RUTGERS LAW RECORD

Volume 32 Spring 2008 Number 64

TRUSTEE DELEGATIONS AND THE PRUDENT INVESTOR ACT: FILLING THE GAPS

By Robert M. Hayden*

I. INTRODUCTION

Consider the following situation. H, a widower, includes a provision in his will that sets aside a portion of his assets in trust for the benefit of his then-living children. The provision states that upon his death, his first request is to have his sister, who will be guardian of his children, serve as trustee. When the children reach the age of 35, the remaining funds will be distributed to them outright.

Under traditional trust law, H's decision to appoint his sister as trustee would seem to make sense. As a close relative, the sister is probably in a good position to understand H's intent. For example, if the trust contained language allowing the trustee to invade for the beneficiary's "health, comfort, maintenance and support," as is typical, the sister would likely know when it is appropriate to invade the trust corpus for these purposes. In addition, under traditional law, even though the sister may not have any investment knowledge, she could fulfill her duty to manage the trust assets simply by investing all of the assets in government bonds or other "safe" investments because her primary legal duty would be to preserve the trust.

Now skip forward to today. Imagine if H knew that the trust assets could triple in value in just a few years if the assets were actively invested in equities. Would H have wanted his sister to keep the trust assets in bonds? Would H even have wanted his sister to

serve as trustee? According to most states today that have enacted the Uniform Prudent Investor Act ("PIA"), the answer to the former question is no. Under the PIA, the sister would probably have a duty to diversify the assets,[1] and would have to choose investments that would balance risk and return, considering the total mix of the entire portfolio.[2] In sum, under the PIA investing the entire portfolio in bonds would likely be a breach of duty.

To mitigate the sister's predicament, the PIA would now allow the sister to delegate those responsibilities that she cannot adequately perform on her own, such as investing, so long as she adheres to certain safeguards.[3] Those safeguards require her to exercise reasonable care in selecting the agent and to supervise the agent to ensure that its actions are within the scope of her specified terms of engagement. Thus, under the PIA it would appear relatively simple for the sister to hire an investment advisor to handle the trust investments.

Yet the sister will quickly realize that the devil of delegation is in the details. That is, in delegating investment responsibility, the sister will encounter at least six issues. First, how will she know what constitutes "reasonable care, skill and caution" with respect to selecting an investment manager? Second, once she has hired the investment manager, how often should she review the investment manager's actions? Third, in reviewing the investment manager's actions, does her obligation cover only a review of the overall asset allocation or does her obligation extend to evaluating the merits of holding a particular investment within an asset class? Fourth, can she permit the investment manager to invest the trust assets in the investment manager's own company stock? Fifth, if the trust agreement required the retention of one or two stocks until

---

* J.D. Candidate, May 2008, Rutgers School of Law - Newark; B.A., May 2004, New York University. The author works full-time for The Bank of New York Mellon as an Assistant Vice President in its New York Family Office division and wishes to thank his colleagues at the Bank for their valuable suggestions during the production of this article.

[1] *See* UNIFORM PRUDENT INVESTOR ACT: DIVERSIFICATION § 3 (1994) ("A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of the special circumstances, the purposes of the trust are better served without diversifying.").

[2] *See* UNIFORM PRUDENT INVESTOR ACT: STANDARD OF CARE; PORTFOLIO STRATEGY; RISK AND RETURN OBJECTIVES. § 2(b) (1994) ("A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust.").

[3] *See* UNIFORM PRUDENT INVESTOR ACT: DELEGATION OF INVESTMENT AND MANAGEMENT FUNCTIONS. § 9(a) (1994) ("A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances.").

termination, thereby obviating the need for active investing, could the sister still delegate? Finally, if the sister were to resign and appoint a corporate trustee, should the corporate trustee also be allowed to delegate its investment responsibility even though the corporate trustee has the ability to delegate investment responsibility? These are among the central problems left unanswered by section nine of the Uniform Prudent Investor Act and its related state law.

This paper will explore both the advantages and the insufficiencies of section nine of the Uniform Prudent Investor Act and similar state laws that allow trustees to delegate those functions that have been traditionally nondelegable. To appreciate the rationale behind section nine of the Uniform Prudent Investor Act, Part I of this paper will trace the history of the law of trust management from its traditional goal of preservation to its modern goal of maximizing total return. Part II will explore how, prior to the PIA, grantors were able to maximize total returns by appointing an outside advisor by establishing a so-called "direction trust." Part III will address how legislatures gradually have begun to allow delegation by trustees, not just grantors, in limited circumstances. Part IV will then explain how section nine of the Prudent Investor Act, now adopted in most jurisdictions, now allows broad delegation by trustees, thus reversing the common law nondelegation rule. Part V will discuss potential pitfalls encountered by a trustee who delegates under these laws and will propose possible revisions to section nine of the Uniform Prudent Investor Act so that the Act would provide states with additional guidance for the delegating trustee.

II. TRADITIONAL TRUST INVESTMENT LAW AND THE NONDELEGATION RULE

To understand why courts have historically disfavored delegation, especially in the realm of investments, one must first understand the historical change in use of trusts.

1. Original Use – Land Transfer

The concept of a trust first developed during the end of the Middle Ages, at a time when real estate was the primary form of wealth. During these times, harsh feudal restrictions often frustrated a landowner's ability to transfer land to his or her family upon death. The concept of a trust was created to bypass these feudal restrictions on transfer by allowing a grantor to transfer

title to a third party trustee, who would then transfer the title to specified beneficiaries according to the grantor's instructions. Thus, the role of the trustee was to serve as a transfer agent at a certain period of time, not to actively manage property over a long period.

2. Active Management – the "Legal List"

As other advantages, such as asset protection, became widely recognized, the trustee also became increasingly more involved in the management of the trust property. Rather than retaining trust assets, trustees began buying and selling the trust assets to achieve better returns for the beneficiaries. Trustees also began managing assets other than land.

Courts began to curtail a trustee's authority to manage property in 1719, when, just one year after the British Parliament authorized trustees within its jurisdiction to invest in the South Sea Company, the South Sea "Bubble" burst and its share prices fell 90 percent. Learning its lesson, the Court of Chancery developed a list of "proper" investments for trustees to retain. This list included, *inter alia*, government bonds and first mortgages. As a result of the "legal list," a trustee who invested in anything other than "safe" investments could be held in breach of duty.[4]

3. The Prudent Man Rule

In the nineteenth century, high inflation rates and increasingly accessible capital markets led many beneficiaries to question their lackluster returns under the conservative approach of traditional trust investment law. In response, the Massachusetts Supreme Court in the seminal case of *Harvard College v. Amory*[5] established a new standard that required trustees 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." This standard, later noted in

[4] As with much of trust law, the "legal list" approach was a default rule, meaning that settlors could draft for broad investment powers. This would allow a trustee to avoid being held in breach if it invested in an asset that was not on the legal list. *See generally* Stephen M. Dickson, *Trust Administration in Georgia and the Prudent Investor Rule: May Trustees Delegate Their Investment Powers?* 14 GA. ST. U. L. REV. 633, 639 (1998) (stating that, despite its inflexibility, the legal lists survived so long in part because it was merely a default rule).

[5] 26 Mass. 446, 461 (1830).

Restatement (Second) of Trusts §227 (1959), became known as "the prudent man rule" and effectively displaced the "legal list" approach in most jurisdictions.[6]

The prudent man rule eventually became a set of court-defined rules as to what is generally imprudent, with several courts finding some investments such as junior mortgages imprudent per se. The emphasis in most cases was on avoiding speculation, and the analysis tended to focus around the speculation of an individual holding rather than its effects on the entire portfolio.

4. The Modern Portfolio Theory

The Modern Portfolio Theory ("MPT") was first espoused by Harry Markowitz in 1952 in his article in the *Journal of Finance*. The key difference between MPT and the prudent man rule was that MPT considers the risk of an asset against the risk of all portfolio assets. Thus, MPT uses a "total return" or "total portfolio" approach rather than an approach based on the appropriateness of holding a single asset.

In taking a "total return" approach to selecting assets, MPT denotes the benefits of diversification. In sum, MPT notes that diversification generally hedges risk. It further notes that an appropriate diversification is largely based on individual investment objectives. However, MPT notes that diversification should lie on an "efficient frontier," that is, an entire universe of portfolios that contain an optimal balance of risk and reward. The "efficient frontier" is constructed by assigning expected values, standard deviations and correlations of individual securities' returns. According to MPT, a rational investor should choose a diversification point along the efficient frontier to maximize his or her investment objective.

In 1958, James Tobin expanded upon Markowitz's work by adding a risk-free asset to MPT analysis. This made it possible to leverage portfolios on the efficient frontier, thus leading to a risk-return option that is superior to any option on Markowitz's efficient frontier. The superior risk-return option is depicted on a line tangential to the efficient frontier known as the

[6] *See generally* John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 644 ("The Massachusetts rule represented a great advance by abandoning the attempt to specify approved types of investment.").

"capital market line." In this line, expected return equals risk-free rate plus the portfolio beta, the latter being the difference between the expected return on the market as a whole and the risk-free rate.

As can be seen from the above analysis, a trustee who is required to follow modern portfolio theory has more heightened investment obligations than under the prudent man rule. Specifically, the modern portfolio theory requires a trustee not only to evaluate the expected performance and risk of holding an individual security but also to evaluate the impact of this security on the entire portfolio. In addition, since most trusts tend to be large (as used mostly by wealthy individuals), and larger trusts tend to have a broader universe of possible investment options, specialization in these investment options is particularly important within trust administration. This need for specialization further warrants support for trustee delegations.

5. Conflicts between the Modern Portfolio Theory and the Prudent Man Rule

It was not long before the prudent man rule began to conflict with the emerging modern portfolio theory. One of the first such conflicts between the prudent man rule and the modern portfolio theory can be seen in the case of *First Alabama Bank of Montgomery v. Martin.*[7] In that case, the court surcharged a trustee for improperly investing the trust assets. The court applied the prudent man rule analysis and evaluated each security transaction in isolation, thereby disregarding both the relevant market conditions and the fact that assumption of risk in some securities would likely result in higher returns to the entire portfolio. Importantly, had the *First Alabama* court applied modern portfolio theory, which notably evaluates the effects of individual transactions on an entire portfolio, it would likely have reached an opposite result.

In addition to its conflict with the modern portfolio theory's focus on total return, the prudent man rule also began to conflict with modern portfolio theory in its restriction against delegation. Restatement (Second) of Trusts §171 (1959) stated that trustees could not delegate to others acts that the trustees could reasonably do themselves. Further to this rule, comment h of the Restatement, which follows the prudent man standard, explicitly states that "a trustee cannot properly delegate to another power to select investments." This principle led the court in

---

[7] 425 So. 2d 415 (Ala. 1982).

Shriners Hospitals for Crippled Children v. Gardiner[8] to find that a trustee had improperly delegated investment responsibility to her son even though the trustee had no investment experience and her son was an investment counselor. Although the court conceded that "a trustee lacking investment experience must seek out expert advice," it held that "a prudent investor would certainly participate, to some degree, in investment decisions."[9] The *Shriners* decision was one of many cases that compelled trust professionals to draft so-called "direction trusts" to expressly allow for outside investment managers.

III. ONE ALTERNATIVE TO THE NONDELEGATION RULE: DIRECTION TRUSTS

Even at common law, the "direction trust" was a small exception to the general rule that a trustee must personally make all discretionary decisions related to the trust.[10] The "direction trust," sometimes also called a "directed trust," allowed a grantor to appoint a person or entity ("advisor")[11] to direct the trustee on certain discretionary decisions of the trust, typically regarding investments.[12] This wrinkle in the law was followed by some case law[13] and written about by some legal commentators,[14] but it was not until 1997 that a state had officially recognized direction trusteeships.[15] Not surprisingly, the lack of legal authority on the subject, and trustees' consequent confusion about their responsibilities under such trusts, were major deterrents to a grantor in creating a direction trust.

---

[8] 733 P.2d 1110 (Ariz. 1987).
[9] *Id*.
[10] *See* RESTATEMENT (THIRD) OF TRUSTS § 171 cmt. i, terms of the trust (1992) ("The trust terms may provide that powers a trustee would otherwise have shall be held instead by some other person. Thus, it may be provided that the trustee shall make only such investment as may be directed by...some third person. In such a case the trustee has no power to select investments.").
[11] The "advisor" could be a beneficiary, an unrelated third party or even the grantor.
[12] The primary difference between a "direction trust" and a "delegated trust" relates to who is appointing the third party. In a direction trust, the grantor is making the appointment. Conversely, in a delegated trust, the trustee is making the appointment. The delegated trust, which is not expressly authorized by the grantor, has become more controversial than the direction trust.
[13] *See*, *e.g.,* Rice v. Halsey, 142 N.Y. Supp. 58 (1913) (holding trustee not liable for acting on grantor's investment directions).
[14] *See*, *e.g.*, *Trust Advisers,* 78 HARV. LAW REV.1230 (1965).
[15] South Dakota was the first state to expressly enact a directed trustee statute. Florida, however, first recognized a general power of direction in 1961 without expressly referring to the directed trust vehicle. *See* Fla. Stat. § 691.04(8) (1961).

IV. OTHER ATTEMPTED BUT FAILED SOLUTIONS TO THE NONDELEGATION RULE

The nondelegation rule therefore left trustees in a troubled position. First, there were several acts that a trustee could do itself but were often inefficient or impractical for the trustee to do, such as organization of information for a judicial accounting. Second, there were acts that a trustee could not always properly do itself, such as investment management.

In response to these problems, several courts allowed a trustee to delegate "ministerial" acts but not "discretionary" acts. This rule did not offer a solution, because it was often unclear what acts constituted "discretion."[16] Moreover, it was difficult, if not impossible, to prove that the trustee in fact exercised its own discretion.[17]

Another solution, espoused by some courts such as that in *Shriners Hospital for Crippled Children v. Gardiner,*[18] began allowing trustees to delegate investment responsibility and to act on the investment advisors' advice so long as the trustees exercise at least minimal independent judgment. This solution also failed in that it did not recognize the problem that there can be little, if any, meaningful independent judgment if a trustee knows nothing on a subject. Thus, the nondelegation rule continued to clash with the heightened investment demands and opportunities in the market.

V. MODERN RULE: PRUDENT INVESTOR ACT § 9

Eventually the "prudent man rule" evolved into the "prudent investor standard."[19] The new terminology, coined by the newly drafted Restatement (Third) of Trusts (1992) and later

---

[16] *See* William L. Cary & Craig B. Bright, *The Delegation of Investment Responsibility for Endowment Funds*, 74 COLUM. L. REV. 207, 224 (1974) ("Even the most menial of tasks involves some discretion.").
[17] In attempt to ameliorate this problem, the Restatement (Second) §171 (1959) provided a list of factors to consider in determining whether a particular duty was "ministerial." However, these factors proved difficult to apply across a multitude of situations. *See* John H. Langbein, *Reversing the Nondelegation Rule of Trust-Investment Law*, 59 MO. L. REV. 105, 110 (1994).
[18] 733 P.2d 1110 (Ariz. 1987).
[19] For further explanation of the change from the "prudent man rule" to the "prudent investor rule," *see* Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 52 (1987).

supported by the Uniform Prudent Investor Act in 1994, followed the modern portfolio theory,[20] which, as noted above, emphasized that in an efficient market risks are necessary to yield higher returns. It thus became the trustee's duty to find the appropriate balance of risk and return for the trust. This duty, along with the diversification imperative, enforced heightened demands on the trustee.

In response to heightened demands on trustees in managing trust assets, along with the problems associated with the ministerial/discretionary distinction, the PIA included a provision that, subject to safeguards, allowed trustees to delegate their discretionary functions to third parties.[21] Indeed, trustees may now be deemed imprudent for failure to delegate in some situations.[22] A notable feature of the delegation provision is that it explicitly allowed trustees to delegate investment functions[23] and effectively overruled the ministerial/discretionary rule.

1. The Substantive Provisions of PIA § 9

The specific provision of the Uniform Prudent Investor Act that allows trustees to delegate discretionary functions is section nine. That section states that "[a] trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances." The section continues by mandating that the trustee must exercise reasonable care, skill, and caution in: "(1) selecting the 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." The section goes on to state that the agent owes a

[20] For further discussion of modern portfolio theory, *see* Edward C. Halbach Jr., *Trust Investment Law in the Third Restatement*, 77 IOWA L. REV. 1151 (1992); *see generally* Richard A. Posner, *Law and the Theory of Finance: Some Intersections,* 54 GEO. WASH. L. REV. 159 (1986) (relating investment analysis to legal risk analysis).

[21] The Uniform Prudent Investor Act (PIA) has been adopted in 43 states, with an additional state applying similar language. Only Georgia, Florida, New York, Delaware, and Louisiana have not expressly adopted the PIA; however, Delaware and Georgia's trust statutes, which allow trustee delegations, are actually more protective of the trustee than the PIA.

[22] *See* RESTATEMENT (THIRD) OF TRUSTS § 171 cmt. a (1992) ("A trustee's discretionary authority in the matter of delegation may be abused by imprudent failure to delegate."). *See also id*. cmt. g (A trustee may be "virtually compelled by considerations of efficiency" to delegate.).

[23] RESTATEMENT (THIRD) OF TRUSTS § 171 cmt. j (1992) (specifically overturning the discretionary / ministerial distinction by stating that delegation "is not precluded because the act in question calls for the exercise of considerable judgment or discretion").

duty of care to the trust and submits itself to the jurisdiction of the trust. In addition, the trustee is not liable for an agent's actions so long as the trustee complied with the safeguards above.

2. Little Case Law under PIA § 9

There has been little case law interpreting section nine or its state law counterpart. One possible theory as to why there is little case law is that several states took years to adopt the Uniform Prudent Investor Act, specifically section nine, and that the majority of states have enacted it only recently. Another possible theory is that even if states have enacted the provision, trustees may have been hesitant to act on it immediately, given its drastic departure from the nondelegation rule. A final possible theory as to why there is little case law is that much of trust litigation comes when an income beneficiary dies and the remaining trust funds are distributed outright to the remainderman, a process that takes several years. It is perhaps all of these theories combined that account for why there is currently little case law on trustee delegations.

Despite the fact that there has been little case law specifically interpreting section nine, some court decisions have given general guidance on delegation by a fiduciary. In *In re Estate of Jones*,[24] for example, the court held that permanent delegation is appropriate for particular acts but that full, permanent delegation of fiduciary responsibilities is never appropriate. This decision is supported by the Restatement (Third) of Trusts §171, comment f., which states that "the administration of a trust may not be delegated in full." The Restatement (Third) of Trusts §171, comment e. does, however, allow temporary delegation under certain circumstances, including illness, reasonable vacations and work-related necessities. The comment states that temporary delegation is proper only if it would not be impractical or in the interests of sound administration to appoint a successor trustee.

Another source for the interpretation of section nine is other uniform fiduciary laws that allow for delegation, for example, the Uniform Management of Institutional Funds Act §5 (1972), the Uniform Trustee Powers Act §3(24) (1964), the Restatement (Third) of Trusts §171 (1992), and the Employee Retirement Income Security Act of 1974 §403(a) (2).

---

[24] 765 N.Y.S.2d 756 (Sur. Ct. 2003).

A final source for the interpretation of section nine is state laws that have adopted the core of section nine but with broadened scope. New York,[25] for example, includes most of the substance of section nine but also requires the trustee to take into consideration the nature and value of the trust assets along with the degree of expertise of the agent in making the selection. In addition, New York explicitly requires the trustee to control costs of the delegation, whereas the PIA merely mentions costs in the comments section.[26] Notably, however, in contrast to the PIA and statutes such as of Florida[27] and Illinois,[28] the New York statute does not relieve trustees of responsibilities for the investment decisions or actions by the agent even though the delegation is proper.[29]

3. Effects of PIA § 9

Few trust law scholars deny that section nine of the Prudent Investor Act has revolutionized trust investments. Absent contrary authority in the instrument, section nine allows a trustee to delegate some of its traditionally non-delegable duties such as the responsibility to choose trust investments. Among other advantages, section nine provides trust beneficiaries with greater management expertise of trust funds that will in turn assist the trustee in maximizing total return of the trust funds. In addition, section nine provides the trust grantor with more options in selecting a trustee. This allows individuals without investment expertise, such as family members, to serve as trustee while delegating such responsibility to another party.

---

[25] For discussion of New York's departure from the nondelegation rule in finding a corporate trustee's investment delegation proper, *see* In re Estate of Younker, 663 N.Y.S.2d 946 (1997).
[26] N. Y. EST. POWERS & TRUSTS LAW § 11-2.3 (3); *see also* UNIFORM PRUDENT INVESTOR ACT § 9 cmt., which states in relevant part:

> The duty to minimize costs that is articulated in Section 7 of this Act applies to delegation as well as other aspects of fiduciary investing. In deciding whether to delegate, the trustee must balance the protected benefits against the likely costs. The trustee must be alert to protect the beneficiary from double dipping. If, for example, the trustee's regular compensation schedule presupposes that the trustee will conduct the investment management function, it should ordinarily follow that the trustee will lower its fee when delegating the investment function to an outside manager.

[27] FLA. STAT. § 518.112(3) (1993).
[28] 760 ILL. COMP. STAT. 5/5-1(c) (West 1991).
[29] *Id*.

The delegation rule of the Uniform Prudent Investor Act can be interpreted as an official recognition that investment opportunities have expanded, and that the complexity of such opportunities warrants a delegation to expert investment managers. It also realizes that there is inherent risk in investing in traditionally "safe" investments that may not keep up with inflation, and that delegating to those with investment expertise aligns with most grantors' desire to maximize total return.[30]

An important aspect of Uniform Prudent Investor Act section nine is that allowing trustees to delegate discretionary authority allows trustees to retain a wider array of assets. Consider the situation where the grantor requires the trustee to retain a business or real property, but the instrument is silent as to delegation and the grantor is now deceased. Arguably, there are several day-to-day "discretionary" decisions that an average trustee could not delegate out under the traditional rule. In addition, the trustee may not be in a position to handle the day-to-day management of the business, either because of lack of industry experience or lack of first-hand knowledge of the intricacies of this particular business or property. Under the traditional nondelegation rule, the average trustee could not accept office without judicial intervention. However, under section nine of the PIA, the trustee can accept office and delegate day-to-day management responsibilities to an expert.

VI. PROBLEMS WITH THE UNIFORM PRUDENT INVESTOR ACT § 9

Delegation of duties under the skeletal framework of section nine can be problematic, especially with investment delegation. Specifically, five major problems persist.

1. When Would a Prudent Trustee Delegate?

A glaring problem lies in determining when a "prudent trustee in the same circumstances" would delegate. The Restatement (Third) of Trusts §171 comment f. provides some guidance in establishing a list of factors that "may be of importance to the trustee or to a reviewing court" in deciding whether delegation is proper. This list includes a consideration of:

[30] For further discussion on how the Uniform Prudent Investor Act section 9 aligns with modern recognition of the advantages of specialization, *see* Langbein, *supra* note 18, at 118 ("Careful delegation for the purpose of taking advantage of external expertise and economies, especially in investment matters, unambiguously benefits the trust and its beneficiaries.").

(1) the nature and degree of discretion involved; (2) the amount of funds or the value and character of the property involved; (3) efficiency, convenience, and cost considerations in light of the situs of the property or activities involved; (4) the relationship of the act or activities involved to the professional skills or facilities possessed by the trustee; and (5) the fairness and appropriateness of the responsibilities in question to the burdens and compensation of the trustee.[31] Despite the value of these additional considerations, without empirical support as examples of what has been determined proper delegation, a trustee considering delegation is without proper guidance.

Some pre-PIA cases have offered some support in determining the appropriateness of delegation. In *Thayer Trust,*[32] for example*,* the Pennsylvania Orphan's court found that a trustee had properly charged the estate with fees for the advice of outside investment counsel. The court found that the testator appointed the trustee for personal reasons, and that the trustee, the testator's son, was not expected to be an expert in investment management. The court noted that it was making its decision during a time when jurisdictions were divided over the issue of whether a trustee's employment of outside investment counsel is ever proper. The *Thayer* decision quickly distinguished itself from that of *In Franklin Trust*[33] where the court noted that the trustee there "[s]urrender[ed] his ultimate judgment for that of hired counsel."

2. What Makes an Agent Adequate?

A problem related to when to delegate is *to whom* delegation should be made. In the language of the PIA, the question is: what constitutes "reasonable care, skill and caution" with respect to selecting agents? In asking this question, several subissues emerge: How much research is sufficient before hiring? With respect to delegating to a large investment firm, is the firm's reputation alone sufficient, or should the trustee meet with the prospective investment managers and require performance history charts? One recent case found that the reputation of the investment firm alone was sufficient to constitute a reasonable selection.[34] However, case law on the subject is far from established.

---

[31] RESTATEMENT (THIRD) OF TRUSTS §171 (1992) cmt. f.
[32] 71 Pa. D & C 2d 734 (1975).
[33] *Id*.
[34] O'Neil v. O'Neil, 2006 Ohio 6426 (2006) (involving Merrill Lynch).

3. Who Interprets the Trust Instrument?

Once it has been determined that delegation should be made and once an agent is selected, a problem arises as to whether the agent has a duty to interpret the terms of the trust independently or whether it should rely on the trustee's interpretation. One hypothetical situation involves a requirement in an instrument to retain a certain class of assets. The trustee's interpretation may be that a particular asset falls within the class, but the investment manager thinks otherwise. Whose interpretation controls?

If one takes the approach that the trustee is the employer of the agent, the trustee's interpretation should control and the agency principle of respondeat superior applies with respect to this issue. This would make sense because the agent is not called upon for its knowledge of trust law, and the trustee is expected to have known about the grantor and trust law to properly interpret the provisions.

However, if one takes a more literal reading of texts of the Uniform Prudent Investor Act and its progeny, the agent should conduct its own interpretation. Specifically, the Uniform Prudent Investor Act explicitly states that the agent is solely liable for actions occurring within the scope of its duties. Arguably, anything involving investments would be within the scope of its duties.

4. Can the Trust Assets be Invested in the Agent's Stock?

It is unclear from the text of the Uniform Prudent Investor Act whether the investment manager owes a duty of loyalty to the trust, not just a duty of care. This matters most when the investment manager wants to invest the trust funds in property that it owns itself, e.g. its own stock. If the investment manager owes a duty of loyalty, at minimum the investment manager would first need to disclose to the trustee and the beneficiaries his conflict of interest. Conversely, if no duty of loyalty is owed, a duty of care alone may not require disclosure. The duty stated in Uniform Prudent Investor Act section 9(b) is framed in terms of a duty of care.[35]

[35] UNIFORM PRUDENT INVESTOR ACT: DELEGATION OF INVESTMENT AND MANAGEMENT FUNCTIONS. § 9(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.").

As an "agent to the trust," presumptively a duty of loyalty would also apply,[36] but the answer is not entirely clear. Moreover, even if disclosure were made, the appropriateness of such an investment would still be unclear. Arguably, the trustee's veto power over the investment would invite objectivity to the transaction that would otherwise be absent in the case where the trustee were investing in its own stock. However, the situation lies dangerously close to the case where the trustee is investing in its own stock, a transaction typically forbidden as self-dealing.[37]

5. Is Delegation Proper for a Nondiversified Portfolio?

Some pre-PIA case law suggests that delegation may not be proper in nondiversified portfolios. In *In re Phipps Family Trusts*,[38] for example, the court denied a corporate trustee's petition to disburse funds to investment counsel because the only asset in the trust, a closely-held stock, did not require the "usual pain and trouble" of a diversified portfolio. Similarly, in *In re Badenhausen's Estate*,[39] the court denied disbursement for investment counsel where the bulk of the assets consisted of a home and closely held stock. Importantly, although these cases were decided prior to the PIA, both jurisdictions of the two cases expressly recognized the authority to delegate at the time.[40]

[36] *See* Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928) ("A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.").

[37] For a discussion of the harm of a trustee owning its own stock, *see generally* RESTATEMENT (THIRD) OF TRUSTS §170, cmt. n, which states:

> A bank or trust company serving as trustee cannot properly purchase its own stock for the trust estate, even though the shares are purchased from third persons. This is true although the purchase of similar shares of another bank would be a suitable investment for the particular trust. . . [s]uch retention is proper when it is authorized in terms that specifically refer to the trustee's shares. When there is a general authorization to retain investments received from the settlor, it is a question of interpretation whether retention of shares of the corporate trustee is permitted. A general authorization in the trust terms would ordinarily apply to the shares of the trustee, for example, if the trustee's conflict of interest was apparent to the settlor at the time the instrument was executed.

[38] 147 N.J. Super. 331 (1976).

[39] 237 N.Y.S.2d 928 (Surr. Ct. 1963).

[40] *Id.* at 931 (noting, "[t]he accepted rule that executors may employ agents to assist them in the performance of specific functions where special circumstances create the necessity for assistance").

6. How Does Communication Circulate?

Beneficiaries may be confused as to whether their point of contact is the trustee or the agent. Similarly, the investment manager may have contact with the beneficiary that the manager will not share with the trustee. This arises because in practice, an investment advisor will often approach a bank with trustee powers, stating that the beneficiary would like to consolidate the assets with the beneficiary's long-trusted investment manager and asking if the bank will serve as trustee under a directed trust relationship. Under this common scenario, information is not always centralized with the trustee, and the investment advisor might not communicate with the trustee on its meetings with the beneficiary. In addition, the corporate trustee or investment advisor may be tempted to conceal beneficiary information in an effort to inhibit competition with one another for other business with the beneficiaries. Because there is no express duty of communication between the agent and the trustee in section nine of the Uniform Prudent Investor Act and similar state statutes, lack of communication could be a major pitfall for a trustee under a duty to handle distributions according to the beneficiary's current situation in life.[41]

7. What Duties Does the Agent Owe and to Whom?

Certain agency problems persist in the context of directed trusts. For example, a problem arises as to whom the investment manager is an agent: Is it an agent to the trustee or to the beneficiaries? The Restatement (Third) of Trusts §171 states that the investment manager is an agent of the trustee, whereas section nine of the Uniform Prudent Investor Act is silent. The distinction is mostly a matter of procedure: Should the beneficiary sue the trustee or the agent for failing investment performance? The distinction can also make a difference in imputing duties to the agent, specifically, whether traditional fiduciary duties, such as the duty to account, are owed to the beneficiaries or just to the trustee.[42]

---

[41] *See*, *e.g.*, Marsman v. Nasca, 573 N.E.2d 1025 (Mass. App. 1991) (finding that trustee who failed to distribute funds to beneficiary had failed in his duty to become familiar with the beneficiary's life situation).

[42] For further discussion on the agency problem, *see* C. Boon Schwartzel, *Is the Prudent Investor Rule Good for Texas?,* 54 BAYLOR L. REV. 701, 805 (Fall 2002) (finding it unclear whether the "duty to the trust" extends to the beneficiary or just to the trustee).

Once it has been determined to whom agency duties are owed, a related question is what duties are owed. For example, typically the fiduciary has a duty to inform and account to the beneficiary. It is unclear, however, whether the agent would have a similar duty to inform and account to the trustee such that the agent would have a duty to share information about the beneficiary with the trustee.[43]

Another issue in delegating investment responsibility is whether the trustee has a duty to educate its investment managers on trust law and fiduciary duties or whether the investment manager has a duty to self educate. The modern law as promulgated in the Uniform Trust Code §1012 has eliminated the common law duty of third parties dealing with the trust to inspect and understand the trust instrument, but it is unclear whether this provision extends to agents of the trust who are "third parties" bound by independent fiduciary duties.[44] The duty to educate may or may not be within the trustee's duty to "establish the scope of delegation."

8. How Far Does the Duty to Supervise Extend?

Another issue relates to the trustee's duty to supervise the agent. Specifically, the question relates to the extent to which the delegating trustee should understand what the agent is doing. Under the Uniform Prudent Investor Act §9(a)(3), a trustee must "[review] the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation."[45] However, it is difficult to imagine how an individual trustee with no investment expertise could possibly supervise the agent's performance, especially when the trust contains complex investment vehicles such as options and hedge funds.

---

[43] The necessity of information about beneficiaries can be seen in *Nat'l Acad. of Sci. v. Cambridge Trust Co.*, 346 N.E.2d 879 (Mass. 1976). There a provision in the instrument required the trustee to pay out the trust income to the decedent's sister so long as she remained alive and unmarried. The court found that the trustee had breached its duty to keep itself apprised of the sister's marital status.

[44] UNIFORM TRUST CODE § 1012. PROTECTION OF PERSON DEALING WITH TRUSTEE (2006), which states in relevant part:

> (a) A person other than a beneficiary who in good faith assists a trustee, or who in good faith and for value deals with a trustee, without knowledge that the trustee is exceeding or improperly exercising the trustee's powers is protected from liability as if the trustee properly exercised the power. (b) A person other than a beneficiary who in good faith deals with a trustee is not required to inquire into the extent of the trustee's powers or the propriety of their exercise.

[45] *See* UNIFORM PRUDENT INVESTOR ACT, *supra* note 1.

A related question here is whether the trustee's "terms of delegation" should instruct the investment manager on the investment objective with asset allocation guidelines. If so, the duty of supervision would probably require the trustee to question any investment that falls outside the allocation model. Still, the PIA doesn't expressly make this requirement.

If the trustee's duty extends beyond a mere review of the asset allocation, perhaps the trustee should question investments in individual assets.[46] An example here is where an investment manager decides to invest in a company that the trustee thinks is unwise because of a recent scandal, or where an investment manager wants to invest in a certain private placement but the trustee, an attorney, questions whether the private placement meets SEC exemptions. In either of these cases it is unclear whether the trustee has a duty to question the agent's actions.

VII. A PARTICULAR ISSUE IN TRUSTEE DELEGATIONS: CORPORATE "DIRECTED" TRUSTS

A final issue in trustee delegations is related to the corporate directed trust. A corporate directed trust differs from the traditional trust in that a corporate directed trust delegates investment responsibility to another firm even though the delegating firm itself has the ability to manage the investments. This is such a novel concept that very few firms offer directed trusts, and the term "directed trust" is not listed in Black's Law Dictionary.[47]

The added benefit of a corporate directed trust is that it allows a financial institution with state or federal trustee powers to serve as trustee while allowing the grantor to choose his trusted investment advisor to manage his trust along with the grantor's other assets. This allows the grantor to consolidate his assets with one investment advisor, who does not have state or federal trustee powers but has long understood the grantor's financial status and objectives. In this

[46] For the various approaches on a fiduciary's duty to supervise its agent, *see* McClure v. Middletown Trust Co., 95 Conn. 148 (1920) (Duty to supervise agent includes duty to utilize reasonable diligence in ensuring that agent was carrying out the duties entrusted.); Estate of Hampton Cooper, 2005 Phila. Ct. Com. Pl. LEXIS 602 (2005) (finding improper supervision of investment advisor notwithstanding lack of investment expertise on the part of the delegator); Duemler v. Wilmington Trust Co. (Del. Ch., Oct. 28, 2004) C.A. 20033, V.C. Strine (finding that under Del. Code §3313(b) a Delaware direction trustee is not liable for failing to provide its outside investment manager with information in order to make investment decision on a tender offer and that in this situation it is not necessary for the trustee to participate at all in investment decisions).

[47] *See* BLACK'S LAW DICTIONARY (8th ed. 2004).

situation, the trustee typically takes custody of the assets, sets the terms of the investment advisor's role, acts on investment advisor's trading instructions, determines the appropriateness of all distributions, sends statements to the beneficiaries, prepares tax returns, and supervises the investment manager on the appropriateness of his actions.

Without authority to delegate in the governing instrument, the trustee must look to governing law or else to seek an amendment to the governing instrument. Assuming that the jurisdiction has adopted some version of section nine of the Uniform Prudent Investor Act, the trustee can usually delegate. If the jurisdiction has not adopted section nine, amending the governing instrument depends on whether the grantor can revoke the trust or not. If the trust is revocable, the grantor can simply amend the terms at any time. If the trust is irrevocable, the trustee and all beneficiaries together can usually amend the trust terms to allow delegation.[48] If the trustee does not want to amend, and the trust is irrevocable, the trustee will typically be outvoted by the grantor and all the beneficiaries. However, an issue arises when the trustee and all beneficiaries disagree as to the amendment of the trust and the grantor is deceased. Under the "English" approach, the beneficiaries' consent trumps the trustees' objection because the beneficiaries are considered owners of the trust property at the grantor's death. Under the "American" approach, however, the trustee's objection trumps the beneficiaries' consent because, as a policy, prospective trust grantors should be encouraged to set up trusts knowing that their intent will be carried through.

One of the major issues in corporate directed trusts is whether the delegation provision of section nine was intended for individuals. There are several arguments on both sides.

1. Arguments for Allowing Delegation for Corporate Trustees

Proponents of allowing delegation for corporate trustees have five arguments.

First, as a practical matter, so long as the overall fee to the trust remains nearly the same as between the corporate trustee's nondirected fee and its directed fee and outside investment fee combined, the difference may be insignificant. Indeed, it would be difficult to prove that had the

---

[48] For a general discussion on the ability to amend trusts, *see* JESSE DUKEMINIER ET. AL, WILLS, TRUSTS, AND ESTATES (7th ed. 2005).

delegation not been made, damage would not have occurred with the corporate trustee's in-house investment management.

Second, the Prudent Investor Act does not differentiate between corporate and individual trustees. The National Conference of Commissioners on Uniform State Laws was clearly aware of the difference, as corporate trustees have been in existence for hundreds of years, yet the Conference chose not to differentiate.

Third, comment f. to the Restatement (Third) of Trusts §171 implies that in some circumstances, the trustee may delegate even what would be reasonable to require it to personally perform. Thus, even though the corporate trustee may have investment capabilities, it can probably delegate investment functions to third parties where appropriate.[49]

Fourth, fiduciary investment law has generally recognized delegation for corporate trustees.[50] Indeed, one case noted that "[s]ituations arise when trustees, *whether corporate or personal*, find themselves beyond their depth or beyond capabilities which can reasonably be expected of them."[51]

Fifth, corporate trustees tend to manage larger assets than individual trustees, and these larger assets are often appropriate for complex investment vehicles such as hedge funds. These complex investment vehicles often benefit from, if not require, particular expertise.[52]

2. Arguments Against Delegations for Corporate Trustees

Critics of allowing delegation for corporate trustees may have six counterarguments.

---

[49] *See, e.g., In re* Estate of Ira and Rose Younker, 663 N.Y.S.2d 946 (allowing a corporate fiduciary to delegate investment responsibility to family investment advisor where delegation was anticipated by the governing instrument and "within the spirit" of New York's Estates, Powers, and Trust Law §11-2.3(c), which follows the Prudent Investor Act in allowing delegation).

[50] *See, e.g.,* NY CLS Bank § 100-c (1) (2007) (expressly allowing banks to invest common trust funds in mutual funds); *In re* Estate of Ira and Rose Younker, *supra* note 52; *see also* Wachovia Bank and Trust Co. v. Morgan, 279 N.C. 265 (1971) (allowing corporate trustee to hire additional administrators to assist in distributions).

[51] Dunbar v. Birmingham Trust National Bank*,* 286 Ala. 186, 188 (1970)(emphasis added).

[52] *In re* Badenhausen's Estate*,* 237 N.Y.S.2d 928, 948 (stating that the Advisory Committee to the Legislature on New York's Surrogate's Court Procedure Act and Estates, Powers, and Trust Law "anticipated that foreign securities or venture capital investments not within the expertise of a corporate fiduciary may be proper areas of delegation").

First, the critics may argue that pre-PIA cases allowing delegation have focused on the necessity for delegation.[53] Arguably, since a corporate trustee itself has the ability to manage assets, delegation, the critics may argue, is usually improper.

Second, the critics may argue that the fact that the Prudent Investor Act and similar state statutes do not differentiate between corporate and individual trustees does not implicitly authorize corporate directed trusts. These critics may point to the legislative history surrounding the act that focused on allowing individuals to delegate without mention of corporate trustees.

Third, the critics may cite one case that stated that "the principal reason cited by banks and trust companies for their selection as trustee, rather than an individual, is their superior investment skill."[54]

Fourth, the critics may argue that allowing corporate directed trusteeships, where the trustee has the ability to, but does not, manage funds, is too radical a departure from the traditional nondelegation rule to have been contemplated by the PIA.

Fifth, the critics may argue that information is spread too loosely for effective trust management when several parties are involved.

And sixth, the critics may argue that the way that the Restatement (Third) frames the delegation rule, with nondelegation being the standard and delegation being the exception, implies that delegation should occur only in the "exceptional" cases.

Despite these arguments against allowing corporate trustees to delegate discretionary functions, the reality of advantages in specialization, the emerging industry that has developed around directed trusts, the lack of differentiation between corporate and individual trustees in the Uniform Prudent Investor Act and similar state laws, and the insignificance of harm from

[53] *See*, *e.g.*, *In re* Phipps Family Trusts, 147 N.J. Super. 331 (1976) (disallowing a corporate trustee to disburse funds to investment counsel because the only asset in the trust, a closely-held stock, did not require the "usual pain and trouble" of a diversified portfolio); IAM Stock Ownership Inv. Trust Fund v. Eastern Air Lines, Inc. 639 F. Supp. 1027 (D. Del. 1986) ("The trustee can properly incur expenses which are necessary or appropriate to carry out the purposes of the trust and are not forbidden by the terms of the trust." (citing the RESTATEMENT (SECOND) OF TRUSTS § 188)).
[54] *See supra* text accompanying note 52.

delegation if the corporate trustee adjusts its fee would all likely lead courts to extend delegation authority to corporate trustees.

3. A Possible Compromise: Seek Investment Advice

One possible solution to a corporate trustee's investment delegation is for the corporate trustee to seek investment "advice." This situation was found in *Shriners Hospitals for Crippled Children v. Gardiner*,[55] a pre-PIA decision noted *supra* in which the court found that it was more appropriate for a trustee to seek investment advice than to delegate its investment function entirely.

Proponents of this solution may argue that seeking advice eliminates agency complications and centralizes beneficiary information. Critics of this solution may argue that those giving advice can fully understand the grantor's intent and beneficiary's situation only if they have full control of investments and are bound by a fiduciary duty. In addition, the requirement that the trustee exercise its own judgment of the investment advisor's advice can be difficult for courts to determine.

VIII. SUGGESTED REVISIONS TO THE PRUDENT INVESTOR ACT § 9

a. Bar full, permanent delegations and allow full temporary delegations, but only when necessary;

b. Provide a list of factors that the trustee is to consider in deciding (i) whether to delegate a particular responsibility, and (ii) to whom delegation should be made;

c. For each provision of section nine, provide examples of proper compliance with each provision in the commentary;

d. Provide that, prior to delegation, the agent and trustee are to convene either in person or by phone or in any other similar manner, during which time the trustee must inform the agent of both the applicable trust terms (e.g., provisions related to

[55] 733 P.2d 1110 (Ariz. 1987).

investments) and about the expectations of the agent pursuant to its fiduciary responsibility, which includes a duty to inform, account and avoid unnecessary costs to both the beneficiary and the trustee;

e. Provide that the trustee is to review the agent's actions at least annually;

f. Provide that all provisions relating to trustee delegations equally apply to corporate trustees;

g. Provide that any investment in the equity of the investment manager's company is considered a breach of duty of loyalty unless either the grantor or all beneficiaries consent to such an investment in a written document delivered to the trustee; and

h. Provide that, when delegating investment responsibility, the trustee should make inquiry into the decisions of the investment manager only to the extent that a particular investment may or may not fall into the asset allocation plan and should not extend to the merits of holding one asset over another within the same class.

IX. CONCLUSION

This paper has attempted to add questions to the existing legal structure for allowing trustees to delegate. It has attempted to show that vague standards such as "prudence" employed by section nine of the Uniform Prudent Investor Act and similar uniform laws can leave delegating trustees with little guidance and may only open the floodgates to litigation should any question of delegation arise. These vague standards are, in the words of the Restatement,[56] but "[l]imited generalizations...couched in terms that are less than self-defining." Furthermore, the lack of case law on the subject or examples in the commentary of uniform laws further supports the need for more guidance. Nevertheless, the ability of the trustee to delegate traditionally nondelegable responsibilities has greatly revolutionized the law of trust management. It adds greater specialization to asset management and provides more options to a grantor in selecting a trustee. With more legal guidance from legislatures, beginning with the National Conference of

[56] RESTATEMENT (THIRD) OF TRUSTS § 171, cmt. h.

Commissioners on Uniform State Laws, all parties involved will benefit from greater certainty in trust management.