My How Prudence Has Changed (or not)!

The Prudent Investor Rule for the Contemporary Fiduciary

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Here with you today

Suzanne
Shier

OF COUNSEL
LEVENFELD PEARLSTEIN, LLC

sshier@lplegal.com
(312) 476-7505

My How Prudence Has Changed (or not)!

The Prudent Investor Rule codified in the Uniform Prudent Investor Act and enacted in 46 states is the guide-star of fiduciary investment. It is the “must know it” concept that is the cornerstone of the processes and procedures of risk management for fiduciary investment. While the Prudent Investor Rule itself pre-dates all of us, it has changed as investments and financial institutions have evolved. In this session we will revisit the fundamentals of the Prudent Investor Rule and the Uniform Prudent Investor Act and examine their application in wealth management today.

Agenda

For Our Discussion Today:

- ➢The changing landscape of prudent investment
- ➢Prudence then and prudence now
- ➢Prudence under the Prudent Investor Act
- ➢ESG
- ➢Crypto-assets
- ➢Prudence never rests – recent cases
- ❖"PPP Pointers" – Prudent Process and Procedures Pointers

Prudence

"Prudence is the virtue by which we discern what to do under various circumstances in time and place." John Milton

The Changing Landscape of Investments

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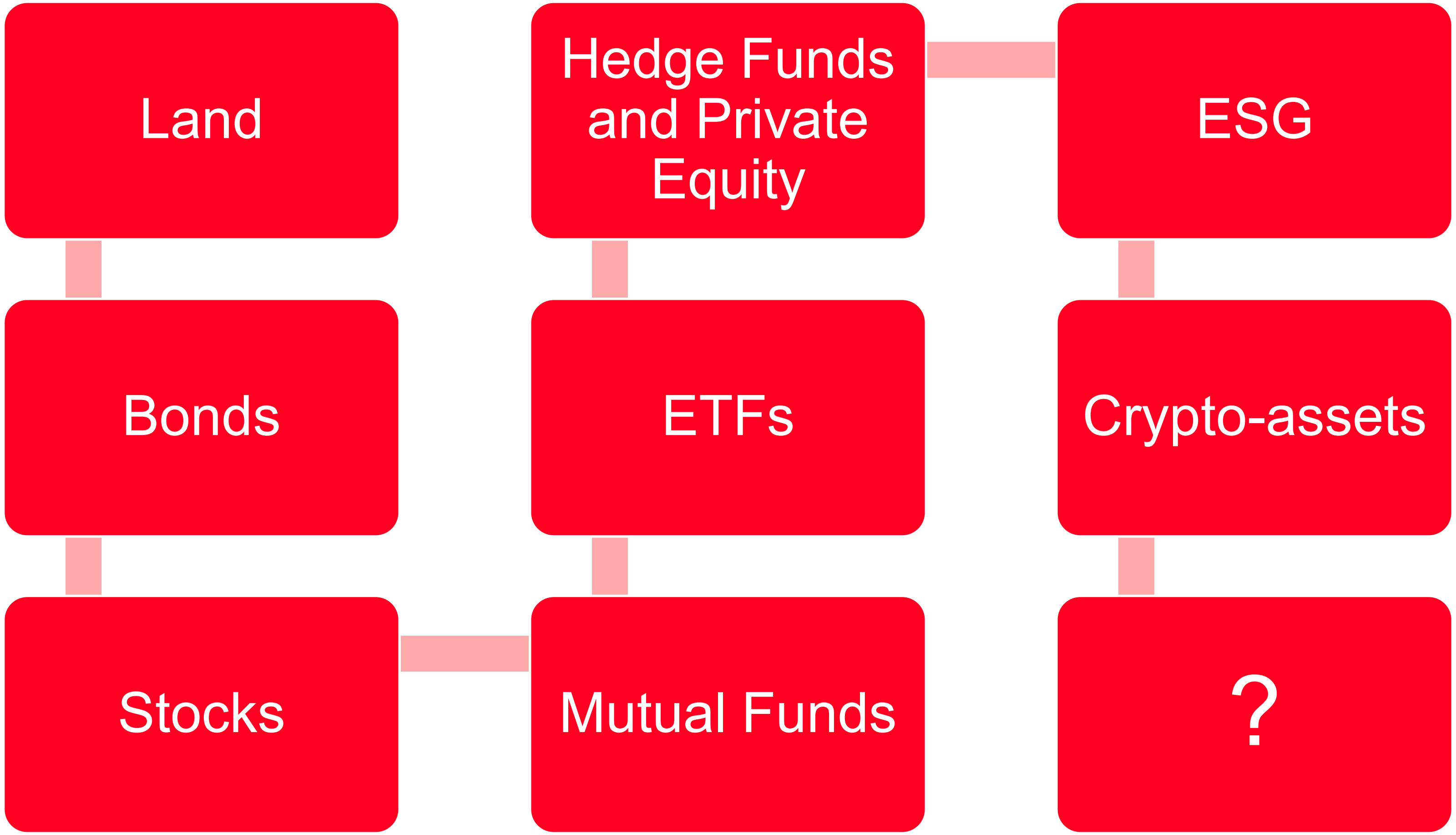

Prudence Then and Now

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Prudence Then

- The prudent *man* investing for themself
- Focus on individual investments in the trust portfolio
- Categoric restrictions on permitted types of investments
- Delegation forbidden
- Diversification an ancillary consideration

Prudence Now

- The prudent *investor* investing for the trust estate
- Focus on total portfolio of trust investments
- No investment is *per se* prohibited; balancing of risk v return
- Delegation permitted, with safeguards
- Diversification integral to prudent investment

Uniform Prudent Investor Act

Uniform Prudent Investor Act

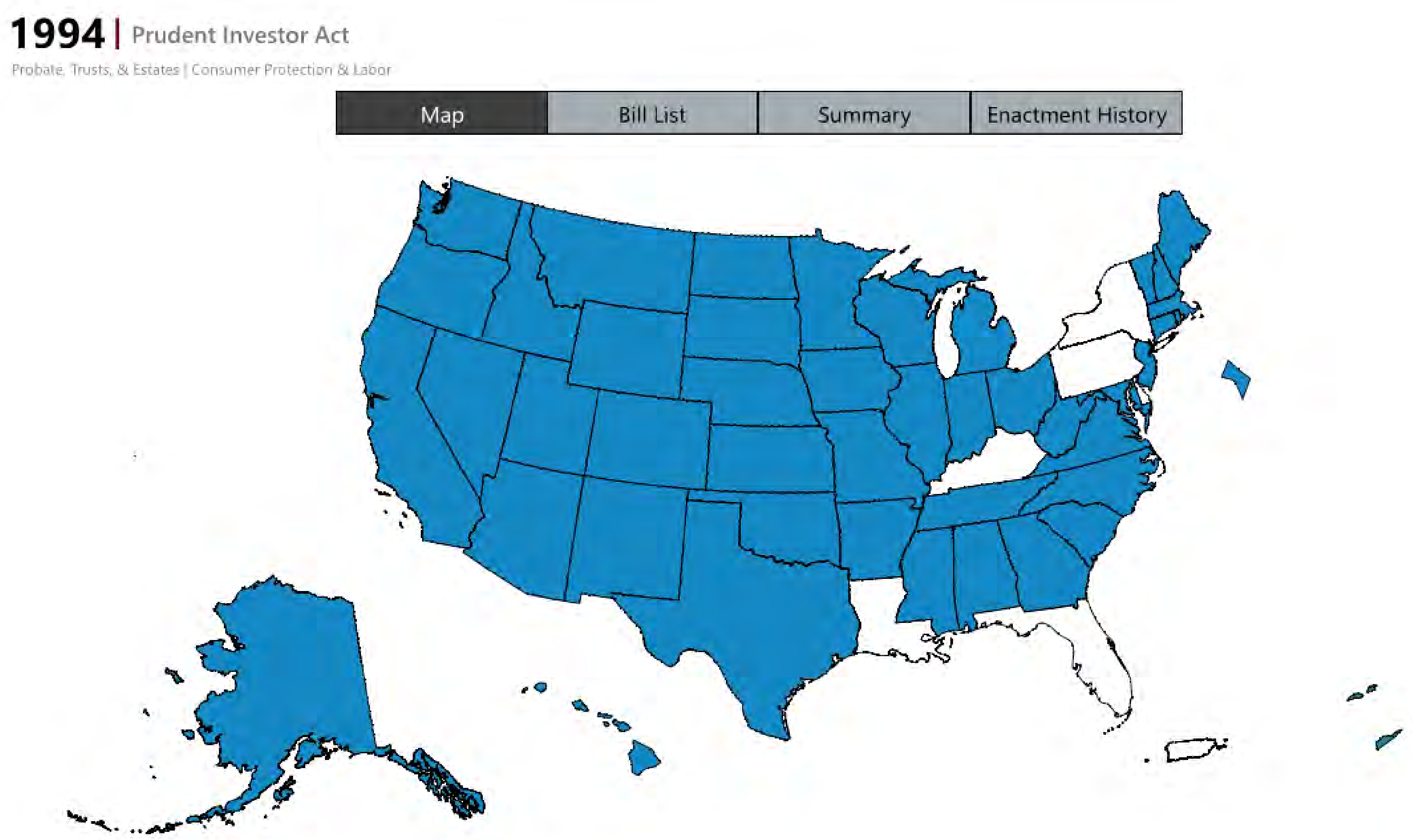
- The Uniform Prudent Investor Act (UPIA) provides rules to govern the actions of trustees with respect to the investment of trust property in the private gratuitous trusts common for wealth transfer.

- The UPIA has been enacted, with modifications, in all but four states since it was promulgated in 1994 – Kentucky, Louisiana, New York, and Pennsylvania.

- Other fiduciaries, such as executors and guardians, are subject to laws which take considerations such as the short duration of their role or safeguards of vulnerable persons into account.

Uniform Prudent Investor Act

[Prudent Investor Act - Uniform Law Commission (uniformlaws.org)]



Uniform Prudent Investor Act

1. The Prudent Investor Rule

Prudent Investor Rule

- Unless the trust agreement provides otherwise, a trustee who invests and manages trust assets owes a duty to the beneficiaries to comply with the prudent investor rule.

- The prudent investor rule is a default rule which may be modified by the provisions of the trust.

- A trustee is not liable to a beneficiary to the extent the trustee acted in reasonable reliance on the provisions of the trust.

- PPP Pointer: Know the terms of the trust with respect to investments.

2. Standard of Care; Portfolio Strategy; Risk and Return Objectives

Standard of Care; Portfolio Strategy; Risk and Return Objectives

- The trustee is required to invest and manage the trust assets as a prudent investor would, by considering the *purpose*, *terms*, *distribution requirements*, and other circumstances of the trust.

- PPP Pointer: The standard is that of an investor investing for a trust, not a person investing for themself.

- PPP Pointer: The duty is to both invest and manage; regularly monitor the suitability of investments.

- PPP Pointer: Purpose matters. A trust whose main purpose is to provide the sole support of an elderly widow will have lower risk and higher income requirements than a trust for a young serial entrepreneur.

Standard of Care; Portfolio Strategy; Risk and Return Objectives

- ➢ A trustee who has special skills or expertise or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.

- ❖ PPP Pointer: The standard for a professional trustee is the standard of prudent professionals, not prudent amateurs (unless specific State law provides otherwise.

- ❖ PPP Pointer: Provide continual training in trust administration and investment for the entire trust team and create an environment of continual communication among team members.

Standard of Care; Portfolio Strategy; Risk and Return Objectives

- A trustee's investment and management decisions respecting individual assets are evaluated in the context of the trust portfolio as a *whole* and as part of the overall investment strategy with risk and return objectives reasonably suited to the trust (rather than in *isolation*).

- PPP Pointer: Regularly review the *entire* trust portfolio in the context of the *current* circumstances of the trust. Consider changes in liquidity needs for distributions, tax payments, etc., the duration of the trust, and beneficiary needs.

Standard of Care; Portfolio Strategy; Risk and Return Objectives

- A trustee is required to make reasonable effort to verify facts relevant to the investment and management of trust assets.

- A trustee may invest in any kind of property or type of investment consistent with the Act.

- PPP Pointer: Evaluation of risk and return with respect to a specific property and whether an investment is appropriate to include in the trust portfolio is determined in terms of the anticipated effect on the particular trust's portfolio.

- PPP Pointer: A loss with respect to a single asset does not mean that the trustee has violated its fiduciary responsibilities. The UPIA takes the truly holistic approach to investment practices.

Standard of Care; Portfolio Strategy; Risk and Return Objectives

➢ Among the circumstances that the trustee is to consider in investing and managing trust assets are such of the following that are relevant to the trust or to the beneficiaries:

- ✓ General economic conditions;
- ✓ The possible effect of inflation or deflation;
- ✓ The expected tax consequences of investment decisions or strategies;
- ✓ The role each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;
- ✓ The expected total return from income and the appreciation of capital;
- ✓ The other resources of the beneficiaries
- ✓ Needs for liquidity, regularity of income, and preservation or appreciation of capital; and
- ✓ An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

Standard of Care; Portfolio Strategy; Risk and Return Objectives

- PPP Pointer: Know the factors include in the version of the Act under the law of the State governing the trust. Illinois for example includes additional environmental, social, and governance considerations in the factors which may be considered.

- PPP Pointer: The list of factors is not exclusive and not all factors are relevant for every trust. Identify those factors that are relevant for the trust at the time.

- PPP Pointer: Tax considerations are present in every trust and are relevant for beneficiaries. Evaluate whether the trust or the beneficiary will bear the burden of taxes and the impact of investments on the tax burden. Basis adjustment to fair market value is a common consideration. Be aware of the unique circumstances of beneficiaries outside the United States.

3. Diversification

Diversification

- ➢ A trustee is required to diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served by not diversifying.

- ➢ There is no *per se* percentage threshold for diversification, but a concentration of 10% is a common level triggering documentation in investment reviews.

- ❖ PPP Pointer: Pooled investments (mutual funds, ETFs, common trust funds) may be especially suitable for diversification for small trusts.

- ❖ PPP Pointer: Diversification is a cornerstone of prudent investment. If relying on the special circumstances, exception to diversification, document the circumstances and regularly review and document the circumstances.

4. Duties at Inception of Trusteeship

Duties and Inception of Trusteeship

- Within a reasonable time after accepting a trusteeship or receiving trust assets, the trust is required to review the trust assets

- The trust is required to implement decisions concerning the retention and disposition of assets to bring the trust portfolio into compliance with the *purposes*, *terms*, *distribution requirements*, and other requirements of the trust and the requirements of the Act.

- PPP Pointer: There is no rule of reasonableness; prompt attention to review and action reduces fiduciary risk.

- PPP Pointer: Identify, document and communicate the purpose, terms and distribution requirements of the trust.

5. Loyalty

Loyalty

- ➢ The trustee is required to invest and manage the trust assets *solely* in the interest of the beneficiaries.
- ➢ The trustee's interests are subordinate to the interests of the beneficiaries.
- ➢ The interests of third parties are subordinate to the interests of the beneficiaries.
- ❖ PPP Pointer: Social investing for causes of importance to a trustee or beneficiary is not in accordance with the duty of loyalty but taking objective environmental, social, and governance considerations into account may be permissible.

6. Impartiality

Impartiality

- If a trust has two or more beneficiaries, the trust is required to act impartially in investing and managing the trust assets, taking into account the differing interests of the beneficiaries.

- <u>PPP Pointer</u>: Identify beneficiaries and their interests (current, simultaneous, and remainder; principal and income) and changes in beneficiaries. Be mindful of the silent beneficiary as well as the vocal beneficiary.

7. Investment Costs

Investment Costs

- In investing and managing trust assets, 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.

- PPP Pointer: Layered costs required special attention and determination of the total cost of investment. Make care full cost comparisons for pooled investment vehicles. Assess costs of alternative investments (private equity and hedge funds).

8. Reviewing Compliance

Reviewing Compliance

- Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee’s decision or action and not by hindsight.

- PPP Pointer: Process and procedure, and contemporaneous documentation matter! A trustee is not an insurer and hindsight is not the measure of prudence. But in the absence of process, procedure, and contemporaneous documentation, the trustee is challenge to establish prudence the under circumstances in time and place.

9. Delegation of Investment and Management Functions

Delegation of Investment Management Functions

- ➢ A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances.

- ➢ The trustee is required to exercise reasonable care, skill, and caution in:
  - ✓ Selecting an agent;
  - ✓ Establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and
  - ✓ Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

Delegation of Investment Management Functions

- In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

- A trustee who complies with the requirements for a prudent delegation is not liable to the beneficiaries to the trust for the decisions or actions of the agent to whom a function was delegated.

- By accepting delegation of a trust function from the trustee of a trust subject to the law of the State an agent submits to the jurisdiction of the courts of the State.

Delegation of Investment Management Functions

- PPP Pointer: Delegation is not synonymous with direction.
- PPP Pointer: Process and procedure matter (again)!
- PPP Pointer: Standardized forms of delegation documentation and careful review of investment management agreements with investment agents are critical. The agent is to submit to the jurisdiction of the courts of the State and this may require modification of choice of law, choice of venue, and arbitration provisions of an investment management agreement.

Environmental, Social, and Governance Investing

Environmental, Social, and Governance

- A slowly growing number of states have incorporated environmental, social and governance facts into their trust investment statutes, including –
  - ✓ Delaware
  - ✓ Georgia
  - ✓ Oregon
  - ✓ New Hampshire
  - ✓ Illinois

Crypto - Assets

Crypto - Assets

- Crypto-assets are the most recent addition to the realm of investment opportunities.

- Evaluation of the prudence of crypto-assets is made under the same risk/return paradigm in light of the purpose, terms, distributions requirements, and other circumstances of a trust.

- OCC Interpretive Letter guidance addresses bank activities and custody, not trust investment.

- Interpretive Letters #1179 authority of a bank to engage in certain cryptocurrency activities, #1174 authority of a bank to engage in stablecoin activities, #1172 authority of a bank to hold dollar deposits serving as reserves for stablecoins, and #1170 authority of a bank to provide cryptocurrency custody services.

Crypto - Assets

- Joint Statement on Crypto-assets Risks to Banking Organizations (January 3, 2023)
- Key risks
  - Fraud
  - Uncertainty related to custody practices, redemptions, and ownership rights
  - Inaccurate or misleading representations and disclosures by crypto-assets companies
  - Significant market volatility
  - Susceptibility of stable coins to run-risks
  - Contagion risk
  - Lack of mature and robust risk management and governance practices
  - Heightened risk generally – lack of governance mechanisms establishing oversight, vulnerability to cyber-attacks

Prudence Never Rests

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- Disputes regarding the prudence of investment management arise in trust, estate, guardianship, and employee benefit scenarios.

- Disputes ostensibly based on investment management often originate from other sources – family acrimony, poor communication with professional trustee.

- Disputes regarding investment management ebb and flow with market performance.

- Recent cases include:

- ✓ <u>Reasonable care, skill, and caution</u>. *Wagley v JP Morgan Chase Bank, N.A., as Trustee of Mary Penney Wagley Irrevocable Trust, 2020 WL 5768688* (U.S.D. Ct. S.D. NY, September 26, 2020)

- ✓ <u>Reasonable care, skill, and caution; diversification</u>. *Matter of Wellington Trusts,165 A.D.3d 809, 86 N.Y.S.3d 497 (October 10, 2018)*

- ✓ <u>Failure to invest cash</u>. *Matter of Gloria T. Mann Revocable Trust*, 468 N.J. Super. 160, 256 A.3d 407 (June 2, 2021)

Prudence Never Rests

- Recent cases include:

✓ <u>Special investment skills</u>. *Bernard v BNY Mellon, N.A.*, 2020 WL 9065879 (U.S.D.C. W.D. Pa., November 30, 2020)

✓ <u>Diversification</u>. *Matter of Trust of Post,* 2018 WL 3862756 (Sup. Ct. N.J. App. Div., August 15, 2018)

✓ <u>Bitter family dispute</u>. *Slezke v. Matherly,* 958 N.W.2d 609 (Ct. App. Iowa, March 17, 2021)

Prudence Never Rests

➢ Recent cases include:

✓ Limited liability company books and records. *Benjamin as Trustee of Ziegler v Island Management, LLC,* 2019 WL 6608754 (Sup. Ct. of Conn., November 5, 2019)

✓ Vexatious suit. *Tatoian v. Tyler,* 2020 WL 6785677 (Sup. Ct. Conn., October 20,2020)

✓ Distribution in cash and in kind. *Cullis v. Cullis as Trustee of Julia A. Culliss Trust*, 62 Kan.App.2d 293 , 514 P.3d 376 (June 17, 2022)

Prudence Never Rests

- ➢ Recent cases include:

- ✓ Self-dealing. *Forbes v Forbes,* 509 P.3d888 2022 WL 1497998 (Sup. Ct. Wy., May 12, 2022)

- ✓ Facts and circumstances at time. *Bryan v Chytil,* 2021 WL 5356205 (Ct. App. Oh., November 10, 2021)

- ✓ Opt-out of prudent investor rule. *Estate of Victor J. Mueller Irrevocable Trust One and Number Two*, 368 Wis.2d 475, 934 N.W.2d 571, 2019 WI App. 48 (July 17, 2019)

Key Take Aways

Key Takeaways

- Prudence is determined objectively; what we determine to do under various circumstances in time and place (just like John Milton said).

- The circumstances of respective trusts differ, and prudent investment takes the unique circumstances of each trust into account; there is no single prudent approach for all trusts for all times.

- Process, procedure, communication, documentation, and training are essential to prudent trust investment and management – yesterday, today, and tomorrow.

Any questions?

Ask anything. All questions are good questions.

Presenter: Suzanne Shier

Suzanne Shier
Of Counsel
Levenfeld Pearlstein, LLC
sshier@lplegal.com
(312) 476-7505

Suzanne Shier is Of Counsel in the firm's Trusts & Estates Group. She is experienced in advising high net worth individuals and families in wealth, tax, business, and philanthropic planning. Her focus is on positioning clients to use their assets to achieve the desired impact, and she advises her clients to use their resources to fulfill the aspirations they have for their families, businesses, and communities. Suzanne's clients include executives, entrepreneurs, professionals, family wealth owners, corporate fiduciaries, and charities with both domestic and international residence and assets. She has decades of experience both in private practice and with a leading global wealth management firm.

Suzanne is a frequent speaker and is regularly quoted in the media, including the Wall Street Journal, the New York Times, Penta, and Barron's. She is the recipient of the Chicago Estate Planning Council Austin Fleming Distinguished Service Award, a fellow of the American College of Trust and Estate Counsel where she is the incoming chair of the International Planning Committee, and an Academician of The International Academy of Estate and Trust Law. Suzanne is an adjunct professor in the Northwestern Pritzker School of Law LLM in Taxation Program, where she mentors law students to use their talents to serve clients and the community.

She is active in the civic community, serving on philanthropic boards, concentrating on access to educational excellence at all levels. Suzanne serves on the Executive Committee of Kids Hope USA, Chicago Scholars Foundation, and Hope College.

Suzanne's greatest joy is her family – her husband, daughters, sons-in-law, and golden retriever. She enjoys spending time outdoors, including hiking, swimming, skiing, and snowshoeing.

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