A TRUSTEE'S CRIME AND PUNISHMENT: MANAGING FIDUCIARY LIABILITY UNDER THE CALIFORNIA PRUDENT INVESTOR ACT

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A new era in family trust asset management was introduced to California with the codification of the California Uniform Prudent Investor Act [*the Act*].[1] Trustees and estate planners, as well as investment management consultants, face new challenges in attempting to cope with this legislation.[2] Since the enactment of the Act, much commentary has been devoted to its requirements. To date, less discussion has been directed at a trustee's potential liability for failing to comply with these requirements, and the ways a fiduciary can protect against this liability.

This article is intended to introduce the practitioner to these issues. The authors will also attempt to provide some suggestions for the appropriate management of the challenge of fiduciary liability in the field of "private" trusts. The authors believe that the prudent trustee will find particular merit in establishing *written investment objectives and guidelines* for decision making. The authors will also argue that the most prudent course of action in managing fiduciary liability may be *appropriate delegation* to qualified professionals. For purposes of clarity, this article distinguishes between "private" trusts and their institutional counterparts. Private trusts are the entities practitioners ordinarily advise. Institutional trusts are qualified retirement plans, usually subject to ERISA[3] requirements. The authors draw this distinction because we believe that courts may look to existing case law developed in the administration of institutional trusts when confronted with litigation arising under the Act.

The cornerstone of the Act may be found in Probate Code Section 16047. That section establishes Modern Portfolio Theory [*MPT*] as the preferred tool for trust investment management. A fundamental concept of MPT is that the value, or price, of an asset is a function of (1) the rate of total return, that is, ordinary income and capital appreciation that the asset is anticipated to generate, and (2) the risk that the actual return will fall short of the anticipated return. Analyzing the risk of an asset not reaching its expected return causes the investor to focus on assets as integral parts of an entire portfolio instead of on each asset in isolation. Determining whether a trustee has fulfilled his or her duties, therefore, becomes dependent upon the manner in which the trustee has made investment decisions. This analysis avoids characterizing individual assets as prudent or imprudent. The trustee's investment performance is scrutinized in relation to circumstances, not in a single-asset vacuum. An advantage to this approach is that the importance of hindsight is reduced.

The Act imposes on the trustee the duty to manage the portfolio as a whole.[4] A component of this duty requires the trustee to manage the trade-off between risk and return.[5] Trustees should determine consciously the level of risk to be taken in pursuit of returns in light of the purposes and terms of the governing instrument. In the language of MPT, trustees must diversify efficiently.[6]

Managing the portfolio as a whole compels the trustee to establish objective portfolio standards, and to assess portfolio risk and return. Probate Code §16047 addresses this objective by suggesting the need to integrate financial planning with general economic analysis.[7] This integration can be accomplished by monitoring existing investments as well as assessing proposed investments. A proper assessment requires the trustee to consider and report net returns and time-weighted returns. “Net returns” are typically computed on an after-tax and after-expense basis. “Time-weighted” returns are typically evaluated by whether the wait is worth the risk. The Act expands the universe of potential trust investment categories, thus facilitating the goal of efficient diversification and risk management.

Even though the prudent investor rule has become the default standard for trust administration, a widespread perception exists among practitioners that most nonprofessional trustees are unaware of the important changes brought about by the Act. The application of the prudent investor rule to a trustee's administration will be governed first by the terms of the instrument, and second by the applicable statute. In the unlikely event that the instrument is silent and no statute applies, The Restatement [*Third*] of Trusts [1992] may be used.

Practitioners realize that it is axiomatic that a beneficiary will be more likely to perceive "wrongdoing" in the course of trust administration if the assets or income have been depleted. Trustees and their advisors who remain oblivious to the implications of the Act may become vulnerable to the risk of a successful claim of breach of fiduciary duty if the trust's investment performance is unsatisfying. Generally, remainder beneficiaries will sue on the basis of "inadequate growth" in the trust corpus, while income beneficiaries may object because of inadequate cash flow to meet expenses. Given the sometimes complex and often conflicting interests of these multiple beneficiaries in the principal and income of a private trust, the authors consider it simply a matter of time before disaffected beneficiaries use the Act as another basis upon which to assess liability against the trustee. A claim of breach of fiduciary duty for failing to comply with the Act will become another measure for the court to calculate damages.

How might a disgruntled beneficiary prove breach of fiduciary duty from the trustee's investment choices? Alternately, does a course of behavior exist to protect the trustee from such claims, notwithstanding lackluster investment performance? The lack of experience under the Act has not afforded courts with much opportunity to provide practitioners with useful guidance. Consequently, practitioners are compelled to speculate on how a court may ultimately decide an issue under the Act.

The Act establishes portfolio administration and management standards similar to those that have evolved in the "institutional" trust field over the past twenty-four years, tax differences notwithstanding. Therefore, practitioners should find it helpful to review and draw some

guidance from those areas of fiduciary liability in the field of institutional trusts that appear to have parallels to private trusts.

In the area of employee benefit trust management, a good deal of case law now serves to provide interpretative guidance on the applicable federal statute, ERISA.[8] Among the basic issues considered by courts construing ERISA have been the following:

- *Who* is a fiduciary? Beyond the obvious of the trustee lie the more distant roles of the advisors.[9]
- What is *prudence*? Is it sufficient for the trustee to act in "good faith" and use "best judgment and effort" in making investment decisions, or must prudence be found in the portfolio's rate of return. In short, is prudence procedural or substantive?
- How does *diversification* relate to prudence? A corollary to this issue is the manner in which the trustee manages the trade-off between expected returns and anticipated risk.[10]
- When can fiduciary responsibility and liability be *delegated*? In contrast to the traditional common law aversion to fiduciaries delegating decision-making power to qualified third parties, the Act specifically recognizes the potential benefit in delegation.[11] Delegation has long been an accepted practice in institutional trusts.[12]
- What *costs* is acceptable once investment decision making has been delegated?[13]

FIDUCIARY

Among private trustees, practitioners are comfortable that the trustee will generally be the only person considered to be the fiduciary. Circumstances may exist when others, such as lawyers, are found to have a fiduciary duty to the beneficiaries.[14] As a general proposition, however, the trustee is the fiduciary.

This bright line does not exist in the administration of institutional trusts.[15] Consequently, the lines may be blurred in subsequent litigation under the Act. ERISA cases have defined a

fiduciary as anyone who exercises discretionary authority over the plan's management, or assets, or who has responsibility for the administration for the trust.[16] Under ERISA, a fiduciary has included any person who renders investment advice for compensation, or who assists in administration for compensation.[17]

This broad definition will provide an aggrieved beneficiary with well-established authority to seek to hold the advisors liable along with the trustee. This theory could also allow the trustee to cross-complain for indemnity against the advisors if the beneficiary does not. Practitioners may find themselves in the awkward position of being held to a fiduciary duty for incidental investment advice provided to the trustee. A lawyer may not be able to escape this net if the lawyer was paid, regardless of how trivial the financial advice provided.

In counterpoint to this potentially liberal construction of fiduciary is a line of authority excusing professionals who do not exceed their professional duties. Lawyers who act strictly as lawyers will not be treated as fiduciaries.[18] The challenge for a trustee's attorney will be to have a file that clearly demonstrates that the lawyer did nothing more than provide legal advice to the trustee. Conversely, attorneys and accountants who are willing to "go the extra mile" for their clients may end the engagement with regrets.

PRUDENCE

Private trust administration may need to look to the institutional experience in defining prudent investing now that Modern Portfolio Theory has become the conceptual paradigm for portfolio management. Practitioners who advise institutional trustees generally accept that prudent fiduciary investing is reflected in numerous and documented acts of investment decision making. This pattern implies a sound decision making process. Nevertheless, a sound decision making process should not be simplistically reduced to rigid adherence to procedure. The goal of a sound process is to establish and follow policies and procedures that encourage well-informed and reasonable decisions by the trustee. After all, the purpose of these decisions is desirable investment outcomes over the course of the trust administration.

An important first step for the trustee in prudent management is the establishment of a written statement of objectives, policies and procedures. This investment policy statement {"IPS") is common in the institutional trust environment.[19] Use of the IPS has become sufficiently common among institutional trustees so that an institution without such a statement usually suffers from severe self-inflicted exposure.

Probate Code Section 16049 appears to impose the requirement upon the private trustee to implement an investment policy statement:

> Within a reasonable time after receiving a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms distribution requirements, and other circumstances of the trust, and with the requirements of this chapter to manage the portfolio as a whole.

The authors anticipate that beneficiaries' attorneys will rely upon the institutional practice, combined with the statutory admonition, to provide justification for a court to find liability and assess damages under the Act against private fiduciaries. In light of this potential exposure, trustees would do well to establish clear investment objectives and guidelines for making strategic investment decisions by adopting and implementing an IPS.

An IPS should set forth realistic objectives. The IPS should also contain the terms and frequency of performance reviews, and the basic definitions of success and failure. While the IPS might then provide a ready source of evidence for a disaffected beneficiary, the trustee will confront considerably more exposure when there is a failure to state objectives and goals. In the absence of a written statement the beneficiary will have a significantly broader basis upon which to complain about the trustee's investment performance.

For example, assume that the trustee's stated investment objective is to equal the performance of a popular market index, such as the Russell 3000. Assume that the trustee fails to meet this objective by 1%, or 100 basis points. The trustee's "worst case" liability, assuming all else to be

equal, will probably be limited to 100 basis points. In any event, the trustee will be able to frame the limits of liability, because of the existence of the investment policy statement.

In contrast, consider the trustee's exposure in the case where investment objectives are not stated, and an IPS does not exist. The measure of damages may be open to any one of a number of calculated remedies. Equally unpleasant for the trustee, the beneficiary will be the party framing the limits of liability.

DIVERSIFICATION

The Act makes a very broad universe of investment classes permissible. This flexibility facilitates portfolio diversification, which is a well-established principal in trust investing. One diversifies in order to reduce the risk. The duty to diversify is codified in Probate Code Section 16048, and is by now well known. The actual risk tolerance, which governs the level of diversification, of the trustee will be determined by the various distribution requirements of the trust beneficiaries.

In the world of contemporary portfolio management, we need to distinguish between event, or "specific risk", and systematic, or "market risk". The former type of risk is firm specific, and the latter is attributable to common macroeconomics. By definition, specific risk is independent of market risk, and the statistical measures of, and management techniques for, these risks are different.

According to modern portfolio theory, the market compensates the investor for market risk.[20] Any compensation for this risk is in the form of an adjustment of the return that inures to the particular asset (generally, a higher rate of return corresponds to a higher market risk of a shortfall).[21] An investor can regulate market risk by selecting a level of risk and reward, and by selecting investments, that are consistent with that level. For example, the investor can select investments that are more risky than, less risky than, or as risky as, the market as a whole.

Specific risk is also known as uncompensated risk. Specific risk refers to those elements of risk that are unique to particular companies. The risk that the chief executive officer of an enterprise will have a fatal heart attack, that an earthquake or flood will render a plant inoperable, or that a company will suffer a labor strike, are all examples of firm-specific risks because they are unique to a particular company. To the extent the risk of shortfall of return is unique to the particular asset, the market does not compensate for the risk.[22]

The Act requires the trustee to consider the universe of investment classes to be used in asset management, and the emphasis, or "weighting," to be placed on accepted investment categories. These considerations require review of the terms and conditions of the trust, as well as prevailing economic and capital market conditions. In the world of financial management, these conditions are known as asset allocation.

Asset allocation makes possible selecting the most efficient set of alternative investment portfolios, in light of purpose and terms of the trust instrument. In MPT this allocation is referred to as portfolio optimization. Asset allocation and portfolio optimization point toward efficient diversification, a cornerstone of contemporary risk management. Efficient diversification requires more than simply adding individual investments, funds or account managers to the trust inventory.

A trustee who fails to utilize asset allocation creates additional, but unnecessary, exposure to the beneficiaries in the event of poor portfolio performance. The contemporary conceptual underpinnings of MPT are heavily tilted toward the effective use of asset allocation. A prudent trustee, therefore, will allocate the assets of the trust portfolio as a matter of course. A trustee who fails to do so, unfortunately, concedes an important prong of "imprudence " to the beneficiary without being able to litigate the issue.

Asset allocation will require a level of investment sophistication that the trustee may not possess. In such circumstances, the trustee will be obligated to employ professional assistance.

DELEGATION

The nonprofessional trustee may assume direct responsibility for setting investment and risk management strategy, making investments, and monitoring results. If the trustee is financially unsophisticated, employment of investment advisors may be a prudent step. Indeed, authority exists for the proposition that a trustee who fails to seek advice with respect to matters about which the trustee lacks skill or knowledge may be liable for failure to exercise proper care in making an investment.[23]

The general rule is that the trustee may delegate authority to make investment decisions, but the delegation must be prudent in terms of selecting the agent, establishing the scope of the delegation, and reviewing the performance of the agent.[24]. Probate Code §16052 specifically authorizes the trustee to employs agents, presumably including investment counselors. Prior case law also supports this approach. The trustee may hire and rely upon the assistance of investment experts.[25] This reasoning explains why the Act expressly reverses the old rule that forbade delegation of investment management functions by trustees to third parties. Authority now exists for the reverse proposition: a trustee who fails to seek advice with respect to matters about which the trustee lacks skill or knowledge may be liable for failure to exercise proper care in making an investment.[26] Fees paid to an investment advisor may also be deductible without regard to the two- percent floor of I.R.C. § 67 for miscellaneous itemized deductions.[27]

The authors expect that trustees will increasingly employ third party professionals to fulfill investment responsibilities. The fiduciary standard of exercising reasonable care and caution in establishing the scope, terms, and conditions of delegation, and in the selection of agents can be most easily demonstrated by the trustee's establishment and adherence to a written policy.[28] This approach would be entirely consistent with the experience of institutional trustees over the past 24 years.

Selection standards for delegates ought to be clearly spelled out. The scope of delegation must be made as precise as possible. Control procedures, including the monitoring and review of

manager decisions and performance should be clearly articulated. Clear lines of communication among selected agents and the trustee ought to be established, including a procedure for informing delegates of any changes in trust objectives. Prudent fiduciary behavior would encourage a trustee to delineate and articulate the overall investment strategy to each agent to whom discretionary investment authority is delegated.

The idea of delegation commended to trustees in the Act implies the establishment of professional relationships that in turn require management. A persuasive argument may evolve that the Act imposes on the trustee the fiduciary duty to undertake the ongoing effective management of these relationships. In this perspective, the IPS may be viewed as a management statement.

The Act appears to provide two major opportunities for trustees to delegate in order to reduce their personal liability in trust management. As described above, one opportunity exists in investment strategy and procedures. A second opportunity exists in day to day investing. A distinction should therefore be drawn between the roles of the investment management *consultant* and portfolio *manager*.

The investment management consultant should be an independent third party who can design the strategic investment plan, as well as develop and implement written investment policies and procedures for the trust. This role typically includes developing an asset allocation model that satisfies the specific purposes, terms, and conditions of the trust. The consultant is usually also instrumental in implementing the IPS. This function generally entails reviewing and evaluating portfolio management firms to assist the trustee in delegating prudently.

The consultant should be responsible for monitoring the activities of the portfolio managers, and for measuring their performance. This measurement should always be net of all expenses, on a risk-adjusted basis, and in relation to the purposes of the trust. The consultant will also be responsible for evaluating the managers' performance relative to the trust's specific portfolio.

The consultant can also serve a useful function in assisting the trustee in meeting the fiduciary duty to incur only reasonable and justifiable expenses in trust management.

In contrast, portfolio managers will typically have discretionary authority over day to day decisions on the individual assets in the trust portfolio. Portfolio or fund managers, not investment management consultants, make specific buy and sell decisions. Generally, trustees choose among various trust management alternatives. These choices can include separate and pooled account managers, mutual funds, and unit investment trusts, or brokerage relationships. In most cases, multiple managers, representing different approaches to investing or investing in different markets may be recommended to the trustee by the consultant. An additional role of the investment management consultant is to assist the trustee in selecting cost efficient money managers.

What appointment standards should the trustee consider when selecting these advisors? The advisor should have a demonstrated grasp of MPT. Clearly, an understanding of macroeconomics is seen to complement a working knowledge of MPT. The Act also makes it clear that the trust management should also include the assessment of current and potential economic conditions and trends. Access to a recognized research capability, and reasonable reliance upon it, should therefore be one criterion. Experience in the field can be another. Actual performance can be a third. The agents who are given the responsibility for managing assets must have a strong and demonstrable working understanding of the analytic tools of MPT. Years of experience in investment management, advanced portfolio management designations reflecting conceptual training in and understanding of MPT, such as a. CIMA, CMIC, CFA, would be useful considerations for the trustee in seeking qualified help at a strategic level of trust management. Depth and quality of analytic and operational resources, objectivity, and sensitivity to the diverse financial planning challenges of trust work are additional factors that must be considered starting points in a search for an investment management consultant. It would be especially helpful if the individual hired as a consultant to the trustee was a multi-disciplinary professional.

The authors expect that these criteria will undergo refinement as the Act matures. A trustee who employs professional investment advisors without these demonstrated credentials, however, may face exposure to a subsequent claim of imprudence in delegation.

Inevitably, use of a consultant and portfolio manager implies the potential for unnecessary additional expense. The "value" of such support is related to the nature of the beneficiaries' interests, as well as the size of the trust. Contrary to common misperception, however, the cost to secure the services of a consultant, together with multiple account managers, is within reach of trusts starting at $2 million in liquid assets. These services will also include custodial and brokerage services. In short, a moderate trust portfolio may be able to enjoy the same benefits as much larger funds.

This potential benefit, in turn, may impose the stricter duty on more trustees to employ multiple levels of professional advisors. In light of these cost considerations, a trustee may face risk if only one portfolio manager or fund is employed. A prudent trustee in these circumstances may therefore have an added burden of selecting multiple portfolios for each portion of the trust's asset allocation structure. The risk of ignoring this burden is potentially significant because the asset allocation structure suited to the terms and conditions of the trust may call for more than one portfolio manager.

EXPENSES

The apparent need and opportunity to delegate must be balanced with the trustee's duty to control expenses. Theoretically, specialization can lead to better management of fiduciary responsibilities. As a practical matter, it can also result in additional expenses. Thus, an important issue for the trustee becomes weighing costs and benefits in making delegation decisions.

The duty to incur only "costs that are appropriate and reasonable in relation to the assets, overall investment strategy, purposes, and other circumstances of the trust"[29] suggests that trustees

inclined to manage their fiduciary responsibilities may wish to consider carefully how much needs to be paid for various types of management services. This area is yet another in which a consultant can provide cost effective assistance.

For example, passive and active portfolio management styles have disparate cost structures. A trustee may choose to index part of the portfolio, while having other components "actively" managed. The ratio of such division should fall within a consultant's duties. Similarly, tax efficiency of portfolios, whether passive or active, is a consideration for which a trustee should be able to rely upon the consultant.

While the case for delegation in most cases may be compelling, the authors recognize that the typical nonprofessional trustee may be resistant to paying for these services. In view of the Act, however, practitioners may find it difficult to defend any trustee who is exercising or delegating investment authority without having first established, and then having maintained, coherent investment decision processes.

Similarly, practitioners will find themselves being held to a new standard. A trustee who fails to create an investment policy statement after having been advised to do so will face any subsequent liability alone. A trustee whose advisor fails to inform the trustee of this requirement, however, will have company on the "firing line".

CONCLUSION

Successful policy implementation presupposes communication and coordination among the trustee, legal counsel, the accountant, and the investment management advisors. Regular meetings involving these parties, complete with written reports and evaluations, will become the norm. An investment policy based on the purposes, terms and conditions of the trust, explicit investment instructions, and rooted in MPT should provide those entrusted with the on-going management and administration of assets the guidance needed to avoid decisions that are counterproductive to the interests of beneficiaries. Respecting this procedure will also be an

economical way to reduce exposure in the event that the portfolio performance is unsatisfactory to the beneficiaries.

Most trustees will benefit by utilizing appropriately qualified professionals in the design, implementation and monitoring of an MPT based investment strategy. While the fiduciary has a duty to control the cost of properly managing trust assets, it may be possible to secure the services of qualified third party specialists at reasonable rates. Fiduciaries working within the guidelines of a properly structured policy should be confident that they have made prudent investment decisions under the Act. Ultimately, these policies, if consistently implemented, should enable those involved with asset management and trust administration to defend successfully claims made by disaffected beneficiaries.

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[1] Probate Code §§16045 ***et seq.***
[2] The Act applies to all private trusts, including those established prior to January 1, 1996, that are administered after that date.
[3] 29 U.S.C.§§1001-1461
[4] Probate Code §16047(b)
[5] Probate §16047[b]
[6] Probate Code §16048
[7] Probate Code §16047 also eliminates the "approved investments lists" of prior law.
[8] 29 U.S.C. §§1001-1461
[9] *See* ERISA §3(21); DOL Reg. §2510.3-21; Donovan *v. Mercer* 747 F.2d 304 (5th Cir. 1984); I.R.C. §4975(e)(3).
[10] *See* Marshall v. Glaziers Pension Plan, Donovan v. Mazzola, Brock v. Berman
[11] Probate Code §16052
[12] *See* ERISA §§402[c][2-3], 405[a],
[13] *See* Whitfield v. Cohen, Leonard v. Drug Fair
[14] *See **e.g***. Pierce v. Lyman (1991) 1 CA4th 1093
[15] ERISA §3(21)(A); DOL Reg.§2510.3-21(c); *See* Credit Managers Ass'n v. Kennesaw Life & Accident ins. Co. 809 F.2d 617 (9th Cir., 1987)
[16] *See* Credit Managers Ass'n v. Kennesaw Life & Accident ins. Co. 809 F.2d 617 (9th Cir., 1987); Donovan v. Mercer 747 F.2d 304 (5th Cir. 1984); Yeseta v. Baima 837 F.2d 380 (9th Cir.,1988)

[17] *See e.g.* Ed Miniat v. Globe Life Ins. Group 805 F.2d732 (7th Cir., 1986)
[18] Nieto v. Ecker 845 F.2d 868 (9thCir.,1988); Yeseta v. Baima 837 F.2d 380 (9th Cir., 1988)
[19] ***See*** Probate Code §§18500-18509, the Uniform Management of Institutional Funds Act.
[20] See e.g., Sharpe, ``Investor Wealth Measures and Expected Returns," Quantifying the Market Risk Premium Phenomenon for Investment Decision Making, Institute of Chartered Financial Analysts (Charlottesville, VA 1990).
[21] Restatement (Third) of Trusts, §227, Comment g.
[22] See generally Restatement (Third) of Trusts, § 227, Comment g.
[23] Probate Code §16006
[24] Probate Code §16052(a)
[25] *Estate of Talbot* (1956) 141 Cal. App. 2d 309, 296 P.2d 848.

[26] Probate Code Section 16006
[27] *William J. O'Neill, Jr. Irrevocable Trust v. C.I.R.* (6th Cir. 1993) 994 F.2d 302
[28] See e.g.. Probate Code Section 16052
[29] Probate Code §16050