A trustee’s duties have always included the duty to prudently invest trust assets. However, recent developments, most notably the Uniform Prudent Investor Act (Prudent Investor Act) and the Revised Uniform Principal and Income Act (UPIA), have changed significantly the scope of that duty. As a result of these new developments, trustees must give even greater attention to the issue of the investment of trust assets.

A. TRUSTEE RESPONSIBILITIES

Both the trustee and the attorney for the trustee have new and modified responsibilities under these laws. The trustee in particular has to master both new laws and changing investment landscapes. First, the trustee must understand the nature of modern investments, which includes not just publicly traded securities (stocks and bonds) and more difficult assets to manage, like real estate and closely held businesses, but also derivatives (like puts, calls, and options), insurance, and alternative investments such as hedge funds. Once the investments themselves are understood, the trustee must determine the tax consequences of those investments. In particular, the taxation of derivatives, of retirement plans, and of trusts themselves can have a significant impact on trust administration.

Once familiar with the types of investments available, the trustee must determine how investment theory affects investment choices. For example, modern portfolio theory dictates that a trustee must address levels of diversification and risk in investment choices. Those choices might also be affected by the trustee’s views about market efficiency versus behavioral finance (an esoteric distinction that nevertheless can have a significant impact on investment choices and returns).

The decision about diversification, in particular, requires a great deal of trustee attention. For example, the trustee ordinarily has to review the assets he or she receives and determine whether they have to be sold. There may be circumstances, however, that mandate that certain assets be retained (for example, when those assets have a special relationship to the settlor or the settlor’s family). Case law in particular has significantly affected diversification requirements.
Another important factor affecting the trustee’s investment choices is the language of the trust agreement. General investment principles can be overturned by the trust terms. However, terms that may at first blush seem clear have been interpreted in interesting ways by courts in the past few years. These interpretations have led to trustee liability in several cases.

To capture the trustee’s investment decisions and communicate them effectively to the beneficiaries, the trustee must prepare a written investment statement, one that considers the entire range of trustee decisions: the beneficiaries’ personal situations, the trust terms, the special circumstances surrounding the trust creation, the law of trust investments (including the case law), and the income and transfer tax consequences of those decisions.

Finally, once the investment choices have been made and the investment plan has been put into place, the trustee must know how to treat those investments under the local principal and income act. In particular, the Revised Uniform Principal and Income Act provides the treatment of investment returns as either income or principal as well as providing potential solutions for the problems that arise when the trustee’s investments favor either principal or income returns, to the detriment of a particular beneficiary.

B. ATTORNEY RESPONSIBILITIES

The trustee is not the only one with significant responsibilities; the attorney advising the trustee has a large role to play in trustee investments. This role is somewhat a confused one because of a central paradox: attorneys are not qualified to provide (and are not typically covered by errors and omissions insurance for providing) investment advice. However, attorneys are hired to interpret the law, part of which is the Prudent Investor Act. So the attorney, in the course of interpreting that law, comes dangerously close to providing such advice.

Like the trustee, the attorney must be aware of the various investment vehicles and the nuance of investment theory. The attorney must also understand the ways in which such nuance is blended into the law of investments, including the Restatement (Third) of Trusts and the Uniform Prudent Investor Act. The attorney also must be aware of all possible contexts in which these laws can arise. For example, charitable remainder trusts and irrevocable life insurance trusts are both governed by these laws, even though the investments in such trusts are not often considered in great detail.

The attorney also has to advise the trustee of his or her duties to the beneficiaries, which include the duties of impartiality and loyalty. Such duties arise in the investment context, particularly when the choice of investments can favor one beneficiary over another (for instance, in the case where one beneficiary is entitled to income, and therefore favors investments in income-producing assets, and another beneficiary is entitled to the trust residue, and therefore favors growth assets that produce little or no income).

The trust document itself is, of course, the attorney’s area of specialty. In the drafting stage, the attorney must be aware of the kinds of issues the
courts will examine when determining the extent to which trust investment provisions (and particularly those provisions that allow a trustee not to diversify) will be respected. The attorney also must be knowledgeable about the alternatives to traditional trust drafting, such as total return trusts and unitrusts. These same issues are important when interpreting trust terms for a trustee after the trust has become irrevocable.

C. WHO SHOULD USE THIS BOOK?

This book was written with the individual trustee in mind. Corporate fiduciaries (including the author’s employer) have developed systems to take into account the issues raised here. However, the vast majority of trusts have individuals serving as trustees. These individuals are often either family members or trusted advisors (perhaps accountants or lawyers) who, although they may have adequate investment knowledge to manage their own affairs, have little familiarity with the nuances of trustee investing. Further, the investment advisors that those individual trustees have hired to manage the individual’s personal finances may not be familiar with these trust issues. So who should use this book?

- Individuals acting as trustees, who need to be aware of what they are about to get (or have already gotten) themselves into.
- Financial planners who are used to advising individuals on their investing but who have little experience in the trust world.
- Accountants who have been assisting individual trustees with their income tax issues and who have been called upon from time to time to give formal or informal investment advice.
- Lawyers who draft trusts and represent trustees.

It is this last group to whom this book is primarily addressed, because it is the lawyers who have perhaps the greatest potential liability exposure: they have the responsibility not only to ensure that the client’s wishes are carried out by properly drafting the trust agreement, but they also are called upon by the individual trustee of that trust to advise on the responsibilities of the trustee and of governing state trust laws.