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Minnesota's Prudent Investor Rule: Aligning Law with Practice

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I. INTRODUCTION

The trust is the most important and versatile instrument in modern estate planning.¹ Once the instrument is created, the settlor and benefici-

¹ See Frederic W. Maitland, The Unincorporate Body, in 3 THE COLLECTED
aries rely on the skill and integrity of the trustee to implement the trust according to plan. The trustee must invest the trust assets according to the standards dictated by state law.

The law of investment management by trustees is in the midst of a major revision, based on a revolution in financial theory that has long been embraced by the market, but until recently, ignored by the law. The prudent man rule has been replaced by a new statutory standard, the prudent investor rule, which became effective in Minnesota on January 1, 1997. The new rule frees trustees from rigid and outdated investment

PAPERS OF FREDERIC WILLIAM MAITLAND (H.A.L. Fisher ed., 1911), reprinted in HISTORICAL WRITINGS IN LAW AND JURISPRUDENCE: THE COLLECTED PAPERS OF FREDERIC WILLIAM MAITLAND, at 272 (R. H. Helmholz & Bernard D. Reams, Jr. eds., 1981) (calling trusts "the greatest and most distinctive achievement performed by Englishmen in the field of jurisprudence"); see also 1 AUSTIN W. SCOTT, SCOTT ON TRUSTS § 1, at 2 (William Franklin Fratcher ed., 4th ed. 1987) (discussing Professor Maitland's observations and suggesting reasons why the creation of the trust concept was so profound — for example, no other system of law has such a flexible tool for making dispositions of property); GEORGE M. TURNER, IRREVOCABLE TRUSTS § 2:2 (3d ed. 1996) (discussing Professor Maitland's observations and adding, "[T]he overall importance of the trust, not just in the practice of law but also in everyday business and society, cannot be overstated").

2. See TURNER, supra note 1, § 3:2 (suggesting that when choosing a trustee, one should consider such important factors as whether the individual has the necessary experience, capacity, and skills to manage the trust adequately and whether the individual can pay damages if management is inadequate).

3. See MINN. STAT. § 501B.151, subd. 2(a) (1996) (stating that a trustee shall invest and manage trust assets as a prudent investor would); In re Trusteeship of First Minneapolis Trust Co., 202 Minn. 187, 194, 277 N.W. 899, 903 (1938) (holding that a trustee exercising the power of investment is controlled by all the restrictions imposed by state statutes); see also United States v. Pierce, 137 F.2d 428, 431 (D. Minn. 1943) (holding that legal interests and rights created by a trust instrument are controlled by the law of the state(s) where the instrument was executed, where the settlor and trustee resided, and where the trust estate was delivered and held). In Minnesota, the governing standard was the prudent man rule prior to January 1, 1997. See MINN. STAT. § 501B.10, subd. 1(a) (1994).

4. The standards established by trust investment law apply to many financial fiduciaries. See Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U. L. REV. 52, 52 (1987); Gordon Williams, The Trouble with T-bills, FIN. WORLD, July 18, 1995, at 80 (asserting that the new prudent investor rule covers "trusts, estates, conservatorships, and the like," and probably covers the administration of 401(k) plans, the Uniform Gifts to Minors Act, and Uniform Transfers to Minors accounts). This Note, however, focuses exclusively on how the prudent investor rule affects trustees.

5. The revolution in financial theory is modern portfolio theory, discussed infra Part III.


7. See MINN. STAT. § 501B.151, subd. 12 (1996) (explaining that Minnesota's prudent investor rule applies to trusts existing on and created after January 1, 1997, and that as applied to preexisting trusts, the new standard only governs decisions or actions occurring after that date).
practices and permits them to use the full array of modern investment tools in selecting and managing investment portfolios.\(^8\) The tradeoff for this freedom is a higher level of responsibility borne by trustees in the selection and management of portfolios.\(^9\) Therefore, prudent trustees and their legal advisers must fully understand the ramifications of this revision.

This Note outlines Minnesota's Prudent Investor Act.\(^10\) Part II discusses the historical development of trust investment law leading up to the prudent investor rule. Part III sketches the basic tenets of modern portfolio theory and briefly explains its significant impact upon trust investment law. Part IV discusses the main reforms instituted by the new rule and contrasts Minnesota's version of the rule to those established by the Restatement (Third) of Trusts and the Uniform Prudent Investor Act. Finally, Part V discusses the responsibilities and opportunities for practitioners under the new prudent investor rule.

II. THE HISTORY OF TRUST INVESTMENT LAW

A. Development in England\(^11\)

The common-law rule regarding investment by trustees was quite restrictive.\(^12\) Absent a provision in the trust instrument authorizing the trustee to invest in other securities, the only proper investment was government securities.\(^13\) England's restrictive trust investment laws resulted from...
a catastrophic collapse of the South Sea Company's share prices early in the eighteenth century. These restrictive rules remained in force until 1859, when Lord St. Leonards' Act authorized trustees to invest in mortgages on land in the United Kingdom, as well as stock in the Bank of England, the Bank of Ireland, or East India stock. While the scope of trust investments was further enlarged through subsequent statutes, it remains quite restrictive in England.

B. Development in the United States

In the United States during the late eighteenth century, the state of trust investment law was unsettled. Courts could not rely on the rigid English rules requiring investment in government-backed securities, because such investments simply were not readily available. Moreover, there was insatiable demand for capital to support the budding enterprises of our new nation. Thus, trust investment law was ripe for a clear statement defining a new standard that would accommodate the realities of the capital market at that time.

of the purposes for limiting investment to government securities was to "maintain a constant market for the royal obligations." Shattuck, supra note 12, at 492. But see 3 SCOTT, supra note 1, § 227.4 (suggesting that there is insufficient information to speculate that the English government intended to restrict trustees to government securities).

14. See Langbein, supra note 12, at 643. In the early 1700s, Parliament authorized trustees to invest in shares of the South Sea Company. See id. Many trustees took advantage of this opportunity only to have their investments plummet in value the following year. See id.; Nelson, supra note 11, at 988 (discussing the bursting of the "South Sea Bubble").

15. See 3 SCOTT, supra note 1, § 227.4; Langbein, supra note 12, at 643.

16. See 3 SCOTT, supra note 1, § 227.4 n.4 (explaining that the Trustee Act of 1925 permitted trustees to invest half of a trust's funds in "wider-range investments," including stock and securities issued in the United Kingdom by a company incorporated there, and that the Finance Act of 1982 permitted investment in shares of unit trusts); Langbein, supra note 12, at 643 (explaining that the 50% equity ceiling remains in effect in England today but that an official revision commission has begun to consider reforming it).

17. See Shattuck, supra note 12, at 493 (explaining that the period from the end of the 18th century to the middle of the 19th century was an enterprising and imaginative one with respect to the administration of trust funds).

18. See 3 SCOTT, supra note 1, § 227.5, at 441; Shattuck, supra note 12, at 493.

19. See Shattuck, supra note 12, at 493 (explaining that during the late 1700s and early 1800s, trust assets were invested in such enterprises as new mills, the clipper trade, and other "semi-speculative enterprises").

20. See Austin Fleming, Prudent Investments: The Varying Standards of Prudence, 12 REAL PROP., PROB. & TR. J. 243, 243 (1977) (explaining that because there was no readily available equivalent to the government-backed securities required under English law, American courts considered whether trustees should be limited to investing in nation-building securities).
1. Harvard College v. Amory

The necessary pronouncement came in 1830, when the Massachusetts Supreme Judicial Court decided *Harvard College v. Amory*.21 This single decision is universally recognized as establishing the prudent man rule.22 The court stated:

All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.23

The aspect of the *Harvard College* decision which has brought it so much praise is its flexibility.24 The decision “freed [trustees] from the ancient English shackles and pointed the way toward [investment strategies] which could be imaginative, daring, [and] fruitful.”25

The prudent man rule was met with two drastically different reactions.26 Many courts and commentators feared that trustee freedom would lead trustees to squander trust assets through risky investments.27 Still others praised the rule’s flexibility and the way it enabled trustees to keep pace with changing investment practices.28 Initially, most states opted for

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21. 26 Mass. (9 Pick.) 446 (1830).
22. *See*, e.g., 3 SCOTT, *supra* note 1, § 227.5, at 442; Gordon, *supra* note 4, at 57; *see also* infra notes 48-80 and accompanying text (discussing the elements of the prudent man rule).
24. *See* RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE introduction at 3 (1992) (stating that the prudent man rule initially was intended to be general and flexible); Shattuck, *supra* note 12, at 494.
26. *See* Lawrence M. Friedman, *The Dynastic Trust*, 73 YALE L.J. 547, 552 (1964). Professor Friedman argues that in trust investment law, two main approaches have been used: the prudent man rule, which permits trustees to invest in any investment, provided the decision is consistent with the standard of the prudent man; and the legal list approach, which dictates which investments are prudent on a per se basis. *See* id.
27. States reacting this way generally opted for the legal list approach. *See infra* notes 30-36 and accompanying text for a discussion on the resurgence of legal lists.
28. *See* BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 12 (1986) (noting that despite the prudent man standard’s advantages, it was not accepted outside of Massachusetts until the 1940s); William P. Wade, *The New California Prudent Investor Rule: A Statutory Interpretative Analysis*, 20 REAL PROP., PROB. & TR. J. 1, 16 (1985) (observing the flexible nature of the prudent man rule and its adaptability to contemporaneous investment methodology). States benefiting from the flexibility of the prudent man rule generally adopted it as their trust investment standard. *See* Shattuck, *supra* note 12, at 502 (listing the states which generally stood by the prudent man rule during a period
the conservative approach – legal lists.\textsuperscript{29}

2. The Resurgence of Legal Lists

In the late nineteenth century,\textsuperscript{30} trust investment law rejected the flexibility of the Harvard College rule in favor of the restrictive laws of England.\textsuperscript{31} In 1889, the New York Court of Appeals prohibited trustees from investing trust assets in stocks,\textsuperscript{32} but it allowed more secure trust investments, such as government or corporate bonds and individual debt secured by mortgages on real estate.\textsuperscript{33} In addition, the New York State legis-
lature codified a list of prudent investments, along with a warning that any divergence from the list would expose trustees to liability. Over the next decade, similar legal lists dominated trust investment law in a majority of states. The legal list era lasted for almost fifty years.

3. The Return of the Prudent Man Rule

In the 1940s, states began to abandon their lists and, once again, adopt the more flexible prudent man rule. This shift was motivated by several factors. During the Great Depression, no single type of investment (including those dictated by legal lists) survived without a substantial decrease in value. As a result, the justification for accepting lower returns—safeguarding principal—was weakened substantially. In the 1930s, an outspoken lobby for corporate trustees fought to eliminate the legal list approach. In 1940, two lawyers drafted a model prudent man

American economy's slide into post-war depression and the dramatic decrease in the value of stocks).


35. See supra note 31. Minnesota's first legal list was introduced in 1905. See Minn. Rev. Laws § 3022 (1905). The section listed seven types of "authorized securities," which included United States bonds, state bonds, municipal bonds, notes secured by mortgages on real estate in Minnesota and neighboring states, certain bank notes, and certain railroad notes. See id.

36. For a general discussion of the legal list era, see Friedman, supra note 26, at 564-71; Shattuck, supra note 12, at 499-501.

37. See Shattuck, supra note 12, at 501. The term "flexible" is used relatively here. While the prudent man rule is clearly more flexible than the legal lists, several commentators began to criticize the prudent man rule for its rigidity. See, e.g., Gordon, supra note 4, at 55 (advocating that the prudent man rule be more consistent with modern portfolio theory; noting a paradox where "a rule founded on the adaptable wit of the prudent man has become a hindrance to sound fiduciary investment").

38. See Shattuck, supra note 12, at 499-501 (citing, inter alia, the following factors as contributing to the shift toward the prudent man rule: an increasing amount of aggregate trust assets, a corresponding shrinking number of eligible securities, and a yield in portfolios that were limited to legal investments of about two percent annually, while it was almost four percent under the prudent man rule).

39. See Longstreth, supra note 28, at 12 (noting that several factors, including the collapse of bond values, led to a shift from legal lists to the prudent man standard during the Depression); see also Gordon, supra note 4, at 57 n.12 ("The Depression showed that virtually no instrument was immune from default or payment moratorium.").

40. See Gordon, supra note 4, at 87 (explaining that competition for trust business seems to have been the main impetus for the shift).

41. See Aalberts & Poon, supra note 34, at 43 (noting that several parties, particularly bankers, tried to eliminate legal lists in the 1930s); Nelson, supra note 11, at 940-41 (explaining that in 1933, the Executive Committee of the Trust Divi-
rule,\(^{42}\) which many states adopted in some form.\(^{43}\)

The prudent man rule remained the guiding principle for trustees for almost fifty years.\(^{44}\) In the 1990s, however, it has begun to give way to the prudent investor rule.\(^{45}\) In order to understand the criticism of the prudent man rule and the changes instituted by the prudent investor rule, one must understand the elements of the prudent man rule\(^{46}\) as established by commentary and judicial pronouncements.\(^{47}\) First, a trustee may

sion of the American Bankers Association adopted a Statement of Principles of Trust Institutions that stated, among other things, that the trustee's investment function should be evaluated in terms of management and care, rather than safekeeping or speculating); see also Langbein, supra note 12, at 644 (concluding that one of the ways the prudent man rule won out was by the promotion of the American Bankers Association on behalf of corporate fiduciaries).

42. See Aalberts & Poon, supra note 34, at 43-44 (explaining how Louis S. Headley and Mayo Adams Shattuck responded to the plight of legal list jurisdictions by drafting a "Model Prudent Man Investment Statute"). The model act is reprinted in Shattuck, supra note 12, app. A at 508-09.

43. See Shattuck, supra note 12, at 501-04 (listing the states that made the switch). For a general discussion of the move from legal lists to the prudent man rule in the 1940s, see Bruce Stone, The Prudent Investor Rule: Conflux of the Prudent Man Rule with Modern Portfolio Theory, in ESTATE PLANNING & ADMINISTRATION 1993, at 9, 14-15 (PLI Tax L. & Est. Plan. Course Handbook Series No. D4-5242, 1993), which discusses the recovery from the depression, the lobby for change by the American Bankers Association, and the Model Act and concludes that the prudent man rule "was adopted with minor variations in virtually all the states and superseded legal list statutes" by the 1960s. In 1943, Minnesota abandoned its legal list for individual and corporate trustees and adopted the prudent man rule, calling it the prudent person rule. See Act of Apr. 24, 1943, ch. 635, §§ 1-6, 1943 Minn. Laws 980, 981-82; see also Note, Current Legislation – Minnesota, 1943, 31 MINN. L. REV. 35, 86 (1946) (announcing the enactment of the prudent man rule and explaining that the rule permits trustees to invest in any kind of property that an ordinary prudent person would).

44. See RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE introduction at 3 (1992) ("In generally similar language, influenced by the original Restatement, the prudent man rule has been adopted by decision or legislation in most American jurisdictions, often displacing the more restrictive, so-called 'legal list' statutes."); LONGSTRETH, supra note 28, at 12 (noting that in 1986, the prudent man rule was "overwhelmingly the standard for investment of private trust funds"); Paul G. Haskell, The Prudent Person Rule for Trustee Investment and Modern Portfolio Theory, 69 N.C. L. REV. 87, 90 (1990). Haskell explains that in 1990, only Alabama, Kentucky, and Maryland had legal lists limited to debt securities, and only Ohio and West Virginia had lists providing for debt securities plus a maximum percentage of common stocks. See id. at 90 & nn.14-15. The remaining states all follow the prudent person rule. See id. at 90 & n.16.

45. See infra notes 129-35 and accompanying text (discussing the development of the prudent investor rule).

46. See Wade, supra note 28, at 2-3 (summarizing the elements of the prudent man rule).

47. Professor Austin Wakeman Scott, the reporter of both the first and second Restatements and the author of the leading treatise on trusts, is credited with playing an extremely significant role in shaping the prudent man rule. See
not speculate. Second, the trustee must evaluate the merits of each investment individually and apart from other investments of the trust. Third, the trustee must diversify. Fourth, the trustee must use the skill of a prudent person. Fifth, the trustee must follow the terms of the trust. Sixth, the trustee many not delegate investment authority.

a. **Speculation**

Trustees have an affirmative duty to make the trust property productive. Under the prudent man rule, the guidelines, within which a trustee had to fulfill that responsibility, were quite narrow. While at first blush prudence seems to be a broad standard, interpretations of the prudent man statutes required the trustee to avoid speculation and preserve capital at all costs. The Restatement explains the standard:

In making investments, . . . a loss is always possible, since in any investment there is always some risk. The question of the amount of risk, however, is a question of degree. No man of intelligence would make a disposition of property where in view of the price the risk of loss is out of proportion to the opportunity for gain. Where, however, the risk is not out of proportion, a man of intelligence may make a disposition which is speculative in character with a view to increasing his property instead of merely preserving it. Such a disposition is not a proper trust investment, because it is not a disposition which makes the preservation of the fund a primary consideration.

Thus, under the prudent man rule, the trustee had to distinguish between those investments for which the risk of loss was excessive and those

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Gordon, supra note 4, at 57-62 (observing that Professor Scott’s version of the prudent man rule narrowed the rule from its original Harvard College formulation and that many courts, out of respect for Scott, adopted his version); see also Longstreth, supra note 28, at 13 (“[I]t would be almost impossible to underestimate the influence of the Treatise and the Restatement. They have both achieved canonical standing in the law of private trusts.”). Because few cases have been decided in Minnesota clarifying the different elements of the prudent man rule, and because Professor Scott’s statements of the rule were so often followed, the discussion below of the elements of the rule relies heavily on the Restatement (Second) of Trusts. See infra notes 48-80 and accompanying text.

48. See Restatement (Second) of Trusts § 181 (1959); 2A Scott, supra note 1, § 181, at 542-43.
49. See Langbein, supra note 12, at 644 (stating that the prudent man rule became “encrusted with a strong emphasis on avoiding so-called ‘speculation’”).
50. See Restatement (Second) of Trusts § 227 cmt. f (1959) (stating that both the purchase of shares of stock on margin and the purchase of bonds selling at a great discount because of the uncertainty of whether they will be paid on maturity are speculative and imprudent); see also Langbein, supra note 12, at 645 (“Ludicrous judicial applications of the notion of speculation continued in some jurisdictions into recent times.”).
51. See 3A Scott, supra note 1, § 227, at 431.
52. Restatement (Second) of Trusts § 227 cmt. a (1959).
for which the risk of loss was prudent.53 Broad categories of investments were considered imprudent per se.54 A trustee investing in growth stocks,55 start-ups,56 options, and futures57 might have faced a surcharge action if those assets depreciated.58 These rules motivated trustees to invest in assets that were per se prudent.59

b. The Individual Investment Standard

Under the prudent man rule, each investment was considered on its own merits, without regard to the rest of the portfolio.60 This concept is reinforced by the anti-netting rule, which provides, in essence, that a trustee who is liable for making a speculative investment cannot reduce the amount of his liability by offsetting the loss against a gain obtained on another part of the trust property.61 This rule has led trustees to ensure that each individual asset held in trust is not speculative.62

53. See Wade, supra note 28, at 3.
54. See 3 Scott, supra note 1, § 227.6, at 444 (explaining that buying securities on margin, speculative shares of stock, and discounted bonds would be per se imprudent).
55. See id. § 227.11, at 471.
56. See id. § 227.6, at 444 n.4 (citing cases). But see Minn. Stat. § 501B.125, subd. 1a (1986) (repealed 1987) (permitting a trustee to invest up to 10% of the trust estate in new and untried enterprises with growth potential).
57. See Note, Current Investment Questions and the Prudent Person Rule, 13 Real Prop., Prob. & Tr. J. 650, 653 (1978) (concluding that there is no clear judicial precedent approving of futures, and that options are risky for the fiduciary because of the traditional rule prohibiting a fiduciary from netting losses against trust gains).
58. See George Gleason Bogert, The Law of Trusts and Trustees § 701, at 193 (rev. 2d ed. 1982) (explaining that if the trustee breaches her duty to invest prudently, the beneficiaries can bring an action against the trustee to receive a surcharge equal to the difference between the return on a prudent investment and the return on the imprudent investment).
59. See John H. Martin, A Preface to the Prudent Investor Rule, Tr. & Est., Nov. 1993, at 42, 42-43 (noting the strictures of prudent man standards where trustees want to embrace new investment vehicles and not simply opt for investments that have been judicially or legislatively deemed prudent per se).
60. See Haskell, supra note 44, at 93.
61. See Restatement (Second) of Trusts § 213 cmt. b (1959); Gordon, supra note 4, at 96-97 (discussing the anti-netting rule).
62. See J. Timothy Ritchie, Prudent Investor Rule is Not a Radical Departure, Tr. & Est., Jan. 1991, at 18, 18. Ritchie writes: A major criticism of the current prudent person rule has been that it mandates the avoidance of risk-taking with respect to each asset of a portfolio, viewing the taking of the risk as impermissible speculation. Consequently, portfolio managers for fiduciary funds have adopted conservative investment approaches with respect to each asset of a portfolio, even though by doing so there will be limited opportunity for appreciation in value of the portfolio as an entity.
c. Diversification

The diversification rule is simply a corollary to the basic risk-minimization philosophy of the prudent man rule: A diversified trust is less risky than a trust where all of the assets are invested in one security. Thus, a trustee must distribute the risk of loss by a reasonable diversification of investments, unless prudence dictates otherwise.

d. Standard of Skill

In carrying out investment responsibilities, a trustee must, at a minimum, use the skill of a person of ordinary prudence. If, however, the trustee has or represents that he has greater skill than that of an ordinary prudent person, the trustee is liable for any loss resulting from the failure to use such skill. The standard for measuring the trustee’s skill is the same as the reasonable man standard in the law of negligence. Thus, skill is assessed by comparing the trustee’s investment decisions to those made by similarly-situated trustees in the industry.

e. Terms of the Trust

In general, the terms of the trust instrument defining permissible investments will supersede otherwise applicable legal restrictions. Thus, a settlor may enlarge or restrict the scope of permissible investments for a particular trust, for example, by permitting investment in speculative securities. However, trust terms generally are construed strictly against an en-
largement of the scope of permissible investments. 73

For instance, even in the face of extreme circumstances, the Minnesota Court of Appeals adhered to this principle in In re Trusts Created by Hormel. 74 The founder of George A. Hormel & Company placed a majority share of the company's stock in trust for his children, directing the trustee to maintain a controlling interest under all circumstances. 75 After the trust was created, Hormel's stock began to decrease dramatically in value. 76 The beneficiaries brought an action against the trustee to sell some or all of the ailing stock in an effort to maintain the value of the trust assets. 77 The court refused to force the trustee to sell the stock, stating, "When a matter is entrusted to the trustee's discretion, a court generally should not intervene unless that discretion has been abused." 78

f. Delegation

Under the prudent man rule, a fiduciary could not delegate investment authority. 79 Thus, even if a fiduciary was selected strictly because of the relationship with the trustor rather than for investment expertise, the fiduciary remained personally liable for all investment decisions, regardless of the trustee's level of expertise. 80

III. MODERN PORTFOLIO THEORY

The prudent man rule has been the subject of sharp criticism since its creation. 81 According to critics, the rule is neither sufficiently versatile to permit trustees to invest trust assets in modern investments nor consistent with modern investment theories. 82 The prudent investor rule is
meant to accord trust law with the practice of the investment management industry generally. Specifically, the Uniform Prudent Investor Act incorporates the teachings of modern portfolio theory.

One of the central tenets of modern portfolio theory is that large and essentially costless gains can be achieved simply by diversifying thoroughly. As a corollary, the prudent investor rule: (1) provides that a trustee who fails to take advantage of these gains acts imprudently, and (2) focuses its analysis not on the prudence of each individual asset, but on the ability of the trustee to diversify an entire portfolio effectively. This Part explains how diversification leads to large and essentially costless gains.

People invest their money with the expectation that they will be compensated for its use. Investors know that they can invest with essentially no risk in short-term U.S. government debt. Thus, any investment involving a risk of default or a disappointing return requires the person raising the capital to pay the investor some return greater than that of government bonds. Indeed, all investments have an expected return that varies positively with risk. Risk is the recognized possibility that an investment is unwarranted and often counterproductive in light of modern asset management practices; Fleming, supra note 20, at 248-51 (criticizing the Model Prudent Man Investment Statute for failing to measure the prudence of investments in terms of a net portfolio as opposed to a single investment, failing to address inflation, and failing to discuss the duty to diversify).

83. See UNIF. PRUDENT INVESTOR ACT, 7B U.L.A. 18-19 (Supp. 1996) ("Over the quarter century from the late 1960's, the investment practices of fiduciaries experienced significant change. The Uniform Prudent Investor Act (UPIA) undertakes to update trust investment law in recognition of the alterations that have occurred in investment practice.").

84. See id. at 19 (noting the influence of modern portfolio theory, which is described as "empirical and theoretical knowledge about the behavior of capital markets"). Modern portfolio theory has been shaped by four decades of important academic research as to the optimal methods of investment management. See Langbein, supra note 12, at 642. Four Nobel Prizes in economics have thus far been awarded for the academic work that identified and verified the theory of efficient markets. See id. For explanations of modern portfolio theory and its relationship to the prudent investor rule, see Haskell, supra note 44, at 100-06; Langbein, supra note 12, at 647-49; Robert A. Levy, The Prudent Investor Rule: Theories and Evidence, 1 GEO. MASON L. REV. 1, 10-19 (1994); Martin, supra note 59, at 44-45; Stephen M. Penner, International Investment and the Prudent Investor Rule: The Trustee's Duty to Consider International Investment Vehicles, 16 MICH. J. INT'L L. 601, 622-36 (1995); and Stone, supra note 43, at 9.

85. See Langbein, supra note 12, at 647.

86. See RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE introduction at 5-6 (1992).

87. See Haskell, supra note 44, at 100.

88. See id.

89. See generally Penner, supra note 84, at 623-27 (discussing individual risk aversion and its effect on an individual's willingness to invest).
investment will perform below its expected return. As the possibility that an investment will perform under its expected return increases, so too does its risk. The greater the risk, the greater the expected return must be in order to justify or compensate for the risk. For example, a fledgling computer software company bears a far larger financial risk than does a company like IBM. Thus, those investing in the start-up company demand a higher rate of return than those investing in IBM. Because risk determines a given security's rate of return, it is important to understand what "risk" is, and what about it is compensated.

Modern portfolio theory isolates three distinct components of the risk of owning any security: market risk, industry risk, and firm risk. Market risk represents the idea that all common stocks are affected by the risk of a rise or fall in the stock market. It reflects general economic and political conditions, interest rates, and so forth. Industry risk is specific to the firms in a particular industry. It represents the risk that an event could cause industry-wide gains or losses. For example, in the wake of the 1973 Arab oil embargo, all oil producers suffered a tremendous drop in their stock prices. Finally, firm risk refers to the factors that affect the profitability of an individual firm, such as labor disputes, management changes, accidents, and the like.

By definition, market risk cannot be eliminated through diversification, since market risk is common to all securities; however, industry and firm risk can be greatly reduced. To understand why, consider a simple example. Imagine an investor who holds two assets: $10,000 in the

90. See Haskell, supra note 44, at 100.
91. See id.
92. See id.
93. See Langbein, supra note 12, at 647. This example is taken from Professor Langbein's recent article discussing the Uniform Prudent Investor Act. See id.
94. See id.
95. See Haskell, supra note 44, at 100-01; Langbein, supra note 12, at 647; Penner, supra note 84, at 629.
96. See Langbein, supra note 12, at 647.
97. See id.
98. See id.
99. See Haskell, supra note 44, at 101 (grouping firm and industry risk together into a concept called unsystemic or specific risk).
100. See UNIF. PRUDENT INVESTOR ACT § 3 cmt., 7B U.L.A. at 23-24 (Supp. 1996) (using the oil embargo as an example of industry risk); see also Langbein, supra note 12, at 647 (demonstrating both industry and firm risk using the oil embargo as an example).
101. See Langbein, supra note 12, at 647.
103. See Haskell, supra note 44, at 101.
104. See Penner, supra note 84, at 628-29. This example is adapted from a similar example used by Stephen M. Penner. See id.
stock of Hurricane Insurance Company, which offers storm accident insurance coverage; and $10,000 in the stock of Building Materials Company, which manufactures and sells building materials to replace damaged structures. Imagine that a hurricane ravages the southeastern seaboard. The insurance company will be forced to make good on many claims and, as a result, its profits will fall. Consequently, the price of its stock will fall. At the same time, however, the hurricane will spur demand for the products of Building Materials Company, which can increase prices and ultimately increase its profits. As a result, the value of its stock will go up. Thus, the investor has been able to reduce the effect of the risk of hurricanes by investing in two assets which react oppositely to a given situation. In other words, the investor can balance the industry and firm risk of one stock with the purchase of another stock which is affected positively by the same factor that adversely affects the first stock.

Under the terminology of modern portfolio theory, industry and firm risk is called uncompensated risk, and market risk is called compensated risk. The distinction requires the introduction of one more principle, market efficiency. In theory, markets are perfectly efficient, which is to say that once information becomes public, stock prices react to it immediately. Since it is common knowledge that industry and firm risk can be eliminated through diversification, the marketplace will not compensate an investor for taking that risk. Thus, it is an uncompensated risk. Similarly, because it is common knowledge that market risk cannot be avoided through diversification, those taking market risk are compensated by higher expected returns.

Theoretically, industry and firm risk can be reduced to zero by including in a portfolio many different securities designed to offset one an-

105. See id. at 628.
106. See id.
107. See id. at 628-29.
108. See id. at 629.
109. See id.
110. See Penner, supra note 84, at 629.
111. See id.
112. See id.
113. See Langbein, supra note 12, at 647-48 (extending his oil embargo example to explain how investments that react differently to different risk factors, or negatively correlated investments, can be used to eliminate firm and industry risk).
115. See id. reporter’s general note on cmts. e-h, at 74-75.
116. See id.
117. See id.
118. See id.
other’s different risk factors. The larger the portfolio, the closer the industry and firm risk of the portfolio can approach zero. However, industry and firm risk can be reduced with as few as twenty stocks. Thus, contemporary economic theory suggests that the investor should maintain a broad portfolio in order to reduce firm and industry risk to a low level. Contemporary economic thinking even allows for the inclusion of investments of a speculative nature in a portfolio that is conservatively invested. If speculative assets complement the other assets in a portfolio in such a way that industry and firm risk for the portfolio as a whole is decreased, then the risk of the portfolio is decreased and the portfolio as a whole is better off. Under the prudent man rule, this strategy would be an invitation to liability for two reasons. Because of the duty to avoid speculative investments and the fact that prudence is measured by looking at the speculative investment individually, the trustee has breached the trust if a speculative investment is not successful, even if the portfolio as a whole is successful. Under the prudent investor rule, this strategy would be applauded and even required.

IV. THE PRUDENT INVESTOR RULE

A. Emergence of the New Rule

As modern portfolio theory became widely accepted in economics and investment management, the law lagged behind. Recognizing this anomaly, the trust bar began a comprehensive review process that resulted

119. See Penner, supra note 84, at 628-34 (explaining how industry and firm risk, or “idiiosyncratic risk,” can be eliminated through diversification). Specifically, Penner states that “[t]he point of diversification is to invest not only in multiple assets but to invest in assets which tend to complement each other as far as risk is concerned.” Id. at 628.

120. See id. at 633-34.

121. See Haskell, supra note 44, at 102.

122. See id.; see also RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE introduction at 5 (1992).

123. See Langbein, supra note 12, at 654-55.

124. See id.

125. See supra notes 48-59 and accompanying text (discussing the trustee’s duty, under the prudent man rule, to avoid speculation).

126. See supra notes 60-62 and accompanying text (discussing the individual investment standard).

127. See id.

128. See infra Part IV.B.3-4 (discussing how the portfolio standard and the direction to diversify, consistent with modern portfolio theory, free trustees to invest in speculative assets).

in the prudent investor rule.\textsuperscript{130} The objective was to articulate a standard which allows various sound investment strategies and is flexible enough to adapt to the inevitable changes in the market, but which also imposes a meaningful duty of prudence on fiduciaries.\textsuperscript{131} Whereas traditional investment practices principally benefited the trustee, by creating a safe harbor from liability, the new rule forces trustees to serve the specific interests of settlers and beneficiaries.\textsuperscript{132} At least thirteen states have enacted some version of the prudent investor rule,\textsuperscript{133} and most states likely will adopt that standard soon.\textsuperscript{134} Minnesota enacted its prudent investor rule in 1996.\textsuperscript{135}

\begin{footnotes}


\footnote{132. See id. at 5.


\footnote{134. See Stone, supra note 43, at 40 ("[T]he trickle of prudent investor legislation that has passed in the past ten years will become a flood.").

Stated simply, the prudent investor rule provides that trustees "shall invest and manage trust assets as a prudent investor would." The heart of the prudent investor rule is a focus on the portfolio as a whole. The rule recognizes that the key job of the trustee is to determine the trade-off between the risk and the return necessary to realize the trust's objectives. Moreover, the rule abolishes absolute restrictions and disavows the prior law's prohibition of speculative or risky investments. Finally, delegation of investment responsibilities is permitted and even encouraged.

B. Components of the New Rule

1. Abrogating Categoric Restrictions

Under the prudent man rule, courts and commentators warned trustees to avoid speculation. Prior to 1997, Minnesota's prudent person rule ostensibly permitted trustees to invest in every kind of property, yet it was not clear whether the rule required trustees to avoid speculation. It offered the same freedom in 1943. In any event, prudent practitioners, wary of precedents in other states, most likely counseled trustees to avoid speculation.

136. Minn. Stat. § 501B.151, subd. 2 (1996). Minnesota's Prudent Investor Act (hereinafter MPIA) and the UPIA are almost identical. See infra notes 199-212 and accompanying text (describing where the two acts diverge).


138. See id. § 227 reporter's general note on cmts. e-h, at 74-75.

139. See infra Part IV.B.1 (discussing the abrogation of per se rules).

140. See infra notes 185-93 and accompanying text (discussing the evolution of the delegation rule).

141. See supra notes 48-59 and accompanying text (discussing the trustee's duty to avoid speculation).


143. See supra notes 48-59 and accompanying text (discussing a trustee's duty to avoid speculation). Although no Minnesota appellate courts have classified any investments as per se prudent or imprudent, dictum in one Minnesota Supreme Court decision suggests that courts may entertain the idea. See In re Will of Gershcow, 261 N.W.2d 335, 340 (Minn. 1977). In Gershcow, the court held that investing in certificates of deposits was not "per se invalid." Id. at 339. Thus, while it did not impose a categoric restriction, the court did use the language of categoric restrictions. See id. Moreover, after citing the prudent man rule language that a trustee can invest in "every kind of property," the court did not take the opportunity to interpret the language literally and decree that there are no per se rules in this context. See id.

144. See Minn. Stat. § 501.125 (1945).

145. See Robert T. Willis, Jr., Prudent Investor Rule Gives Trustees New Guidelines, 19 Est. Plan. 338, 338-39 (1992). Willis suggests that prior to the development of the prudent investor rule, it was common practice for fiduciaries, particularly family member and noncorporate fiduciaries, to invest the bulk of the trust assets in interest-bearing instruments. See id. (noting that interest-bearing invest-
To the extent that there was concern about avoiding speculative investments in Minnesota, that concern was put to rest by the prudent investor rule, which permits a trustee to invest in any kind of property. While this may be equally as ambiguous as the prudent man statute, the official comment in the UPIA states "that no particular kind of property or type of investment is inherently imprudent."

In place of the old preoccupation with avoiding speculation, the prudent investor rule requires a sensitivity to the risk tolerance of the particular trust. Thus, investments that would have been seen as speculative under the old law may now be considered sensible, even risk-reducing, additions to a portfolio. As an example of a trustee's responsibility to be sensitive to the specific goals of a particular trust, the comment explains that if the purpose of a particular trust is to support an elderly widow of modest means, that trust will have a lower risk tolerance than a trust set up for the benefit of a younger person of substantial wealth.

2. Battling Inflation

In 1977, the Minnesota Supreme Court decided In re Will of Gershcow. In Gershcow, the plaintiff-beneficiary claimed inter alia that her trustee breached the trust by failing to reinvest assets, received in the form of certificates of deposit, in an investment that would produce a higher yield. The rate of return during the relevant period was about five percent. The court ultimately held that the investments were not imprudent. Under the prudent investor rule, Gershcow would have been decided differently.

ments, such as bank CDs, government bonds, and high-grade corporate bonds, are made in the belief that the best way to preserve capital is to be assured of the repayment of principal and to receive a market rate of interest).
The directive that an investment strategy be based upon risk and reward objectives suitable for the specific trust recognizes the importance of battling inflation. Thus, under the prudent investor rule, a trustee should be concerned with preserving a trust's real purchasing power and with the effects of inflation on that power.

The new rule signals relief for trust beneficiaries, such as those in Gershcow, whose trust assets may have been invested too conservatively. In Gershcow, the settlor created a trust with assets of about $75,000. The trust provided income for the life of three beneficiaries, and upon their death, three remaindermen were entitled to equal shares of the trust assets. The trustee invested the assets in certificates of deposit earning only five percent interest. The trustee's investment choice clearly did not guard against inflation erosion and, thus, most likely would be found improper under the prudent investor rule.

3. Diversification

Minnesota's prudent investor rule demands that trustees diversify the investments of the trust. This duty also existed under prior law. Under the prudent investor rule, however, trustees must diversify for a new purpose. Modern portfolio theory instructs that diversification entails...
more than simply investing in different assets; rather, diversification
should be implemented with an eye to finding assets that complement
each other and eliminate uncompensated risk.16 Still, the prudent inves-
tor rule recognizes that diversification may be inappropriate in some cir-
cumstances,169 such as when taxes would become due on the disposition of
a concentrated low-basis portfolio or when control of a business is impor-
tant to the interest of the beneficiaries.170

4. Portfolio Standard

Under the prudent man rule, each individual investment a trustee
made was considered on its own merits, without regard to the rest of the
portfolio.171 The individual investment standard is completely inconsistent
with modern portfolio theory.172 If uncompensated risk is to be decreased,
a portfolio must be diversified so that different investments complement
each other in terms of risk.173 The elimination of risk is achieved by the
fact that some investments will rise in value when others fall.174 If a trus-
tee’s prudence is judged only with respect to the investment that fails, the
investment will appear imprudent.175 Revisiting the hurricane example,176

J. 407 (1992) and Edward C. Halbach, Jr., Redefining the “Prudent Investor Rule” for
Trustees, Tr. & Est. Dec. 1990, at 14 (“Sound diversification is fundamental to the
management of uncompensated risk. It is, therefore, ordinarily required of trus-
tees, not simply as a means of moderating the dangers inherent in investing but as
a means of minimizing uncompensated risk.”); Penner, supra note 84, at 628 (not-
ing that sound diversification of investments requires multiple assets, as well as
risk-complementary assets).

168. See Penner, supra note 84, at 628.

169. See MINN. STAT. § 501B.151, subd. 3 (1996) (requiring diversification
unless the trustee reasonably determines that special circumstances dictate other-
wise).

170. See UNIF. PRUDENT INVESTOR ACT § 3 cmt., 7B U.L.A. 24 (Supp. 1996); see also David R. Hodgman, Fiduciary Investments: Drafting for Nonconformity, 23 EST.
PLAN. 489 (1996) (examining the drafting issues that arise when the prudent in-
vester rule does not apply).

171. See supra notes 60-62 and accompanying text (discussing the individual
investment standard).

172. See Gordon, supra note 4, at 90 (“Appreciation of the gains from an un-
constrained [r]ule requires acceptance of a new financial model, in which the risk
of an investment is measured as part of a portfolio, not in isolation.”).

173. See supra notes 116-22 and accompanying text.

174. See supra notes 116-22 and accompanying text.

175. See White, supra note 156, at 229. White uses a colorful example to dis-
cuss the change in the rule, stating:
For example, if you were a fiduciary for a trust that owned shares of Mi-
crosoft, which did well, and also owned another technology company
that went belly-up, you could be sued and surcharged— that is, made to
compensate the beneficiary— for the loser, regardless of how big the
winner. Laws like that encouraged money managers to stick to so-called
safe stocks. The new law says it’s okay to risk a wipeout in Zilchsoft if
when the hurricane comes and the stock of Hurricane Insurance Company falls, a trustee could face liability, despite the fact that the stock in Building Materials Company has gone through the roof.\textsuperscript{177}

In 1989, Minnesota amended its prudent man statute by inserting language that appears to incorporate modern portfolio theory to some degree.\textsuperscript{178} The statute permitted trustees to consider the "composition of the portfolio of the trust with regard to diversification" in determining the prudence of a particular investment.\textsuperscript{179} This language, however, begs the question of how much weight a court should attach to a trustee's consideration of diversification in making individual investments.\textsuperscript{180} For instance, is it merely one of the factors to consider?\textsuperscript{181} More importantly, does it provide sufficient flexibility for trustees to invest in both Hurricane Insurance Company and Building Materials Company and, yet, be confident that because the decision was based on diversification, it will not be attacked later as being imprudent? To the extent that ambiguity existed after the 1989 amendment, the prudent investor rule answers this question with a resounding "yes."\textsuperscript{182} The unmistakably clear language of the new rule requires that a trustee's investment and management decisions respecting individual assets be evaluated not in isolation but in the context you had sound reasons for buying it.

\textit{Id.}

\textsuperscript{176} See supra notes 104-13 and accompanying text.
\textsuperscript{177} See supra notes 157-58.
\textsuperscript{178} See Act of June 1, 1989, ch. 340, art. 1, § 10, 1989 Minn. Laws 3021, 3023-24 (codified at MINN. STAT. § 501B.10 (Supp. 1989)); see also Haskell, \textit{supra} note 44, at 90 ("Several recent statutes supplement the prudent person principle with language that provides that the trustee's investment decisions are to be judged on the basis of the portfolio as a whole."); Ronald A. Sages, \textit{The Prudent Investor Rule and the Duty Not to Delegate}, Tr. & Est., May 1995, at 22 (explaining that shortly after the 1990 adoption of the Restatement, Minnesota was one of seven states to "implement[ ] provisions somewhat comparable in scope" to the Restatement's).

\textsuperscript{179} See MINN. STAT. § 501B.10 (Supp. 1989).
\textsuperscript{180} See \textit{In re Bank of New York}, 323 N.E.2d 700, 703 (N.Y. 1974).
\textsuperscript{181} In \textit{In re Bank of New York}, the New York Court of Appeals answered this question affirmatively, stating:

The record of any individual investment is not to be viewed exclusively, of course, as though it were in its own water-tight compartment, since to some extent individual investment decisions may properly be affected by considerations of the performance of the fund as an entity, as in the instance, for example, of individual security decisions based in part on considerations of diversification of the fund or of capital transactions to achieve sound tax planning for the fund as a whole. The focus of inquiry, however, is nonetheless on the individual security as such[\ldots] and factors relating to the entire portfolio are to be weighed only along with others in reviewing the prudence of the particular investment decisions.

\textit{Id.}

\textsuperscript{182} See MINN. STAT. § 501B.151, subd. 2(b) (1996).
text of the trust portfolio as a whole. Thus, trustees can now be confident that they possess the necessary flexibility to diversify the trust portfolio effectively, and they need not worry about liability arising from an individualized examination of each asset in a portfolio.

5. Delegation

It is a general rule of trust law that trustees may not delegate their fiduciary responsibilities to others. As a corollary, under the prudent man rule, trustees were not permitted to delegate their investment functions. Although trustees could seek advice, they were required to come to their own independent conclusions. One commentator has observed that this often resulted in trustees rubber-stamping expert decisions and, in reality, delegating their duties. As the investment world becomes more and more sophisticated, the antiquated and unrealistic notion of nondelegation has become particularly inappropriate.

In the 1960s, a variety of laws began to reverse the nondelegation rule for investment in specific areas. Some commentators expressed concern that trustees buying shares of stock in investment companies or mutual funds were improperly delegating their investment duties. These concerns were laid to rest when state legislatures expressly authorized trustees to invest in mutual funds.

183. See id.
184. See id.
185. Cf. RESTATEMENT (SECOND) OF TRUSTS § 171 (1959) ("The trustee is under a duty to the beneficiary not to delegate to others the doing of acts which the trustee can reasonably be required personally to perform.").
186. See id. cmt. h ("A trustee cannot properly delegate to another power to select investments."); supra notes 79-80 and accompanying text (discussing the prohibition on delegation under the prudent man rule).
187. See Langbein, supra note 12, at 651.
188. See id.
189. See id.
192. See Langbein, supra note 12, at 652.
193. See, e.g., MINN. STAT. § 501B.151, subd. 11 (1996) (stating expressly that trustees may invest in mutual funds); see also Langbein, supra note 12, at 652; Audio Tape of Commerce, Tourism & Consumer Affairs Comm. of the Minn. House of Representatives, H.F. 1998, Jan. 23, 1996 (testimony of Joyce James of the First Bank National Association, on behalf of the Minnesota State Bar Association, Probate and Trust Law Section Legislative Committee) (explaining that the statutory changes were simply a restatement of existing law) (audio tape on file at the Minnesota Legislative Library).
The new rule for delegation has two components. First, the trustee may delegate, effectively reversing the prudent man rule's nondelegation mandate. Second, trustee liability is adjusted to contemplate delegation.

Under the prudent investor rule, delegation is not only permitted, but encouraged, and in some cases required. The new rule permits trustees to delegate any trust function that a prudent person of comparable skills would properly delegate under the circumstances. In fact, a comment to the new Restatement suggests that the trustee may have a duty to delegate under a prudent investor standard.

The second component of the new delegation rule requires close attention. It is one of the few places where Minnesota's Prudent Investor Act diverges from the Uniform Prudent Investor Act. The UPIA obviates the responsibility a trustee had under the nondelegation regime to oversee the day-to-day mechanics of investing funds. In its place, the UPIA requires prudence in the delegation act itself. Under the UPIA, the trustee bears duties of care, skill, and caution in selecting agents, formulating the terms of the delegation, and reviewing and monitoring the agent's performance and compliance with the terms of the delegation. The UPIA provides that the trustee who complies with these standards is not liable for the decisions or actions of the agent to whom the function was delegated. Instead, an aggrieved beneficiary must look exclusively to the agent, who owes a duty to the trust to exercise reasonable care in

194. See Minn. Stat. § 501B.152 (1996); infra notes 196-98 and accompanying text.
195. See infra notes 199-212 and accompanying text.
197. See id.
199. See Audio Tape of Commerce, Tourism & Consumer Affairs Comm. of the Minn. House of Representatives, H.F. 1998, Jan. 23, 1996 (testimony of Christopher Hunt of Messerli & Kramer, P.A., on behalf of the Minnesota State Bar Association, Probate and Trust Law Section Legislative Committee) (tape on file at the Minnesota Legislative Library). Hunt testified that there are two principal areas where Minnesota's Prudent Investor Act differs from the Uniform Prudent Investor Act. See id. The first is with respect to the delegation rule. See id. This divergence is explained in detail infra. The second divergence is the omission of UPIA sections 5 and 6, which set forth a trustee's duties of loyalty and impartiality with regard to investing trust assets. See id. Hunt explained the rationale for the divergence, noting that Minnesota has a well-established body of common law on those duties and that the UPIA represents a departure from Minnesota's common law. See id.
201. Id. § 9(a), 7B U.L.A. 28.
203. Id. § 9(c), 7B U.L.A. 28.
complying with the terms of the delegation.\textsuperscript{204}

Likewise, Minnesota's rule places a duty to exercise care, skill, and caution in selecting agents,\textsuperscript{205} formulating the scope and terms of the delegation,\textsuperscript{206} and periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.\textsuperscript{207} Minnesota also adopted the language of the UPIA providing that the trustee who complies with these standards is not liable for the decisions or actions of the agent to whom the function was delegated.\textsuperscript{208} Further, an aggrieved beneficiary can look to the delegatee agent, who owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.\textsuperscript{209} However, the Minnesota rule provides that the agent's duty of care is enforced by the trustee.\textsuperscript{210} Thus, while under the UPIA an aggrieved beneficiary must look exclusively to the agent,\textsuperscript{211} under the Minnesota act, the aggrieved beneficiary may bring an action against the agent directly or compel the trustee to do so.\textsuperscript{212}

\textsuperscript{204} See id. § 9(b), 7B U.L.A. 28. The official comment explains the rationale for the structure of the new delegation rules. Id. § 9 cmt., 7B U.L.A. 28. It states that "[i]f the trustee delegates effectively, the beneficiaries obtain the advantage of the agent's specialized investment skills or whatever other attributes induced the trustee to delegate." Id. If, however, "the trustee delegates to a knave or an incompetent, the delegation can work harm upon the beneficiaries." Id. The requirement that the fiduciary remain accountable for responsible delegation decisions "is designed to strike the appropriate balance between the advantages and the hazards of delegation." Id.

\textsuperscript{205} See MINN. STAT. § 501B.152(a)(1) (1996).

\textsuperscript{206} See id. § 501B.152(a)(2).

\textsuperscript{207} See id. § 501B.152(a)(3).

\textsuperscript{208} See id. § 501B.152(c).

\textsuperscript{209} See id. § 501B.152(b).

\textsuperscript{210} See id.

\textsuperscript{211} See UNIF. PRUDENT INVESTOR ACT § 9(b), 7B U.L.A. 28 (Supp. 1996).

\textsuperscript{212} See id.; see also Audio Tape of Commerce, Tourism & Consumer Affairs Comm. of the Minn. House of Representatives, H.F. 1998, Jan. 23, 1996 (testimony of Christopher Hunt of Messerli & Kramer, P.A., on behalf of the Minnesota State Bar Association, Probate and Trust Law Section Legislative Committee) (tape on file at the Minnesota Legislative Library). Hunt explained the bar association committee's decision not to recommend the UPIA's language:

We didn't like this [provision] because we thought it would encourage a multiplicity of lawsuits by beneficiaries going after that agent when the trustee failed to pursue the agent. So what we have added to what the commissioners have suggested is another duty on the part of the trustee, so that if there has been a misperformance [sic] by the agent, the trustee has an affirmative [duty] to pursue that against the agent, even when the delegation is proper.

Id.
6. **Default Rule**

It should be noted that the prudent investor rule is a default standard that applies only if the trust instrument does not articulate another fiduciary standard. The new rule expressly permits settlors to expand, restrict, eliminate, or otherwise alter the rule by the provisions in a trust. Trustees who rely on the terms of a trust are not liable to the beneficiaries.

V. **RESPONSIBILITIES AND OPPORTUNITIES FOR PRACTITIONERS**

Even before the advent of the prudent investor rule, the position of trustee was not one to be envied, and the new rule adds to the list of required trustee duties. Trustees, particularly unskilled trustees, will need advice on whether to assume the role of trustee in the first place, what to do if they do accept the responsibility, and whether they should seek professional assistance. Thus, before taking on the role of trustee, drafting so that trustee investment decisions are governed by the Act is quite simple. Trust instruments can omit any mention of investment standards and rely on the default aspect of the rule, or they can use language defined by the rule as invoking the new standard. For example, use of the words “authorized investments,” “prudent man rule,” or “prudent investor rule” will in-
those contemplating the position should be fully aware of the burdens they will have to bear. 220

Those who choose to be trustees will require guidance on several points. First and foremost, they must establish an overall investment strategy. 221 This policy should be in writing 222 and should expressly state the trust purpose, how the investment strategy will achieve that purpose, 223 how the trust will achieve diversification, how diversification will decrease

voke the rule. See id. subd. 7 (listing language invoking the rule). Drafting so that trustee investment decisions are not governed by the new rule may be more difficult. See Hodgman, supra note 170, at 489. Drafters must not include language which inadvertently invokes the prudent investor standard. See Minn. Stat. § 501B.151, subd. 7 (listing language invoking the rule). One commentator suggests that merely authorizing a trustee to invest in life insurance, maintaining the equity in a family business, or having a conflict of interest may not be sufficient to draft around the rule. See Hodgman, supra note 170, at 490. Rather, the trust instrument should require the trustee to take a certain course of action. See id. at 490-93 (providing specific drafting examples).

Because of the heightened responsibilities borne by trustees, beneficiaries could prove to be a fertile source of new plaintiffs' litigation. See Todd, supra, at 282 (commenting on trustees' failure to take modern portfolio theory into account in making their investment decisions and noting that this sometimes results in harm to beneficiaries); see also Sages, supra note 178, at 22. Writing from the perspective of an advisor to bank trust departments, Sages suggests that there are two primary ways a bank trust department could capitalize on the new rule. See id. at 27. First, as an investment manager, a bank could directly manage portfolios for individual trustees. See id. Second, it could act "as a consultant on matters of portfolio risk assessment and reduction, asset allocation and portfolio construction." Id. Finally, in giving any advice, practitioners should include the caveat that the prudent investor rule is new, and as such, it has yet to be tested and defined by the courts. See Hodgman, supra note 170, at 489 (noting that the full implications of the prudent investor rule are not completely understood); Williams, supra note 4, at 80 (opining that the definition of "prudence" will not be settled for at least a generation).

220. See CHARLES E. ROUNDS, JR. & ERIC P. HAYES, LORING: A TRUSTEE'S HANDBOOK § 6.2.2.2 (1994) (stating that an exhaustive examination and accounting of the portfolio should precede any decision to accept a trustee position).

221. See Minn. Stat. § 501B.151, subd. 2(b) (1996) (explaining that a trustee's investment decisions will be evaluated as part of an overall investment strategy); see also White, supra note 156, at 229 (describing the most important new responsibilities as: (1) developing an overall plan that takes into account risk and reward, the size of the portfolio, liquidity, inflation, and the needs of the beneficiaries; and (2) diversifying the portfolio).


uncompensated risk, and how the trust will deal with inflation. Second, the trustee must make investment decisions consistent with that strategy. In light of the abrogation of categoric restrictions, trustees must consider investments that have not been considered appropriate in the past if the risk tolerance of the beneficiaries is high. Nontraditional investments also may be appropriate to meet the new rule’s mandate of diversification for the purposes of avoiding uncompensated risk and battling inflation.

Third, once the trust’s investment portfolio is established, the trustee must diligently monitor the investments to make sure that the trust pur-

224. See supra notes 165-70 (discussing the prudent investor rule’s duty to diversify with an eye toward eliminating uncompensated risk).

225. See supra notes 157-64 (explaining that under the prudent investor rule, trustees should be concerned about inflation’s effect upon the purchasing power of trust assets).

226. See Todd, supra note 219, at 282.

227. See supra Part IV.B.1 (discussing the abrogation of categoric restrictions).

228. See Taylor, supra note 222, at 62 (suggesting that trustees should consider the benefits of investing in nontraditional assets such as mortgages and other asset-backed securities, real estate, venture capital, or life insurance); see also George Crawford, A Fiduciary Duty to Use Derivatives?, 1 STAN. J.L. BUS. & FIN. 307, 325 (1995) (discussing modern portfolio theory and stating that “[i]n today’s financial environment, derivative vehicles – including options, futures, and swaps – offer opportunities for diversification, sometimes at lower costs or risks than other alternatives”). Trustees may also need to consider investing internationally. See Penner, supra note 84, at 643 (suggesting that trustees invest internationally – although the rule does not require them to do so – because of the excellent portfolio benefits offered by international diversification; advising trustees to document their reasoning if they decide not to invest internationally); see also Langbein, supra note 12, at 659 (explaining that the abrogation of categoric restrictions has opened the door for trustees to “include in the portfolio relatively novel types of assets . . . . The best example of this new openness to fiduciary investing is occurring in foreign securities.”).

229. See supra note 228. For a discussion of the use of mutual funds to achieve diversification, see Taylor, supra note 222, at 61 (observing that mutual funds are expressly sanctioned by the new Restatement and that such pooled investment vehicles are particularly helpful in diversifying when the amount of money under management is modest and/or the trustee is not a professional). But see Williams, supra note 4, at 80 (“[J]ust plunking all of your money in the We-Never-Lose Mutual Fund probably won’t get you off the hook. Even the diversification of one mutual fund – even an index fund that tries to replicate an entire investment market – is probably not sufficient under today’s standards of prudence.”).

230. See Taylor, supra note 222, at 62 (suggesting that trustees should consider hedging against inflation by investing in growth stocks, bullion, or real estate); see also Welch, supra note 218, at 21 (explaining that even in cases where a conservative, fixed-income approach is justified, a trustee should either invest a portion of the trust in growth-oriented securities or “be prepared to defend and justify the decision to exclude or minimize equity investment”).
poses are being achieved. Fourth, as part of their monitoring duties, trustees should document in writing all important trust events. Such events may include completed transactions; descriptions of meetings with advisors, associates, or beneficiaries to consider changes in investments or investment policies; information prepared to report investment results; subscriptions to investment information services that are used in making investment decisions; and the trustee's attendance at investment programs and seminars.

Fifth, to the extent a trustee is incapable or lacks confidence in performing one or more of these tasks, practitioners should suggest the possibility of using a professional expert. If a trustee chooses to delegate responsibilities, the practitioner should recommend that documentation be kept for the file and for communication to the beneficiaries. The documentation should record the process used to select the agent, the reasons and cost justification for the delegation, the scope of authority of the delegation, and objective standards by which the agent's performance can be monitored and judged. Practitioners should stress that delegation of investment duties does not mean that trustees can simply wash their hands of investment responsibilities, particularly in Minnesota.

231. See Minn. Stat. § 501B.151, subd. 2(a) (1996) (requiring the trustee to invest and manage trust assets as a prudent investor would).
232. See Welch, supra note 218, at 23; see also Taylor, supra note 222, at 62-63. Taylor suggests that at the trust's inception, the trustee write an opinion letter articulating the trust objectives and investment strategy. See id. The trustee should then provide periodic statements of account during the trust's life, and update beneficiaries on specific transactions. See id. However, Taylor notes that this should be accomplished without requiring prior consent or ratification for every action. See id.; see also Todd, supra note 219, at 282. Todd recommends that three things should be done once a portfolio is established. First, performance should be monitored and records should be kept. See id. Second, performance reviews should be made for all assets in the portfolio, taking into consideration overall market conditions. See id. Finally, a comparison between appropriate benchmarks and investment managers with similar investment styles should be performed. See id.
233. See Welch, supra note 218, at 21 (stating the rule that an unskilled trustee need not delegate investment functions to an expert). But see Williams, supra note 4, at 80 (stating that unskilled trustees are obliged to seek help from those who are experts). Such investment professionals should not be hard to find. See Welch, supra note 218, at 22. Moreover, a growing number of financial service firms usually offer investment consulting services at a reasonable fixed rate. See id.
234. See Welch, supra note 218, at 24.
235. See id.
236. See Todd, supra note 219, at 282 (noting that the Restatement sets guidelines for monitoring, record-keeping, and biannual reviews; and even though an investment management consultant may supervise performance, trustees still need to be kept abreast of investment decisions and the progress of the portfolio).
237. See supra notes 208-12 and accompanying text (explaining that under
Rather, trustees should maintain regular contact with their agents and monitor the progress of the trust portfolio. Rather, trustees should maintain regular contact with their agents and monitor the progress of the trust portfolio.238 Moreover, one commentator suggests that trustees should monitor the agent's "qualitative aspects, such as personnel, investment philosophy, administrative support, ownership, growth, and accounts gained and lost."239

VI. CONCLUSION

Minnesota's adoption of the Prudent Investor Act marks an exciting time for practitioners, settlors, beneficiaries, and trustees. Practitioners will enjoy new business opportunities and responsibilities in advising settlors, beneficiaries, and trustees of their relative rights and obligations under the new Act. Settlors will enjoy increased confidence that assets placed in trust will be managed to achieve their intended objectives. Beneficiaries likely will benefit through increased investment returns with unchanged risk levels. Finally, trustees will be free to invest trust assets in a manner consistent with contemporary economic thinking and practice. 

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238. See Todd, supra note 219, at 282.
239. Id.