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The Oregon Prudent Investor Act: Some New(ish) Updates

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The Oregon Prudent Investor Act has been around now for 27 years. There has been little if any Oregon case law directly on point, but there have been many decisions around the country, and one statutory change in Oregon, that have come out since the 2018 edition of *Administering Trusts in Oregon* was published by the Oregon State Bar. This article will highlight some of those developments (including some developments that the author should have included but missed).

Background

What follows is a general overview of the Oregon Prudent Investor Act; it is not comprehensive, but is intended to provide a background for the developments that follow. Oregon adopted the Uniform Prudent Investor Act (UPIA) in 1995, which is now codified at ORS 130.750–130.775. The prefatory note to the UPIA states that it "draws upon the revised standards for prudent trust investment promulgated by the American Law Institute in its Restatement (Third) of Trusts: Prudent Investor Rule (1992)." Because Oregon adopted the UPIA almost verbatim, the comments to both UPIA and the Restatement have great validity in interpreting Oregon's prudent investor rule.

The Oregon prudent investor rule is a "default rule that may be expanded, restricted, eliminated or otherwise altered by the provisions of a trust." ORS 130.750(2). To the extent it is not overridden, "a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule." ORS 130.750(1).

A trustee must "invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust." UPIA §2(a). A trustee's investment and management decisions are to be evaluated "in the context of the trust portfolio as a whole and as a part of the overall investment strategy having risk and return objectives reasonably suited to the trust." ORS 130.755(2).

As a result of these guiding principles, an Oregon trustee has several other duties to follow when investing trust assets:

- "A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." ORS 130.760.
    - Diversification is critical to meeting other trust investment standards. For example, if the purposes and circumstances of a trust might require substantial disbursement of funds on relatively short notice, a portion of the portfolio should be invested in relatively liquid assets to minimize the risk that a call for funds might come at a time when the liquidation of longer-term investments might not otherwise be advisable.

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  - The comments are also clear that circumstances may overcome the duty to diversify. For example, "if a tax-sensitive trust owns an undiversified block of low-basis securities, the tax costs of recognizing the gain may outweigh the advantages" of diversification. UPIA §3, comment. Furthermore, "[t]he wish to retain a family business is another situation in which the purposes of the trust sometimes override the conventional duty to diversify." UPIA §3, comment.
- In general, a trustee must invest for the benefit of the trust beneficiaries alone. ORS 130.655(1); Restatement (Third) of Trusts: Prudent Investor Rule §§227(c), 170 (1992). Except for receiving reasonable compensation, the trustee generally must not derive personal benefit from the trust fund or its investments.
- Unless the trust agreement clearly states otherwise, the trustee must invest with due regard to the interests of all trust beneficiaries. ORS 130.660, 130.765; Restatement (Third) of Trusts: Prudent Investor Rule §§227(c)(1), 183 (1992).
- The duties of impartiality and loyalty raise some interesting points. Twenty-seven years ago, for example, the UPIA comments stated that "social investing," in which a trustee makes an investment decision based on social causes, is deemed to be inconsistent "with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries—for example, by accepting below-market returns." UPIA §5, comment.

Duty to Monitor Fees

A case with serious consequences for trustees is *Tibble v. Edison Int'l*,[1] decided by the U.S. Supreme Court in 2015. The facts are straightforward: the petitioners (beneficiaries of a defined-contribution plan) argued that the respondents (the employer and others, who sponsored the plan) violated their fiduciary duties by offering six higher priced retail-class mutual funds as plan investments when materially identical lower-priced institutional-class mutual funds were available. The petitioners claimed that a large institutional investor could have obtained materially identical lower-priced institutional-class mutual funds that are not available to retail investors.

Ostensibly, the issue before the Court was whether the petitioners' claims were time-barred under the six-year statute of limitations. The lower courts held that the statute began running when the mutual fund interests were acquired (eight years before the claim was filed), ruling against the petitioners' argument that, because the funds underwent significant changes within that six-year statutory period, the respondents should have undertaken a full due-diligence review at that time and converted the higher priced retail-class mutual funds to lower-priced institutional-class mutual funds.

The Supreme Court overturned the lower court decisions, ruling that the petitioners' claims should be considered. The Court stated that in determining the contours of an ERISA fiduciary's duty, courts often must look to the law of trusts. It stated that "[u]nder trust law, a trustee has a continuing duty to monitor trust investments and remove imprudent ones. This continuing duty exists separate and apart from the trustee's duty to exercise prudence in selecting investments at the outset." The trustee must systematically and regularly review all trust investments. The Court reached its conclusion based in part on the Uniform Prudent Investor Act. As a result, the Court held that a plaintiff can file a claim for breach of fiduciary duty by failing to properly monitor investments, as long as the alleged breach of the continuing duty occurred within the statutory period. The lower courts erred by applying the statutory framework based solely on the initial choice of funds, so the Court remanded to the Ninth Circuit for reconsideration.

It would be easy to assume that this decision applied solely to ERISA plan managers and their advisors, or that it required automatic review of certain share classes held as plan assets. However, the *Tibble* decision should be seen in a broader context: all trustees have an ongoing duty to monitor the appropriateness of their investments even after they are selected initially. This duty applies not only to the selection of classes of shares or funds but more broadly to the choice of one fund or another. This is particularly true in the case of index funds (for example, a fund that tracks the S&P 500): The trustee must take ongoing care that such funds have (all things being equal) the lowest cost among their competitors. The individual trustee who has delegated its responsibility of investing trust assets to an advisor must periodically ensure that that advisor is monitoring such expenses.

ESG Investing

One aspect of investing that continues to draw attention is the extent to which environmental, social and governance (ESG) factors should be considered in building an investment portfolio. Using such a perspective involves taking into account not only a company's profitability, but also its impact on issues like climate change, labor conditions, board diversity and executive compensation. The goal is that, by focusing on those issues, companies can be selected for portfolio investment that are not

1 575 US 523 (2015).

only generating a profit but also are better placed to be successful in the future.[2]

At its inception, ESG investing was referred to as socially responsible investing (or SRI). Early SRI investing relied on "negative screens," under which a portfolio manager would not invest in companies that the investor felt were ethically or morally wrong (such as oil, tobacco or gun producers). Importantly, negative screening involves using a non-financial metric in determining whether or not to make an investment. In other words, it places a moral or ethical judgment on the part of the investor ahead of purely financial considerations. It was from this perspective that the comments to the UPIA, quoted above, put forth the view that social investing violated a trustee's duty of loyalty. And in large part, this is the view of many lawyers and clients, despite the fact that ESG investment theory has developed significantly in the last thirty years.

A better way to think of ESG investing is as "ESG integration," a strategy that combines ESG factors (a company's environmental impacts, its labor relations and how it interacts with communities, for example) with traditional financial metrics when analyzing companies. The thought is that ESG integration improves stock selection by expanding the scope of information about a stock, thus identifying more potential risks and opportunities.[3] And indeed, studies have shown that funds using such an approach generate similar results to those that don't consider ESG factors.[4]

Such an analysis presumes, however, that stock selection is being used at all. Such is the case with actively-managed funds, in which fund managers believe they can deliver higher returns through their analysis and selection of individual securities. However, passive investing, which involves simply holding all of the stocks, and in the proportions, set forth in an index (the S&P 500 being perhaps the most popular), does not use any stock selection at all. As a result, its administrative costs (the salaries it pays to fund managers and analysts) are significantly lower. An article written in the early years of modern portfolio theory held that fund managers generally could not outperform index funds over long periods of time, and therefore the higher administrative costs from actively managed funds was an unjustifiable expense.[5] This view found its way into the UPIA, which holds that actively managed funds must adequately outperform their passive index benchmarks in order to justify their increased costs.

Which raises the question whether ESG integrated portfolios (which are by definition actively managed) outperform an appropriate passive index benchmark. At least one study found that, although ESG portfolios performed better, in general, than the fund universe as a whole (which would include active and passive funds), such portfolios will always be more expensive than their passive index-tracking counterparts.[6]

Another concern for ESG investing is the extent to which fund managers engage in "greenwashing;" that is, expressing concern for and taking superficial steps toward ESG factors simply as a cover to sell more investment products. Surveys of managers tend to show that 68% – 74% of them claim to use ESG integration. However, these results are self-reported with no oversight. There are few standard definitions or assessments. At least one consultant has tried to apply due diligence to the process by asking whether the ESG integration is observable, material and additive to the investment process. The consultant found that 86% of funds claimed to use ESG factors, but only 35% did so in a meaningful way, passing muster under the consultant's due diligence process.[7] Analysis like this shows how hard it can be to determine whether a fund has truly adopted ESG integration, or has simply claimed to do so for window-dressing.

One final consideration is ORS 130.755(3)(i), which provides that a trustee "shall consider all relevant circumstances in investing and managing trust assets, including . . . the intent, desire and personal values of the settlor, including the settlor's desire to engage in sustainable or socially responsible investment strategies that align with the settlor's social, environmental, governance or other values or beliefs to the extent known by the trustee." This statute should allow a trustee to follow a settlor's ESG goals without worrying about whether those goals conflict with the prudent investor rule. However, this provision also creates two difficulties. First, in the author's experience, most clients don't understand the notion of ESG integration. Rather, the common view is that social investing equates to negative screening: for example, avoiding oil and gas companies in the portfolio. Second, it could be a challenge to determine whether and to what extent the settlor wanted the trustee to pursue such strategies. Are general statements made during a client meeting adequate? Should those desires be set forth in a writing, and specifically included in the trust agreement? Requiring a future trustee to understand the "intent, desire and personal values of the settlor" without a writing to support it would probably lead to greater confusion. An attorney drafting a will or trust for a settlor who has strong opinions about social investing should include in the trust

2 For an excellent discussion, *see* Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration,* 90 U. of Co. L. Rev. 731 (2019).
3 *Id.* at 745-46.
4 *Id.*
5 *Id.*at 754-55.
6 *Id.* at 756.
7 Fiducient Advisors, *Greenwashing in ESG: Don't Judge a Book by its Cover* (December 2021).

agreement a provision that states both the intent that the trustee pursue ESG investing, and what such investing should entail (in other words, ESG integration versus negative screening).

Duty of Loyalty

A trustee must invest trust assets solely for the benefit of the beneficiaries; transactions involving the trustee's own interests are generally prohibited unless certain standards are met. Breaches of this duty often occur when individual trustees invest trust assets in businesses in which the trustee has an (often controlling) interest, and with corporate trustees who use their own proprietary funds.

In *Jackson v. Mercantile Safe Deposit & Trust Co.*,[8] a corporate trustee was found liable for damages after failing to adequately monitor investments and investing in its own funds, which lagged behind the performance of the S&P 500. The corporate trustee assumed management responsibilities in 1947; by 1960, with a market value of $142,025, the trust assets consisted of a 70% stock 30% fixed income allocation. Annual reviews took place regularly and until the mid-1970's the market value of the trust equities kept a reasonably close relationship to that of the S&P 500. However, in approximately 1975 through 2007, the S&P 500 returns significantly outpaced the trust returns. This resulted from three factors. First, the trustee sold the remaining stocks and bonds and invested almost exclusively in its own proprietary funds, which occurred in 1975 and lasted until 1998, when the trustee determined that investment in its own funds might be contrary to the terms of the Trust. Second, the trustee failed to maintain any consistent balancing of the allocation of the trust assets. Third, there was frequent turnover of personnel handling the account; as it became a "smaller" account, it was passed to a less-experienced officer to manage. And, while the account in theory was subject to an annual review by the Trust Investment Committee, the records before the court did not reflect that such a review took place on any regular basis during the later years.[9] See also *Parris v. Regions Bank*,[10] in which a trustee's summary judgment motion was dismissed where trustee invested 72% of trust assets in trustee's proprietary junk bond fund, failed to disclose to the beneficiary material facts of the fund and failed to diversify trust assets after the fund incurred significant losses.

On the other hand, in *Banks v. Northern Trust Corp.*, [11]the Ninth Circuit held that a corporate trustee that invested in its own funds did not breach its fiduciary duty. In this case, such investments were authorized by the trust agreement, it was permitted under state law, and beneficiaries received adequate notice.[12]

In *Donahue v. Donahue*,[13] the grantor established a family trust and funded the trust with $45 million in assets, which included an interest in an umbrella partnership REIT that constituted about 50% of the trust's assets. Following the death of the grantor, the grantor's brother, who was also the president and CEO of the REIT, was named trustee of the trust. In order to provide adequate income to the grantor's spouse during her lifetime and an appropriate remainder for the grantor's children, the trustee determined that he needed to diversify the trust assets because the REIT alone provided inadequate income. The trustee sold a 40% interest in the REIT, and used the proceeds to pay off the family's mortgage on their residence, to fund trusts for the children and to diversify in assets other than real estate. Three years later, the beneficiaries sued the trustee because the REIT had appreciated significantly in value after the sale, resulting in lost appreciation to the trust of approximately $20 million.

The court held that the trustee's diversification strategy did not violate the prudent investor rule. The beneficiaries argued that the trustee, as an insider, knew that the REIT interest would appreciate in value. Citing the housing crisis of 2008 and the collapse of Lehman Brothers, the court, however, found that the unreliability of long-term projections demonstrated the flawed nature of mere predictions of future performance, regardless of whether from financial advisors or insiders. The court reiterated that when executing the duty to diversify, the trustee is eliminating "risks higher than suitable to a trust's purposes, return requirements, and other circumstances."

In an Illinois case,[14] the trustee breached his duty to diversify by retaining a 100% ownership interest in a family printing and newspaper business. The grantor created a trust to hold his ownership interest in a closely held business. In 1987, the trust appointed the Northern Trust Company as trustee. The trustee discussed at annual reviews the importance of diversifying the trust assets; however, the beneficiaries did not wish to sell the family business for various reasons. In 2000, the trustee assigned a new asset manager to the trust, who again stressed the importance of diversification. The trustee sought to sell a

8 2012 BL 300343 (D. Md. 2012).

9 *See also Wagley v. JP Morgan Chase Bank, N.A.*, No. 18 Civ. 8668, 2020 BL 369314 (S.D.N.Y. Sept. 26, 2020), in which the court partially denied the trustee's motion to dismiss plaintiffs' breach of fiduciary claim where trustee engaged in "self-interested transactions" by investing trust property in proprietary funds directly managed by trustee.

10 2011 U.S. Dist. LEXIS 92167 (W.D. Tenn. 2011).

11 No. 20-55297, 2021 BL 296963 (9th Cir. Aug. 6, 2021).

12 *See also Watkins v. PNC Bank*, 2015 Ky. App. Unpub. LEXIS 76 (2015).

13 *Donahue v. Donahue*, No. G040259, 2010 BL 36677 (Cal. Ct. App. 2010).

14 *Moss v. Northern Trust Company*, No. 7 CH 24749 (Ill. Cir. Ct. 2015).

portion of the family business but, ultimately, determined that it was not in the best interests of the trust because many beneficiaries worked for the family business and a majority of the beneficiaries did not want to sell the business. The trustee did not perform any detailed analysis explaining the risk of not diversifying the trust assets. In 2007, the beneficiaries sued the trustee for failing to diversify the trust assets. The court held that the trustee breached his duty to diversify because the beneficiaries' requests to retain the family business and the trust instrument's instruction authorizing the trustee to retain the family business were not sufficient to exempt the trustee from the duty to diversify altogether. In other words, the beneficiaries argued that the trustee shouldn't have listened to them.

The court, however, refused to hold the trustee liable for damages because the beneficiaries did not prove damages where the trustee's investments generated significantly greater income than the beneficiaries' hypothetical investment model.

In *Mennen v. Wilmington Trust Co.*, C.A. No. 8432-ML (Del. Ch. 2015), the trust at issue held stock in the Mennen Company, which was privately held. Although Wilmington Trust Company was a named defendant, the trust agreement apparently named the individual co-trustee (who was also the brother of the trust beneficiary) as having sole investment responsibility. This may have been appropriate when the sole trust asset was stock in the family-owned business, but when that business was sold to Palmolive, suddenly the trustees had real investment work to do. The court presented the situation as follows:

> It is undisputed that the trust, once valued at over $100 million, was reduced to a value closer to $25 million through a series of debt and equity investments largely focused on two insolvent, unproven, and ultimately unsuccessful private companies with no established record of profitability. There can be no doubt that the investments were astonishing failures. The question is whether, divorced of hind-sight bias regarding the outcome of the challenged transactions, the trustees' investment decisions expose them to liability to the beneficiaries.

The court found that the individual co-trustee used the assets of his brother's trust to further his own "pride:"

> because most of the trustee's personal fortune was out-of-reach in his own trust, the trustee turned to his brother's trust as a piggy bank he readily opened to fund a few private companies in which the trustee had invested his time and on which he had staked a claim that he was uniquely skilled at selecting and advising small fledgling companies that he could turn into the "next big thing." Certain that fortune and acclaim were around the bend, the trustee eschewed the interests of the beneficiaries in favor of subsidizing his self-aggrandized standing as a financier.

The individual co-trustee also failed to provide adequate investment information to his brother, overcharged on expenses and was an unreliable witness. Therefore, the court had little trouble finding him liable, despite the presence of an exculpation clause in the trust. The court held that his actions amounted to bad faith, and therefore the clause did not protect him.

Delegation of Investment Duties

In a Minnesota case,[15] the court held that the trustee properly relied upon the professional advice of a financial advisor in deciding the appropriate investment vehicles for a trust with an income beneficiary with special needs and remainder beneficiaries that were minor children. At the recommendation of the financial advisor and pursuant to a sophisticated investment plan, the trustee invested in three variable deferred annuities. The court found that the trustee, who had no prior experience managing trust assets, reasonably acted when she sought advice from the grantor's financial advisor. Even though the variable deferred annuities depreciated in value between 2007 and 2010, the court emphasized that the trustee obtained sufficient competent advice, guidance and assistance to formulate and implement the investment strategy of the trust.

Duty to Diversify

The Surrogate's Court of New York[16] held that an attorney-executor committed multiple, egregious violations against New York's Prudent Investor Act[17] by grossly mismanaging a decedent's estate, including breaching his duty to diversify. The executor knew that decedent's multimillion-dollar estate consisted of her home, checking and savings accounts, and General Electric (GE) stock that was not only the majority of decedent's investments, but was the majority of decedent's entire estate. The executor failed to liquidate and diversify the estate's $4.6 million investment portfolio, 85% of which consisted of GE stock.

But failure to diversify was just the tip of the malfeasance iceberg. The executor did not maintain fiduciary standards when selling decedent's home. He failed to obtain a formal appraisal for the home, and he imprudently invested estate assets to renovate the property

15 *In re Amendment & Restatement of Revocable Living Trust of Berget*, No. A13-2295, 2014 BL 343076 (Minn. Ct. App. 2014).

16 Matter of Kenney, 64 Misc.3d 1232(A) (N.Y. Sur. Ct. July 19, 2019).

17 N.Y. EPTL §11-2.3.

using a personal long-time contractor rather than selling the home in "as-is" condition. To make matters worse, the executor hired his personal contractor without soliciting other bids or entering into a written contract with a clearly defined scope of work. As a result, the house was sold at a total loss rather than at the lower "as is" value he could have obtained. And of course, the executor paid himself legal fees for years without a court order, contrary to the requirement in the letters testamentary. The Surrogate's Court imposed numerous damages and surcharges due to attorney-executor's breach of his fiduciary duties along with statutory interest, denied him statutory commissions, denied him legal fees, and removed him as executor of the estate. This case is less instructive because the general breach of fiduciary duty was so broad, but it does point out that, during an estate or post-mortem trust administration, an executor or a trustee should decide early on whether assets should be sold to avoid a drop in value. Here, "diversifying" probably really would have meant liquidating and going to cash or safe, short-term investments.

A Rhode Island case[18] supports the proposition that the extent of the duty to diversify depends upon the facts and circumstances of a particular matter. Upon the death of the grantor in 2010, a trust was created for the benefit of the beneficiary; however, the trust was to terminate upon the beneficiary reaching the age of 25, which would occur in 2014. The trustee had the discretion to distribute the trust assets outright to the beneficiary prior to 2014. When the trustee received the beneficiary's share of the grantor's estate in 2010, she placed the trust assets in a cash account. The trustee attempted to make an outright distribution to the beneficiary many times between 2010 and 2013. The beneficiary rarely responded to the trustee's letters sent by certified mail, telephone calls and text messages. When the beneficiary did respond, she refused to sign a general release discharging the trustee of her duties and releasing her of any liability. This resulted in significant delays in, and additional expenses related to, the administration of the grantor's estate. The beneficiary sued the trustee for violating the prudent investor rule by placing the trust assets in a cash account that received less than $50 in interest income in four years.

The Supreme Court of Rhode Island held that the trustee did not violate her duties under the prudent investor rule by placing the trust assets in the cash account because the trustee intended to make an outright distribution to the beneficiary and the beneficiary prevented the trustee from making the distribution for nearly four years. The court found the trustee's decision to place the trust assets in a cash account was reasonable to insulate the assets from the risk of market volatility, especially considering the short time horizon over which the trustee intended to hold the trust assets.

Duty of Impartiality

Income beneficiaries always complain that the trust investments are not throwing off enough income, while remainder beneficiaries always complain that the trust investments are not growing fast enough. In those situations, the best a trustee can hope to do is disappoint both sides equally. In a Pennsylvania decision, *In re Montgomery*,[19] the income beneficiary claimed that the asset allocation of 65% equities and 35% fixed income was not generating sufficient income. The court held that the portfolio balance was appropriate because it was designed to "manage the trusts in a balanced and impartial way" to "meet the needs of the income beneficiary as well as grow the principal relative to inflation and hopefully in excess of inflation for the remainder interest." The court observed that the allocation assured principal growth that benefits not only remainder beneficiaries, but also the income beneficiary, as larger principal generated higher income from dividends; and that allocation of all trust assets to fixed income would result in "dramatic" decrease in principal growth, while "not . . . gaining that much in the way of income." Note that this decision might have gone the other way in a higher interest rate environment; during the period at issue, stock dividends were close to bond yields.

18 In re Bagdis, 2016 BL 90944 (R.I. 2016).

19 No. 3007 EDA 2019, 2020 BL 307795 (Pa. Super. Ct. Aug. 13, 2020) (citing earlier decision *In re Montgomery*, 161 A.3d 392 (Pa. Super. 2017)

Questions, Comments, Suggestions About This Newsletter?

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Events Calendar

Advanced Planning Seminar
Put on by the Estate Planning Section
June 17, 2022

The Editors want to include announcements of upcoming events that are open to the public and may be of interest to our readers. If you know of an event, please send basic information, including point of contact information to Chris Cline at *chriscline@riverviewbank.com* for inclusion in the next issue of the Newsletter.