

Fiduciary Investment Guidelines & Rules Governing Trustee Investments

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I. Introduction

Among the many duties that fiduciaries owe beneficiaries, wards, minors and intestate heirs is the duty to hold, preserve, safeguard and invest assets under their charge. The duty to invest, in particular, appropriately requires a great deal of the fiduciary's time and attention. And while all fiduciaries in Connecticut, be they executors, administrators, conservators or custodians, are generally subject to some of the same common law and statutory rules governing investments, this outline focuses primarily on the rules governing executor and trustee investments.

Investing by executors and trustees is governed first and foremost by the governing instrument, i.e., a will or trust agreement. Nonetheless, intimate familiarity with the terms of the will or trust agreement alone is insufficient. The executor or trustee must also be aware of and familiar with a plethora of common law and statutory rules concerning investments, which sometimes overlap and even contradict one another.

II. Common Law Fiduciary Duties with Regard to Assets

All fiduciaries have certain duties, including the duty of loyalty, of diligence, to take, secure and segregate assets, to account and report, and otherwise communicate, of impartiality, and to generally preserve property. As a fiduciary you (or your client) are subject to the highest legal standards of conduct -- "the punctilio of an honor the most sensitive", in fact. See Meinhard v. Salmon, 249 N.Y., 458, 164 N.E. 545 (1928) (Cardozo, J.).

A. Duty to Protect and Preserve Assets

In addition to scrupulously complying with the terms of the trust, perhaps the paramount duty of a trustee is to preserve trust assets. When holding non-traditional assets such as tangibles, closely held business interests and real estate, the duty to

preserve property includes storing, safe keeping, insuring, appraising, paying taxes, expenses, and premiums, managing businesses, and a myriad of other related tasks. The most common asset class held by trustees, however, is intangible personal property: i.e., cash, stocks, bonds, mutual and exchange traded funds, etc. Accordingly, this outline will address the investing rules concerning intangible, non-private assets.

B. Duty to Invest Trust Assets

The duty to invest trust assets derives not only from the duty to protect trust assets and to make such assets productive of income, but also from the duty to act reasonably, the duty to not waste trust assets, and the even the duty of diligence. It is axiomatic as a general proposition that a trustee has an affirmative duty to invest trust assets. 11 Scott Trusts Section 181 (3rd Edition, 1967). The Connecticut Supreme Court long ago held that “if a trustee be guilty of any unreasonable delay in investing [trust assets] . . . he will be accountable to the [beneficiaries] for interest during the period of his laches.” Wright v. Lee, 101 Conn. 401 (1924).

Generally, a trustee must invest trust assets with prudence, skill, care and intelligence, and in a manner that is appropriate for the trust given its size, duration and needs of trust beneficiaries.

III. Sources of Authority Governing Investments

A. Will/Trust Agreement

Although state common and statutory law provide the general framework within which assets must be invested, the trust agreement or will can and often do expand or restrict state law provisions. That is to say, with some very important exceptions discussed in detail below, state statutes are default rules which apply absent a direction in an instrument to the contrary. Therefore, the primary source of all estate and trust investing rules and direction is the governing document. Thus, the inherent power and authority of executors and trustees to manage and invest trust assets arises from the terms and provisions of the governing instrument.

B. C.G.S. Section 45a-203, Investment of Funds by Trustees

This section, applicable only to trustees, guardians and conservators, enumerates a list of permitted investments, including bonds, stocks, and mutual funds. It is typically ignored, for good reason, since it seems duplicative with the Connecticut Uniform Prudent Investor Act, which it cross-references and incorporates.

C C.G.S. Section 45a-204, Retention

See discussion in Section V, below.

D. C.G.S. Section 45a-209, Investments in Open-end or Closed-end Management Investment Companies.

E. Connecticut Fiduciary Powers Act

1. The Connecticut Fiduciary Powers Act, C.G.S. §45a-233 et. seq., provides certain standard powers which may be conferred upon fiduciaries, included among them are certain investment related powers, including the power to:

- a) retain original property
- b) invest in stocks, bonds, debentures, notes, mortgages or other securities, as well as in investment trusts, mutual funds and common trust funds “as the fiduciary shall deem advisable . . . even though such investment shall not be of a character approved by applicable law except for this provision”
- c) make investments which cause a greater proportion of the total property held to be invested than would be considered appropriate for the fiduciary (i.e., not diversify)
- d) vote shares of publically traded companies
- e) exercise options
- f) employ agents as investment counsel (i.e., delegate)

C.G.S. §45a-234.

A testator or donor may confer these powers on an executor or trustee by either expressly including them in the will or trust or by incorporating them by reference in the governing document.

2. The Fiduciary Powers Act includes other “additional” powers, many of which relate to investing. Unlike the “standard” powers of §45a-234, however, these powers must be specifically included or referenced in the governing instrument. C.G.S. §45a-235. These powers include the power to:

- a) invest in stock issued by the fiduciary
- b) purchase annuities
- c) invest in partnerships, including private equity and hedge funds

d) speculate in real estate, commodities, options, oil and gas interests, foreign currencies

C.G.S. §45a-234

3. Conflict

In the event of a conflict between one of more of the powers of §§45a-234 and 45a-235 and the terms of the governing instrument, the governing instrument shall control. In the event of a conflict between one of more of the powers contained in sections 45a-234 and 45a-235, and any other provisions of the general statutes, the statute claims that the power of powers contained in sections 45a-234 and 45a-235 shall control. C.G.S. 45a-233(c). Whether this is always the case, however, is uncertain at this time.

F. Restatement (Third) of Trusts (Prudent Investor Rule)

While not binding authority in any way in Connecticut, the Restatement of the Law (Third), Trusts (Prudent Investor Rule), established the modern understanding of investment risk and return as a frame of reference for evaluating the fiduciary standards of care, skill and caution and is essential for any trustee or trust attorney.

As stated in the Introduction of the Restatement, the objectives of Section 227 “range from that of liberating expert trustees to pursue challenging, rewarding, non-traditional strategies when appropriate to the particular trust, to that of providing other trustees with reasonably clear guidance to safe harbors that are practical, adaptable, readily identifiable, and expectedly rewarding . . . in order to protect trust beneficiaries and settlor objectives while also providing standards by which to judge and guide trustees’ conduct. (Emphasis added.)

IV. Connecticut Prudent Investor Rules

We all know that trustees are required to invest with prudence, discretion and intelligence. But where did this standard come from? What is the difference, if any between the prudent man rule, prudent investor rule and Uniform Prudent Investor Rule?

A. Background

From time immemorial until 1997, Connecticut executors and trustees were, generally speaking, governed and judged by the common law prudent investor rule, once known as the prudent man rule. This rule was first articulated in the seminal Massachusetts case of Harvard College v. Amory, 26 Mass. 446 (1830), in which the court stated that:

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

Id. At 461.

Connecticut adopted the common law prudent investor rule and courts have used similar language in describing the investment duties of a trustee:

“The law governing the duties of a trustee respecting investment of trust assets is well settled. Generally, a trustee must act with the care of a prudent investor.”

United States Trust v. Bohart, 197 Conn. 34, 49 (1985). See also Jackson v. Conland, 178 Conn 52 (1979); Hartford National Bank and Trust Co. v. The Parish of Trinity Church, et al., 25 Conn. Supp. 23 (1963); Marcus Richard Kimball et al. v. The New England Trust Co., 14 Conn. Supp. 432 (1947).

Thus, the prudent investor rule has been adopted by decision or legislation in most American jurisdictions, usually replacing the more restrictive “legal list” statutes, which enumerated investment classes which were per se proper or improper. See e.g., C.G.S. §45a-203(a).

Over time the common law prudent investor rule was seen to be less and less adequate and sufficient to deal with changing economic conditions and financial markets. High inflation, low interest rates, high market volatility, shorter business cycles and other phenomenon eventually required a more modern approach to trust investing.

Hence the emergence of the Uniform Prudent Investor Act, the Uniform Principal and Income Act and the Restatement of the Law of Trusts (Third).

B. Connecticut Uniform Prudent Investor Act. C.G.S. § 45a-541 et. seq.

In 1997, Connecticut effectively codified and expanded upon the prudent investor rule by adopting the Connecticut Uniform Prudent Investor Act.

The Act, which applies only to trustees (and not executors, administrators, conservators or guardians), directs that those trustees who invest and manage trust assets owe a duty to the beneficiaries of the trust to comply with the prudent investor rule. C.G.S. 45a-541a(a).

But the Act goes further: It greatly expands the common law rule with regard to permissible investments and it provides more guidance to trustees.

Some characteristics of the Connecticut Uniform Prudent Investor Act include:

1) It's a Default Rule

The prudent investor rule is a default rule which may be expanded, restricted, altered or eliminated. §45a-541a(b)

See Section VII, below, however, for important exceptions to the ability of a donor to entirely eliminate the prudent investor rule.

2) Duty to Invest with Care, Skill and Caution

A trustee must exercise reasonable care, skill and caution in managing trust assets and in doing so must take into consideration the purposes, terms, distribution requirements and other circumstances of the trust. §45a-541b(a)

3) The Portfolio is the Thing

The trustee shall be evaluated on the composition of the entire portfolio, not each particular investment within the portfolio, taking into consideration the overall investment strategy and risk and return objectives. §45a-541b(b)

No particular investments or assets classes are per se prudent, or per se imprudent, forever obviating the old legal list method of investing.

4) Multi-Factor Considerations

The Act requires a trustee to take into consideration multiple factors when making trust investment decisions. These factors include:

- a. economic conditions;
- b. inflation or deflation;
- c. tax consequences;
- d. total portfolio composition;
- e. expected total return;
- f. need for liquidity, income distributions and preservation or appreciation of capital;
- g. size of the portfolio; and
- h. estimated term of the trust.

§45a-541b(c).

This Section is both a help to and a challenge for trustees in Connecticut. The section requires that trustees consider some factors which are not only out of the trustee's control, but also may be well outside the trustee's scope of competence.

5) Duty to Diversify

The Restatement (Third) states that sound diversification is fundamental to risk management and is therefore ordinarily required of trustees.

The Connecticut Prudent Investor Rule prescribes an affirmative duty to diversify trust investments “unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversification.” C.G.S. §45a-541c. Thus a trustee has a clear duty to diversify unless it has a very good reason not to – either the document waives the duty or there are compelling retention issues.

In many ways the duty to diversify trust assets is the hallmark of the prudent investor rule. This section is the implicit recognition of Modern Portfolio Theory, giving the trustee the ability to invest in a wide range of assets and asset classes and to invest for total return. The trustee need not avoid all risk (as if this were possible), but rather to understand, analyze, measure and balance risk with return.

Absent express direction in the governing document directing a trustee to retain a single or concentrated position in a particular stock, unit, etc., i.e., a direction not to diversify, it is the foolhardy trustee, indeed, who does not heed well this rule.

6) Duty to Minimize Costs of Investing

Rule holds that a trustee “may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust and the skills of the trustee.” §45a-541g. The Restatement (Third) goes further: Trustees have a duty to avoid fees, transaction costs and other frictional costs that are not justified by the needs and realistic objectives of the trust’s investment program.

Query: does this duty create a presumption for the use of a passive investment approach? See Section IX, below. The Restatement (Third) appears to encourage the use of this approach. See, e.g., Restatement (Third), Introduction, Section 227. Pages 6-7.

7) Test of Conduct, Not Result

A trustee will be judged by its conduct, process, etc. at the time an investment is made, not by the ultimate result that is achieved looking through the rear view mirror. §45a-541h.

As stated in the Restatement, “the test of prudence is one of conduct, not one of performance.” Section 227, Page 23.

V. Retention of Inception Assets

Connecticut statutes expressly permit the retention of securities received by fiduciaries even if, ordinarily, such securities would not be proper fiduciary investments, so long as such retention is not inconsistent with the governing document. See C.G.S. §45a-204 and §45a-234(l). Beware, though, that the statute may not alter the requirement that the trustee act prudently by adapting to changes vis a vis the investment during the term of the trust. Professor Langbein has made a forceful argument that some fiduciary responsibilities should not be waivable. See John H. Langbein, Mandatory Rules in the Law of Trusts, 98 NW. U.L. Rev. 11005 (2004). Professor Cooper, on the other hand, argues that narrowly drawn retention clause should be and are effective. See Jeffrey A. Cooper, Speak Clearly and Listen Well: Negating the Duty to Diversify Trust Investments, 33 Ohio N.U. L. Rev. 903 (2007).

Who’s right?

VI. Delegation of Investment Function

The Connecticut Uniform Prudent Investor Act allows for delegation by the trustee of the duty to invest so long as it is done so prudently. See C.G.S. §45a-541i. In so delegating, the trustee must exercise reasonable care, skill and caution in:

- 1) selecting an agent;
- 2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and
- 3) periodically reviewing the agent's actions in order to monitor performance and compliance with the scope and terms of the delegation.

There should be no liability for the trustee who delegates accordingly.

VII. Opting Out of Connecticut Prudent Investor Act

Although §45a-541a(b) expressly provides that the rule is only a default rule that can be eliminated by provisions of the trust, a trustee must be very careful before it acts contra to the Rule. See, e.g., Langbein, *supra*.

VIII. Total Return Investing, Modern Portfolio Theory, and the Power to Adjust Under the Connecticut Uniform Principal and Income Act

A. Investing for Total Return

B. Uniform Principal and Income Act

1. Power to Adjust, C.G.S. §45a-542c

C. Modern Portfolio Theory

Modern Portfolio Theory recognizes that risk and return are inexorably linked in that one follows the other. The prudent trustee must not mindlessly avoid all risk, but rather understand and manage risk, primarily by diversifying trust assets, and make deliberate decisions concerning the appropriate level of risk to take given the purpose and term of the trust and the needs of the beneficiaries.

1. Balancing risk and return. Two types of risk:

a) Market Risk - Investor is compensated.

b) Company-Specific Risk (sector, asset class, style, country) -- Investor is not compensated

IX. Active vs. Passive Investment Approaches

A. Historically

B. Efficient Market Hypothesis

C. Passive Investing