Advisory Committee: Prudent Investor Act

by Hon. C. Raymond Radigan

After my first report in 1991 as chairman of the EPTL Advisory Committee, in which we focused on the revision of the Right of Election and Descent and Distribution statutes, we recommended an examination and revision of the remaining articles of the Estate, Powers and Trusts Law (EPTL) and the Surrogate's Court Procedure Act (SCPA). Upon the Senate and Assembly's approval of the EPTL Advisory Committee's expanded scope, our committee evolved into the EPTL-SCPA Legislative Advisory Committee (committee). In my previous column (*The New York Law Journal*, Dec. 3, 2003, at p. 3), I indicated I would review in this column what was set forth in our Third Report with respect to the enactment of the New York Prudent Investor Act for fiduciaries.

The committee proposed legislation that would serve to codify a new Prudent Investor Rule for fiduciaries, which rule would manifest the then-changing economic conditions and theories as well as the appearance of new planning and investment strategies. The discussion that follows examines the case law and committee observations and recommendations to revise the law regarding fiduciary investment management in New York upon which the current provisions of the law are based.

Prudent Man Rule

The New York Court of Appeals in King v. Talbot, 40 NY 76 (1869), embraced the Prudent Man Rule, the predecessor of the Prudent Investor Rule. The Court observed that a "trustee is bound to employ such diligence and such prudence in the care and management [of the principal's funds], as in general, prudent men of discretion and intelligence in such matters, employ in their own affairs." As originally codified, our Legislature required fiduciaries to manage the principal's funds as "prudent men of discretion and intelligence in such matters who are seeking a reasonable income and preservation of their capital." In addition, case law during the Prudent Man Rule era highlighted the well- established principle that it is insufficient for a finding of imprudence to merely demonstrate that hindsight would show an alternate course of investment as more advantageous. In re Atkinson, 148 AD2d 839, 539 NYS 112 (3d Dept. 1989). Rather, "prudence is tested at the time of the investment decision, not from the vantage point of hindsight ... [and, as such,] there can be no doubt that the test to be applied is one of conduct rather than performance." In re Morgan Guar. Trust Co. of New York, 89 Misc2d 1088, 1091, 396 NYS2d 781, 784 (Sur. Ct. New York County 1977).

Although some fiduciaries would have preferred to alleviate their responsibility of selecting proper investments by simply relying on the advice of others, the Prudent Man Rule prohibited the delegation

of such responsibility as a means for the delegor-fiduciary to achieve absolution from possible future surcharge. The fiduciary must nevertheless exercise the requisite reasonable degree of skill in choosing investments.

The Prudent Man Rule applied to investments made between the rule's inception on May 1, 1970 and Dec. 31, 1994 and applied to personal representatives, trustees, guardians, donees of a power during minority, committees and conservators. Please note that, during the same period of time, the designation "Prudent Man Rule" eventually evolved into "Prudent Person Rule.'

Prudent Investor Act

Upon our recommendations, the Legislature enacted a new law to govern fiduciary investments in the Prudent Investor Act of EPTL §11-2.3, unsurprisingly termed the Prudent Investor Rule. The act also contains a Prudent Investor Standard in the EPTL §11-2.3(b)(3). The enacted statute is effective as to investments made or held by fiduciaries on or after Jan. 1, 1995.

One significant requirement under the current law is that the trustee must ascertain the needs of the trust or estate in order to determine whether or not to diversify. In doing so, the trustee must take into account the terms of the governing instrument. Paralleling this responsibility is that the trustee is thereafter required to scrutinize and, if necessary, adjust the allocation to manage the risks inherent in such investments. Hence, the standard, as carried over from the previous law, is conduct and not performance in evaluating a trustee's performance. The concept of diversification is further discussed infra. Essentially identical to the definition under the Prudent Person Rule, the Prudent Investor Act defines "trustee" as "personal representative, trustee, guardian, donee of a power during minority, guardian under eighty-one of the mental hygiene law, committee of the property of an incompetent person and conservator of the property of a conservatee." EPTL §11-2.3(e)(1). The office of guardian under the Mental Hygiene Law Article 81 has superseded the latter two offices.

Unlike the Prudent Person Rule, EPTL §11-2.3(b)(4)(C) permits the fiduciary to delegate investment and management functions in certain instances. The committee recognized that where a fiduciary's own financial and investment expertise is limited, delegation to an individual or institution with savvy in a particular sphere of economics is necessary. In addition, we acknowledged that the law should provide for a degree of accountability for delegee fiduciaries. As such, we recommended that delegation be permitted and that a measure of liability lie with the delegee fiduciary, provided that the delegor fiduciary "exercise[ ] care, skill and caution in choosing and instructing the delegee and in periodically reviewing the delegee's conduct." Third Report to the Legislature of the EPTL-SCPA Legislative Advisory Committee; see Warren's Heaton, Surrogate's Courts, vol. 14, app. 3, at 20 (6th ed., rev. 2003). As

reflected in the language of EPTL §11-2.3(b)(4)(C), the Legislature adopted our recommendations in this regard in enacting the current law.

Subsection (a) of the Prudent Investor Act contains the Prudent Investor Rule, which, pursuant to the Legislature's adoption of the committee's recommendations, requires the fiduciary to conform its investment and other financial management conduct to the Prudent Investor Standard of EPTL §11-2.3(b), unless otherwise provided for by the governing instrument. Although the statute enables the principal to opt out of the Prudent Investor Standard, the instrument may not exonerate the fiduciary(ies) from gross negligence. In fact, if the governing instrument creates a different standard, such standard may not exonerate the fiduciary for conduct exercised without reasonable care, diligence and prudence. Exoneration of a fiduciary therefrom would violate New York public policy, as indicated in EPTL §11-1.7(a)(1).

Prudent Investor Standard

The Prudent Investor Standard applies as to the entire portfolio rather than to a particular investment or investments viewed in isolation from the overall plan. That is, the primary purpose of the standard is to focus on the fiduciary's overall investment plan and the implementation and supervision thereof, rather than on the prudence or imprudence, for that matter, of a particular investment vehicle. As to the particular investment strategy, we noted, and the statute reflects, that no particular investment is prudent or imprudent per se. EPTL §11-2.3(b)(4)(A). The fiduciary is thereby given greater flexibility in choosing investments provided that the same advances the overall investment plan and that such plan be prudent. The Summary of Provisions of the committee's Third Report explains the foregoing concept by way of an example: "a fiduciary may invest in a particular asset that is not income producing if the entire portfolio is designed to meet appropriate income objectives." Third Report to the Legislature of the EPTL-SCPA Legislative Advisory Committee; see Warren's Heaton, Surrogate's Courts, vol. 14, app. 3, at 18 (6th ed., rev. 2003).

As to objectives, the fiduciary must preliminarily identify those objectives appropriate for the principal. For example, a middle-age person with adequate current income flow and a desire to provide for his or her retirement would be well served by investing in long-term growth securities, whereas a person seeking a potentially higher and faster, albeit riskier, rate of return would be best served by more-speculative positions. In addition to the principal's personal objectives, EPTL §11-2.3(b)(3) requires the fiduciary to consider other factors in choosing and/or adjusting the mix of investment for an appropriate investment strategy, such as the portfolio size, liquidity and distribution requirements of the governing instrument, inflation or deflation, general economic conditions, tax consequences, the needs of the beneficiaries and the portfolio's total expected return. EPTL §11-2.3(b)(3)(B). Please note that "total

return" includes income as well as capital appreciation.

Bankers, Bar Associations
With the invaluable insight and assistance of various committees from the New York State Bankers and Bar associations, we determined that, in furtherance of the within described objectives, diversification of the assets within the fiduciary account portfolio should be required, unless otherwise provided in the governing instrument or particular circumstances otherwise dictate. Upon submission to the Legislature, our recommendation was so adopted. This did not come as a surprise since, although unspecified under prior law, diversification came to be widely expected in our courts.

Diversification, or blending of different asset types within a portfolio, minimizes investment risk as this blend permits the gains on some of the assets to offset the losses sustained from others. There is no formulaic method for diversification since what is considered to be proper and prudent will vary depending upon facts and circumstances. Proper diversification necessitates attentiveness to the overall investment plan and the supervision thereof.

In this connection, we recommended that the fiduciary determine whether to sell and reinvest or retain the assets received from the principal "within a reasonable time after the creation of the fiduciary relationship." EPTL §11- 2.3(b)(3)(D). A problem may arise, however, where the governing instrument directs the fiduciary to retain certain assets. A fiduciary would be best advised to seek expert consultation in such a situation. It is, generally, imprudent for a fiduciary to retain an investment that would not have been prudent for the fiduciary himself or herself to initially make. Even where the governing instrument directs retention, a fiduciary may nevertheless dispose of an asset where it appears that the estate would otherwise suffer a loss. In the absence of any such express direction, however, the fiduciary should not retain the initial assets lest he or she face the grim possibility of a surcharge. When determining which, if any, assets to retain, the fiduciary must perform due diligence to ascertain the existence of other resources available to the beneficiaries. In addition, the fiduciary should also consider whether the decedent intended that certain assets be preserved for the beneficiaries.

One must be mindful that the statute is a default statute, meaning that the testator or grantor creating the governing instrument is free to provide otherwise, subject to the restrictions set forth under EPTL §11-1.7(a)(1). As an example, one may wish to have an investment retained because it would particularly benefit a primary beneficiary as a source of income, employment or direct involvement in the investment.

Although nearly a decade in force, the nature and interpretation of the Prudent Investor Act, coupled

with the ever-changing economic conditions of late, has spurred a great deal of concern for individual and institutional fiduciaries. As such, not only should the practitioner be thoroughly familiar with the current statute as well as its common-law evolution, but prudence would dictate that the practitioner ally with sophisticated financial and economic professionals in order to adequately preserve the interests of both the estate and the fiduciaries thereof.

Forthcoming

In my next article, I will discuss the committee's studies, findings and recommendations, contained in our Fourth Report, regarding lifetime, or inter vivos, trusts.

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