



# What Attorneys Need to Know About Trustee Investing

**.75 General CLE credit  
ID 96638 (part of 94713)**

**From the Oregon State Bar CLE seminar *Basic Trust  
Administration*, presented on November 18, 2022**



# Chapter 6

## What Attorneys Need to Know About Trustee Investing

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The Oregon Prudent Investor Act has been around now for 27 years. It governs a trustee's obligation to invest trust assets. It also creates something of a conundrum for lawyers. On the one hand, a lawyer's job is to advise trustee-clients on what the law is. On the other hand, this law deals with investing, which takes the lawyer dangerously close to providing investment advice, which probably isn't covered by professional liability insurance.

This article will identify some select issues regarding the law of trustee investments. It is meant to supplement, rather than replace, the 2018 edition of *Administering Trusts in Oregon*, published by the Oregon State Bar.

### **Background**

What follows is a general overview of the Oregon Prudent Investor Act; it is not comprehensive, but is intended to provide a background for the developments that follow. Oregon adopted the Uniform Prudent Investor Act (UPIA) in 1995, which is now codified at ORS 130.750–130.775. The prefatory note to the UPIA states that it “draws upon the revised standards for prudent trust investment promulgated by the American Law Institute in its Restatement (Third) of Trusts: Prudent Investor Rule (1992).” Because Oregon adopted the UPIA almost verbatim, the comments to both UPIA and the Restatement have great validity in interpreting Oregon's prudent investor rule.

The Oregon prudent investor rule is a “default rule that may be expanded, restricted, eliminated or otherwise altered by the provisions of a trust.” ORS 130.750(2). To the extent it is not overridden, “a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule.” ORS 130.750(1).

A trustee must “invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust.” UPIA §2(a) A trustee's investment and management decisions are to be evaluated “in the context of the trust portfolio as a whole and as a part of the overall investment strategy having risk and return objectives reasonably suited to the trust.” ORS 130.755(2).

As a result of these guiding principles, an Oregon trustee has several other duties to follow when investing trust assets:

- “A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.” ORS 130.760.
  - Diversification is critical to meeting other trust investment standards. For example, if the purposes and circumstances of a trust might require substantial disbursement of funds on relatively short notice, a portion of the portfolio should be invested in relatively liquid assets to minimize the risk that a call for funds might come at a time when the liquidation of longer-term investments might not otherwise be advisable.
  - The comments are also clear that circumstances may overcome the duty to diversify. For example, “if a tax-sensitive trust owns an undiversified block of

low-basis securities, the tax costs of recognizing the gain may outweigh the advantages” of diversification. UPIA §3, comment. Furthermore, “[t]he wish to retain a family business is another situation in which the purposes of the trust sometimes override the conventional duty to diversify.” UPIA §3, comment.

- In general, a trustee must invest for the benefit of the trust beneficiaries alone. ORS 130.655(1); Restatement (Third) of Trusts: Prudent Investor Rule §§227(c), 170 (1992). Except for receiving reasonable compensation, the trustee generally must not derive personal benefit from the trust fund or its investments.
- Unless the trust agreement clearly states otherwise, the trustee must invest with due regard to the interests of all trust beneficiaries. ORS 130.660, 130.765; Restatement (Third) of Trusts: Prudent Investor Rule §§227(c)(1), 183 (1992).
- The duties of impartiality and loyalty raise some interesting points. Twenty-seven years ago, for example, the UPIA comments stated that “social investing,” in which a trustee makes an investment decision based on social causes, is deemed to be inconsistent “with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries—for example, by accepting below-market returns.” UPIA §5, comment

### **Asset Allocation**

The investment world is constantly changing: “The number and variety of investment alternatives has increased dramatically, and the once well-defined boundaries between asset classes often overlap.”<sup>1</sup> Computer trading, globalization, retreats from globalization and other issues have changed the investment environment, and the “traditionally diversified U.S. stock and bond portfolio will become increasingly inadequate in the investment world of the future.”<sup>2</sup> As a result, the importance of asset allocation has grown to become the “main work of the fiduciary investor.”<sup>3</sup>

From a pure investment perspective, designing an investment portfolio should consist of the following four steps:

- (1) deciding which asset classes will be represented in the portfolio;
- (2) determining the percentage that each of these asset classes will be to the total;
- (3) specifying for each asset class the range within which the allocation be altered (to take advantage of relative performance among asset classes); and
- (4) finally selecting the specific investments within each asset class.

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<sup>1</sup> Roger C. Gibson, *Asset Allocation: Balancing Financial Risk*, at 11 (4th ed. 2008).

<sup>2</sup> *Id.*

<sup>3</sup> *Id.* (quoting Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 Iowa L. Rev. 641, 646 (March 1996)).

Following these steps, and thereby establishing a long-term investment policy, is what generates long-term returns. However, the trustee has the additional responsibility of undertaking these steps in light of the purposes, distribution terms, and expected duration of the trust.

Market timing (that is, attempting to get into a market right before an upswing in value and out right before a downturn), on the other hand, does not work. Most of the gains in a rising (or “bull”) market occur rapidly at the beginning of a market recovery, making it difficult for an investor entering the market to catch the market appreciation. Further, it is much more important to forecast bull markets than downturning (or “bear”) markets. The average return of an investor who correctly forecasts all the bear markets but only 50% of the bull markets will underperform a simple buy-and-hold strategy.<sup>4</sup>

Time horizon, on the other hand, is critical. There are two primary investment risks: (i) volatility (i.e., the size of the swings up and down in value of a particular investment); and inflation (i.e., the general increase in price resulting in the decrease of purchasing power).<sup>5</sup> Each is affected differently by the passage of time. For example, the volatility found in equity investments swamps the expected payoff of the investment in the short-run, but makes it a clear winner over fixed income investments in the long run. Inflation, on the other hand, may be an insignificant factor in the short term, but over time it can significantly erode the value of a portfolio (particularly one built primarily of fixed income investments).<sup>6</sup> Interestingly, investors tend to underestimate their time horizon and, as a result, underweight their exposure to the more volatile investments that provide the best protection against inflation.<sup>7</sup> So determining the time horizon (for example, the life expectancy of the investor or trust beneficiary) can dramatically alter an investor’s tolerance for volatility.

Once a time horizon is determined, the asset selection process can begin. The key in asset selection is diversification, which involves not only diversifying within an asset class (e.g., buying more than one stock) but also diversifying among asset classes. The benefit of this multiple asset class allocation is that it tends to yield greater returns with less volatility than one or two asset class portfolios.<sup>8</sup>

To summarize, the principles of investment management can be distilled down to addressing the two risks of volatility and inflation, and avoiding the superficial allure of market timing. These risks are best addressed by determining the time horizon for the investment. Portfolios with short time horizons face danger primarily from volatility, while those with longer time horizons must seek to avoid loss due to inflation. Once time horizon is determined, a multiple asset class allocation may be the best way to implement an investment strategy designed to address that time horizon.

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<sup>4</sup> *Id.* at 78.

<sup>5</sup> *Id.* at 89.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.* at 101.

<sup>8</sup> See generally Roger C. Gibson, *Asset Allocation: Balancing Financial Risk*, at ch. 9 (4th ed. 2008).

### **Active Versus Passive Management**

The Restatement<sup>9</sup> distinguishes between "passive strategies" and "active strategies" when investing trust assets. Passive strategies involve investing in "index funds that track major stock exchanges or widely published listings of publicly traded stocks." This is a "practical investment alternative to be considered by trustees seeking to include corporate equity in their portfolios" because it offers the "pricing security and economies of buying in essentially efficient markets." On the other hand, active strategies also are allowable, which involve hiring professional to search for "advantageous segments of the market or for individual bargains in the form of under priced securities." Such strategies, however, "entail investigation and analysis expenses and tend to increase general transaction costs, including capital gains taxation." These considerations are "relevant to the trustee initially in deciding whether, to what extent, and in what manner to undertake an active investment strategy." If the costs and risks of such a program are substantial, such added costs and risks "must be justified by realistically evaluated return expectations." Therefore, if the trustee decides to proceed with an active investment program, the trustee must make the determination that: (a) gains from the program can reasonably be expected to compensate for its additional costs and risks; (b) the program is reasonable in terms of its economic rationale and its goal within the trust portfolio; and (c) the trustee has a credible basis for concluding that the asset manager has the competence necessary to carry out the program and that supervision of delegation if any is appropriate.<sup>10</sup> These comments comparing active versus passive strategies imply that passive strategies are the favored investment because there is no rigorous standard applied to such investments as there are to active ones.

But is it true that passive outperforms active management? To answer this question, you must first define your terms. First, what is "passive?" As defined above, it would appear to apply primarily to the purchase of publicly-traded stocks through low-cost "index" funds. But that, in turn, raises two further questions. First, how does it apply to other asset classes, like bonds, REITs, emerging market investments, and so on? Second, even for publicly-traded stock, you have to decide which "index" you're talking about: the S&P 500, the Russell 3000, the Russell 2000, the Dow Jones Industrial Average? The question becomes even more complicated in the case of fixed income investing. The Bloomberg Aggregate Bond Index (often referred to as "the Agg", and previously known as the "Barclay's Agg") is a broad-based fixed-income index that is often used by bond traders and fund managers either as the model for a bond index fund, or as a benchmark against which a manager measures its performance. It consists of U.S. investment-grade fixed income investments, including Treasury securities (which represent almost 40% of the total index), corporate bonds, mortgage-backed securities, asset-backed securities and municipal bonds. It is one of the most (if not the most) commonly used total bond market indices.

But notice that, by definition, it does not include international bonds or high-yield (often known as "junk") bonds, both of which can be an important source of diversification. It is also can be considered conservative, given its weighting toward U.S. Treasuries. In other words, "index investing" is not as simple nor effective as it seems.

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<sup>9</sup> Restatement (Third) of Trusts: Prudent Investor Rule (1992).

<sup>10</sup> *Id.* at 30.

One investment consulting firm has evaluated the persistency of top quartile mutual funds, both active and passive, since 2007.<sup>11</sup> This evaluation has consistently led to the observation that “actively-managed strategies tend to struggle in strong up markets compared to passive strategies, especially in domestic equity asset classes. Many asset classes generate outperformance in the top quartile of their peer group and to a lesser extent the median manager more often in down markets.” Further, passive investing “does not completely insulate investors from volatility in relative performance compared to active peers and in some asset classes has guaranteed sub-part results over the most recent 10-year period.”

To conclude, the “active management versus index investing” debate is far from resolved. When the Restatement refers to index investing, it always refers to large-cap, domestic stocks. But even though such holdings may constitute the bulk of a trust portfolio, there are other corners of the market where active investment may still be justified.

### **Pricing of Securities and Market Timing**

Publicly-traded securities are those stocks and bonds that are traded on public markets (as opposed to privately-held companies, stock in which cannot be purchased on demand). Public markets are, to some degree, “efficient.” This means that all the information that can be publicly known about a stock or a bond (like the health of the company issuing it, the projected change in interest rates by the Fed, or any proposed federal or state laws that may impact the business) is already built into the price.

So, for example, the price of a given bond is based in part on what investors think will happen to interest rates over the next year. If investors get an inkling that rates will go up by .25% each quarter for the coming year, then those rate projections are immediately built into the price of that bond. As the year progresses, the price of that bond will change very little if the projected rate rises occur at the time and in the amount expected. In other words, believing that interest rates will go up is not, by itself, a reason to buy or sell a bond (or a bond fund).

The things that really move stock and bond prices are surprises. Genuinely new information, and not market conditions in general, makes prices go up or down. In our example above, the price of the bond we’re considering buying has built into it the assumption that interest rates will go up .25% each quarter. If that happens, then the price of the bond will not change during that year (all other things being equal). It’s only when the Fed provides new information, or when new economic data comes out, that prices change. For example, if inflation reports indicate that the United States experienced a higher level of inflation than projected, investors worry that the Fed, in response, will raise interest rates more than .25%, and therefore prices will drop on the *expectation* of higher rates. This pricing movement will happen the same day that the new data is released.

It's the new information, not the general environment of rising rates, that makes the price of the bond go down. And there is no way of finding that new information out early enough to act on it before the rest of the market does. Notice too that, had the inflation information been more favorable, the price of the bond might have gone the other way, and owners of that bond at that time might have experienced an increase in value, despite the general rising-rate environment.

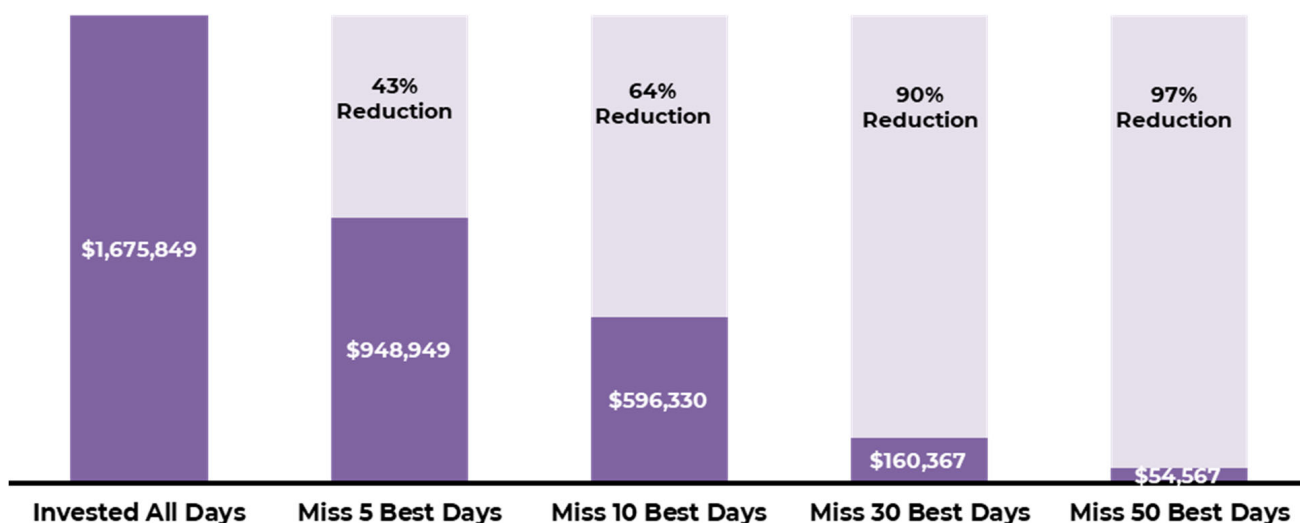
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<sup>11</sup> Fiduciant Advisors, *The Next Chapter in the Active versus Passive Debate* (September 2021).

The conclusion is that investing in public markets at any given moment isn't affected by general conditions, but rather immediately new information, including information that makes investors think something else might happen because of it (like higher inflation leading to higher interest rates). If that something else never actually happens (like the rates never rise), the price of the stock or bond being considered for purchase will correct back to where it was.

With that knowledge in mind, can investing be “timed” to take advantage of market highs and lows? Intuitively, people are tempted by the idea that they can sell securities when prices are relatively high, and then buy back those securities after their value has dropped (or “corrected”). This is commonly known as “market timing.” The “common sense” notion is that, when a recession appears imminent, the investor sells their securities, anticipating the market decline. Once the decline has happened, the investor buys back the securities they sold, thus avoiding the drop in value.

The evidence suggests that most people (including investment professionals) can't time the market profitably. Rather, the most important factor in navigating investment volatility is not timing the market but rather time *in* the market. The following graph shows the potentially devastating effect getting out of the stock market. Since 1980 the S&P 500 has had over 10,000 trading days. However, if you only miss a small fraction of the best days the impact can be material. Said another way, the cost of trying to time the market can be very high.



Source: Morningstar Hypothetical Growth of \$10,000 invested in the S&P 500 Index (TR) from January 1st, 1980 to December 31st, 2021

These results are astounding: an investor who missed only the 50 best days out of 10,000 would have missed 97% of the return. Further, most of those “best days” in the market occurred very shortly after most of the worst days. What this means is that, even if you were able to predict the top and the bottom of the market during a period of volatility, your portfolio would still suffer below average returns if your predictions or your execution were off by only a day or two.

Further, market recoveries tend to occur all at once, and often shortly after significant drops. As the chart below shows, within a year of hitting the bottom of a six to eight week losing streak, the S&P 500 has delivered a very respectable average return of 5.6%.

S&P 500: Longest Consecutive Down Weeks (1928 - 2022)									
Down Week Data			S&P 500 Forward Total Returns						
End Week	Streak % Decline	Streak	3-Month	6-Month	9-Month	1-Year	3-Year	5-Year	10-Year
5/22/1970	-14.5%	8	10%	16%	34%	40%	44%	25%	47%
3/23/2001	-14.9%	8	8%	-15%	1%	2%	2%	25%	38%
3/28/1980	-12.9%	7	17%	29%	41%	41%	78%	128%	421%
5/20/2022	-14.0%	7							
8/7/1931	-10.6%	6	-18%	-43%	-55%	-50%	-35%	16%	-24%
9/20/1946	-15.2%	6	6%	4%	3%	3%	7%	61%	225%
8/23/1957	-6.6%	6	-8%	-8%	-1%	7%	28%	33%	114%
1/10/1969	-4.0%	6	1%	-5%	-7%	-8%	3%	-2%	-5%
2/11/1977	-5.2%	6	-1%	-2%	-4%	-10%	18%	30%	279%
2/17/1984	-7.3%	6	1%	8%	9%	22%	103%	127%	327%
8/24/1990	-10.4%	6	2%	20%	24%	31%	61%	108%	495%
10/13/2000	-7.3%	6	-4%	-13%	-11%	-20%	-21%	-6%	1%
10/4/2002	-11.9%	6	14%	11%	25%	31%	62%	109%	123%
7/23/2004	-2.9%	6	1%	8%	7%	16%	49%	-4%	123%
7/11/2008	-9.6%	6	-27%	-27%	-29%	-27%	16%	47%	172%
6/10/2011	-4.4%	6	-9%	0%	10%	7%	64%	84%	305%
Average			-0.5%	-1.2%	3.1%	5.6%	31.8%	52.1%	176.1%

In other words, the issue with trying to profit from market timing is not whether an investor can spot the coming downturn or recovery, but whether they can do so by pinpointing the actual days they occur.

### ESG Investing

One aspect of investing that continues to draw attention is the extent to which environmental, social and governance (ESG) factors should be considered in building an investment portfolio. Using such a perspective involves taking into account not only a company's profitability, but also its impact on issues like climate change, labor conditions, board diversity and executive compensation. The goal is that, by focusing on those issues, companies can be selected for portfolio investment that are not only generating a profit but also are better placed to be successful in the future.<sup>12</sup>

At its inception, ESG investing was referred to as socially responsible investing (or SRI). Early SRI investing relied on "negative screens," under which a portfolio manager would not invest in companies that the investor felt were ethically or morally wrong (such as oil, tobacco or gun producers). Importantly, negative screening involves using a non-financial metric in determining

<sup>12</sup> For an excellent discussion, see Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration*, 90 U. of Co. L. Rev. 731 (2019).

whether or not to make an investment. In other words, it places a moral or ethical judgment on the part of the investor ahead of purely financial considerations. It was from this perspective that the comments to the UPIA, quoted above, put forth the view that social investing violated a trustee's duty of loyalty. And in large part, this is the view of many lawyers and clients, despite the fact that ESG investment theory has developed significantly in the last thirty years.

A better way to think of ESG investing is as “ESG integration,” a strategy that combines ESG factors (a company's environmental impacts, its labor relations and how it interacts with communities, for example) with traditional financial metrics when analyzing companies. The thought is that ESG integration improves stock selection by expanding the scope of information about a stock, thus identifying more potential risks and opportunities.<sup>13</sup> And indeed, studies have shown that funds using such an approach generate similar results to those that don't consider ESG factors.<sup>14</sup>

Such an analysis presumes, however, that stock selection is being used at all. Such is the case with actively-managed funds, in which fund managers believe they can deliver higher returns through their analysis and selection of individual securities. However, passive investing, which involves simply holding all of the stocks, and in the proportions, set forth in an index (the S&P 500 being perhaps the most popular), does not use any stock selection at all. As a result, its administrative costs (the salaries it pays to fund managers and analysts) are significantly lower. An article written in the early years of modern portfolio theory held that fund managers generally could not outperform index funds over long periods of time, and therefore the higher administrative costs from actively managed funds was an unjustifiable expense.<sup>15</sup> This view found its way into the UPIA, which holds that actively managed funds must adequately outperform their passive index benchmarks in order to justify their increased costs.

Which raises the question whether ESG integrated portfolios (which are by definition actively managed) outperform an appropriate passive index benchmark. At least one study found that, although ESG portfolios performed better, in general, than the fund universe as a whole (which would include active and passive funds), such portfolios will always be more expensive than their passive index-tracking counterparts.<sup>16</sup>

Another concern for ESG investing is the extent to which fund managers engage in “greenwashing;” that is, expressing concern for and taking superficial steps toward ESG factors simply as a cover to sell more investment products. Surveys of managers tend to show that 68% – 74% of them claim to use ESG integration. However, these results are self-reported with no oversight. There are few standard definitions or assessments. At least one consultant has tried to apply due diligence to the process by asking whether the ESG integration is observable, material and additive to the investment process. The consultant found that 86% of funds claimed to use ESG factors, but only 35% did so in a meaningful way, passing muster under the consultant's

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<sup>13</sup> *Id.* at 745-46.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at 754-55.

<sup>16</sup> *Id.* at 756.

due diligence process.<sup>17</sup> Analysis like this shows how hard it can be to determine whether a fund has truly adopted ESG integration, or has simply claimed to do so for window-dressing.

One final consideration is ORS 130.755(3)(i), which provides that a trustee “shall consider all relevant circumstances in investing and managing trust assets, including . . . the intent, desire and personal values of the settlor, including the settlor’s desire to engage in sustainable or socially responsible investment strategies that align with the settlor’s social, environmental, governance or other values or beliefs to the extent known by the trustee.” This statute should allow a trustee to follow a settlor’s ESG goals without worrying about whether those goals conflict with the prudent investor rule. However, this provision also creates two difficulties. First, in the author’s experience, most clients don’t understand the notion of ESG integration. Rather, the common view is that social investing equates to negative screening: for example, avoiding oil and gas companies in the portfolio. Second, it could be a challenge to determine whether and to what extent the settlor wanted the trustee to pursue such strategies. Are general statements made during a client meeting adequate? Should those desires be set forth in a writing, and specifically included in the trust agreement? Requiring a future trustee to understand the “intent, desire and personal values of the settlor” without a writing to support it would probably lead to greater confusion. An attorney drafting a will or trust for a settlor who has strong opinions about social investing should include in the trust agreement a provision that states both the intent that the trustee pursue ESG investing, and what such investing should entail (in other words, ESG integration versus negative screening).

### **Duty to Monitor Fees**

A case with serious consequences for trustees is *Tibble v. Edison Int’l*,<sup>18</sup> decided by the U.S. Supreme Court in 2015. The facts are straightforward: the petitioners (beneficiaries of a defined-contribution plan) argued that the respondents (the employer and others, who sponsored the plan) violated their fiduciary duties by offering six higher priced retail-class mutual funds as plan investments when materially identical lower-priced institutional-class mutual funds were available. The petitioners claimed that a large institutional investor could have obtained materially identical lower-priced institutional-class mutual funds that are not available to retail investors.

Ostensibly, the issue before the Court was whether the petitioners’ claims were time-barred under the six-year statute of limitations. The lower courts held that the statute began running when the mutual fund interests were acquired (eight years before the claim was filed), ruling against the petitioners’ argument that, because the funds underwent significant changes within that six-year statutory period, the respondents should have undertaken a full due-diligence review at that time and converted the higher priced retail-class mutual funds to lower-priced institutional-class mutual funds.

The Supreme Court overturned the lower court decisions, ruling that the petitioners’ claims should be considered. The Court stated that in determining the contours of an ERISA fiduciary’s duty, courts often must look to the law of trusts. It stated that “[u]nder trust law, a trustee has a continuing duty to monitor trust investments and remove imprudent ones. This continuing duty

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<sup>17</sup> Fiduciant Advisors, *Greenwashing in ESG: Don’t Judge a Book by its Cover* (December 2021).

<sup>18</sup> 575 US 523 (2015).

exists separate and apart from the trustee’s duty to exercise prudence in selecting investments at the outset.” The trustee must systematically and regularly review all trust investments. The Court reached its conclusion based in part on the Uniform Prudent Investor Act. As a result, the Court held that a plaintiff can file a claim for breach of fiduciary duty by failing to properly monitor investments, as long as the alleged breach of the continuing duty occurred within the statutory period. The lower courts erred by applying the statutory framework based solely on the initial choice of funds, so the Court remanded to the Ninth Circuit for reconsideration.

It would be easy to assume that this decision applied solely to ERISA plan managers and their advisors, or that it required automatic review of certain share classes held as plan assets. However, the *Tibble* decision should be seen in a broader context: all trustees have an ongoing duty to monitor the appropriateness of their investments even after they are selected initially. This duty applies not only to the selection of classes of shares or funds but more broadly to the choice of one fund or another. This is particularly true in the case of index funds (for example, a fund that tracks the S&P 500): The trustee must take ongoing care that such funds have (all things being equal) the lowest cost among their competitors. The individual trustee who has delegated its responsibility of investing trust assets to an advisor must periodically ensure that that advisor is monitoring such expenses.

### **Duty of Loyalty**

A trustee must invest trust assets solely for the benefit of the beneficiaries; transactions involving the trustee’s own interests are generally prohibited unless certain standards are met. Breaches of this duty often occur when individual trustees invest trust assets in businesses in which the trustee has an (often controlling) interest, and with corporate trustees who use their own proprietary funds.

In *Jackson v. Mercantile Safe Deposit & Trust Co.*,<sup>19</sup> a corporate trustee was found liable for damages after failing to adequately monitor investments and investing in its own funds, which lagged behind the performance of the S&P 500. The corporate trustee assumed management responsibilities in 1947; by 1960, with a market value of \$142,025, the trust assets consisted of a 70% stock 30% fixed income allocation. Annual reviews took place regularly and until the mid-1970's the market value of the trust equities kept a reasonably close relationship to that of the S&P 500. However, in approximately 1975 through 2007, the S&P 500 returns significantly outpaced the trust returns. This resulted from three factors. First, the trustee sold the remaining stocks and bonds and invested almost exclusively in its own proprietary funds, which occurred in 1975 and lasted until 1998, when the trustee determined that investment in its own funds might be contrary to the terms of the Trust. Second, the trustee failed to maintain any consistent balancing of the allocation of the trust assets. Third, there was frequent turnover of personnel handling the account; as it became a "smaller" account, it was passed to a less-experienced officer to manage. And, while the account in theory was subject to an annual review by the Trust Investment Committee, the records before the court did not reflect that such a review took place on any regular basis during the later years.<sup>20</sup> See also *Parris v. Regions Bank*,<sup>21</sup> in which a

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<sup>19</sup> 2012 BL 300343 (D. Md. 2012).

<sup>20</sup> See also *Wagley v. JP Morgan Chase Bank, N.A.*, No. 18 Civ. 8668, 2020 BL 369314 (S.D.N.Y. Sept. 26, 2020), in which the court partially denied the trustee's motion to dismiss plaintiffs' breach of fiduciary claim where trustee engaged in “self-interested transactions” by investing trust property in proprietary funds directly managed by trustee.

trustee's summary judgment motion was dismissed where trustee invested 72% of trust assets in trustee's proprietary junk bond fund, failed to disclose to the beneficiary material facts of the fund and failed to diversify trust assets after the fund incurred significant losses.

On the other hand, in *Banks v. Northern Trust Corp.*,<sup>22</sup> the Ninth Circuit held that a corporate trustee that invested in its own funds did not breach its fiduciary duty. In this case, such investments were authorized by the trust agreement, it was permitted under state law, and beneficiaries received adequate notice.<sup>23</sup>

In *Donahue v. Donahue*,<sup>24</sup> the grantor established a family trust and funded the trust with \$45 million in assets, which included an interest in an umbrella partnership REIT that constituted about 50% of the trust's assets. Following the death of the grantor, the grantor's brother, who was also the president and CEO of the REIT, was named trustee of the trust. In order to provide adequate income to the grantor's spouse during her lifetime and an appropriate remainder for the grantor's children, the trustee determined that he needed to diversify the trust assets because the REIT alone provided inadequate income. The trustee sold a 40% interest in the REIT, and used the proceeds to pay off the family's mortgage on their residence, to fund trusts for the children and to diversify in assets other than real estate. Three years later, the beneficiaries sued the trustee because the REIT had appreciated significantly in value after the sale, resulting in lost appreciation to the trust of approximately \$20 million.

The court held that the trustee's diversification strategy did not violate the prudent investor rule. The beneficiaries argued that the trustee, as an insider, knew that the REIT interest would appreciate in value. Citing the housing crisis of 2008 and the collapse of Lehman Brothers, the court, however, found that the unreliability of long-term projections demonstrated the flawed nature of mere predictions of future performance, regardless of whether from financial advisors or insiders. The court reiterated that when executing the duty to diversify, the trustee is eliminating “risks higher than suitable to a trust's purposes, return requirements, and other circumstances.”

In an Illinois case,<sup>25</sup> the trustee breached his duty to diversify by retaining a 100% ownership interest in a family printing and newspaper business. The grantor created a trust to hold his ownership interest in a closely held business. In 1987, the trust appointed the Northern Trust Company as trustee. The trustee discussed at annual reviews the importance of diversifying the trust assets; however, the beneficiaries did not wish to sell the family business for various reasons. In 2000, the trustee assigned a new asset manager to the trust, who again stressed the importance of diversification. The trustee sought to sell a portion of the family business but, ultimately, determined that it was not in the best interests of the trust because many beneficiaries worked for the family business and a majority of the beneficiaries did not want to sell the business. The trustee did not perform any detailed analysis explaining the risk of not diversifying the trust assets. In 2007, the beneficiaries sued the trustee for failing to diversify the trust assets. The court held that the trustee breached his duty to diversify because the beneficiaries' requests

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<sup>21</sup> 2011 U.S. Dist. LEXIS 92167 (W.D. Tenn. 2011).

<sup>22</sup> No. 20-55297, 2021 BL 296963 (9th Cir. Aug. 6, 2021).

<sup>23</sup> See also *Watkins v. PNC Bank*, 2015 Ky. App. Unpub. LEXIS 76 (2015).

<sup>24</sup> *Donahue v. Donahue*, No. G040259, 2010 BL 36677 (Cal. Ct. App. 2010).

<sup>25</sup> *Moss v. Northern Trust Company*, No. 7 CH 24749 (Ill. Cir. Ct. 2015).

to retain the family business and the trust instrument's instruction authorizing the trustee to retain the family business were not sufficient to exempt the trustee from the duty to diversify altogether. In other words, the beneficiaries argued that the trustee shouldn't have listened to them.

The court, however, refused to hold the trustee liable for damages because the beneficiaries did not prove damages where the trustee's investments generated significantly greater income than the beneficiaries' hypothetical investment model.

In *Mennen v. Wilmington Trust Co.*, C.A. No. 8432-ML (Del. Ch. 2015), the trust at issue held stock in the Mennen Company, which was privately held. Although Wilmington Trust Company was a named defendant, the trust agreement apparently named the individual co-trustee (who was also the brother of the trust beneficiary) as having sole investment responsibility. This may have been appropriate when the sole trust asset was stock in the family-owned business, but when that business was sold to Palmolive, suddenly the trustees had real investment work to do. The court presented the situation as follows:

It is undisputed that the trust, once valued at over \$100 million, was reduced to a value closer to \$25 million through a series of debt and equity investments largely focused on two insolvent, unproven, and ultimately unsuccessful private companies with no established record of profitability. There can be no doubt that the investments were astonishing failures. The question is whether, divorced of hind-sight bias regarding the outcome of the challenged transactions, the trustees' investment decisions expose them to liability to the beneficiaries.

The court found that the individual co-trustee used the assets of his brother's trust to further his own "pride:"

because most of the trustee's personal fortune was out-of-reach in his own trust, the trustee turned to his brother's trust as a piggy bank he readily opened to fund a few private companies in which the trustee had invested his time and on which he had staked a claim that he was uniquely skilled at selecting and advising small fledgling companies that he could turn into the "next big thing." Certain that fortune and acclaim were around the bend, the trustee eschewed the interests of the beneficiaries in favor of subsidizing his self-aggrandized standing as a financier.

The individual co-trustee also failed to provide adequate investment information to his brother, overcharged on expenses and was an unreliable witness. Therefore, the court had little trouble finding him liable, despite the presence of an exculpation clause in the trust. The court held that his actions amounted to bad faith, and therefore the clause did not protect him.

### **Delegation of Investment Duties**

In a Minnesota case,<sup>26</sup> the court held that the trustee properly relied upon the professional advice of a financial advisor in deciding the appropriate investment vehicles for a trust with an income beneficiary with special needs and remainder beneficiaries that were minor children. At the

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<sup>26</sup> *In re Amendment & Restatement of Revocable Living Trust of Berget*, No. A13-2295, 2014 BL 343076 (Minn. Ct. App. 2014).

recommendation of the financial advisor and pursuant to a sophisticated investment plan, the trustee invested in three variable deferred annuities. The court found that the trustee, who had no prior experience managing trust assets, reasonably acted when she sought advice from the grantor's financial advisor. Even though the variable deferred annuities depreciated in value between 2007 and 2010, the court emphasized that the trustee obtained sufficient competent advice, guidance and assistance to formulate and implement the investment strategy of the trust.

### **Duty to Diversify**

The Surrogate's Court of New York<sup>27</sup> held that an attorney-executor committed multiple, egregious violations against New York's Prudent Investor Act<sup>28</sup> by grossly mismanaging a decedent's estate, including breaching his duty to diversify. The executor knew that decedent's multimillion-dollar estate consisted of her home, checking and savings accounts, and General Electric (GE) stock that was not only the majority of decedent's investments, but was the majority of decedent's entire estate. The executor failed to liquidate and diversify the estate's \$4.6 million investment portfolio, 85% of which consisted of GE stock.

But failure to diversify was just the tip of the malfeasance iceberg. The executor did not maintain fiduciary standards when selling decedent's home. He failed to obtain a formal appraisal for the home, and he imprudently invested estate assets to renovate the property using a personal long-time contractor rather than selling the home in “as-is” condition. To make matters worse, the executor hired his personal contractor without soliciting other bids or entering into a written contract with a clearly defined scope of work. As a result, the house was sold at a total loss rather than at the lower “as is” value he could have obtained. And of course, the executor paid himself legal fees for years without a court order, contrary to the requirement in the letters testamentary. The Surrogate's Court imposed numerous damages and surcharges due to attorney-executor's breach of his fiduciary duties along with statutory interest, denied him statutory commissions, denied him legal fees, and removed him as executor of the estate. This case is less instructive because the general breach of fiduciary duty was so broad, but it does point out that, during an estate or post-mortem trust administration, an executor or a trustee should decide early on whether assets should be sold to avoid a drop in value. Here, “diversifying” probably really would have meant liquidating and going to cash or safe, short-term investments.

A Rhode Island case<sup>29</sup> supports the proposition that the extent of the duty to diversify depends upon the facts and circumstances of a particular matter. Upon the death of the grantor in 2010, a trust was created for the benefit of the beneficiary; however, the trust was to terminate upon the beneficiary reaching the age of 25, which would occur in 2014. The trustee had the discretion to distribute the trust assets outright to the beneficiary prior to 2014. When the trustee received the beneficiary's share of the grantor's estate in 2010, she placed the trust assets in a cash account. The trustee attempted to make an outright distribution to the beneficiary many times between 2010 and 2013. The beneficiary rarely responded to the trustee's letters sent by certified mail, telephone calls and text messages. When the beneficiary did respond, she refused to sign a general release discharging the trustee of her duties and releasing her of any liability. This resulted in significant delays in, and additional expenses related to, the administration of the

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<sup>27</sup> Matter of Kenney, 64 Misc.3d 1232(A) (N.Y. Sur. Ct. July 19, 2019).

<sup>28</sup> N.Y. EPTL §11-2.3.

<sup>29</sup> In re Bagdis, 2016 BL 90944 (R.I. 2016).

grantor's estate. The beneficiary sued the trustee for violating the prudent investor rule by placing the trust assets in a cash account that received less than \$50 in interest income in four years.

The Supreme Court of Rhode Island held that the trustee did not violate her duties under the prudent investor rule by placing the trust assets in the cash account because the trustee intended to make an outright distribution to the beneficiary and the beneficiary prevented the trustee from making the distribution for nearly four years. The court found the trustee's decision to place the trust assets in a cash account was reasonable to insulate the assets from the risk of market volatility, especially considering the short time horizon over which the trustee intended to hold the trust assets.

### **Duty of Impartiality**

Income beneficiaries always complain that the trust investments are not throwing off enough income, while remainder beneficiaries always complain that the trust investments are not growing fast enough. In those situations, the best a trustee can hope to do is disappoint both sides equally. In a Pennsylvania decision, *In re Montgomery*,<sup>30</sup> the income beneficiary claimed that the asset allocation of 65% equities and 35% fixed income was not generating sufficient income. The court held that the portfolio balance was appropriate because it was designed to “manage the trusts in a balanced and impartial way” to “meet the needs of the income beneficiary as well as grow the principal relative to inflation and hopefully in excess of inflation for the remainder interest.” The court observed that the allocation assured principal growth that benefits not only remainder beneficiaries, but also the income beneficiary, as larger principal generated higher income from dividends; and that allocation of all trust assets to fixed income would result in “dramatic” decrease in principal growth, while “not . . . gaining that much in the way of income.” Note that this decision might have gone the other way in a higher interest rate environment; during the period at issue, stock dividends were close to bond yields.

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<sup>30</sup> No. 3007 EDA 2019, 2020 BL 307795 (Pa. Super. Ct. Aug. 13, 2020) (citing earlier decision *In re Montgomery*, 161 A.3d 392 (Pa. Super. 2017))