of the broad language used in the factors. The breadth of the factors indicates that trustees must investigate many factors that may affect the trust and its investments.

Second, it is critical for corporate and professional trustees to be aware that §117.004(f) holds them to a higher standard than individual trustees. Corporate trustees must invest, diversify, and maintain their trust estates in accordance with this elevated standard.

IV. Miscellaneous

The following are excellent sources of opinions and comments regarding the Uniform Prudent Investor Act:

- Uniform Law Commission Prudent Investor Act Summary which can be found online:
<http://www.uniformlaws.org/ActSummary.aspx?title=Prudent%20Investor%20Act>
- Trust Investment and Allocation Rules: Texas Enters a New Era by Gerry W. Beyer
- The Uniform Prudent Investor Act of Texas with the official comments of The National Conference of Commissioners on Uniform State Laws and The Real Estate, Probate, and Trust Law Section of the State Bar of Texas
- A Trustee's Balancing Act: Income and Remainder Beneficiaries' Rights by Richard M. Horwood and Jeffrey A. Zaluda

It is evident that the Prudent Investor Rule has had several variations since the 1700s, however, the one constant is the Act's protection of the beneficiaries. Therefore, it is always important to keep abreast of not only the statutory changes, but also the case law as it relates to this area.