ACTEC Law Journal

Volume 44 | Number 3 Article 6

6-1-2019

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Recommended Citation

Rizzo, Elisa Shevlin and Lord, Erica E. (2019) "Prudence of Passivity vs. Prudence of Process: Can a Default Approach be Prudent?," *ACTEC Law Journal*: Vol. 44: No. 3, Article 6.
Available at: https://scholarlycommons.law.hofstra.edu/acteclj/vol44/iss3/6

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Prudence of Passivity vs. Prudence of Process: Can a Default Approach be Prudent?

*Elisa Shevlin Rizzo**
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In *The Prudence of Passivity: An Argument for Default Passive Management in Trust Investing*,[1] Bryon W. Harmon and Laura A. Fisher argue that trustees should adopt a default passive investment approach in *most* circumstances to better fulfill the trustee's mandate to balance risk and return objectives reasonably suited to the trust. Their critique of active management presents the notion that use of active investments implicates a trustee's fiduciary duty of loyalty.

While Harmon and Fisher advance a strong case in favor of passive investing, we decline to adopt a default rule. Consistent with the Prudent Investor Rule (the "Rule"), we posit that a fiduciary's duty is to develop a strategy suitable for the unique trust presented, and under this approach, passive, engineered, alternative and select active strategies may all play a role in a prudently constructed, diversified trust portfolio.

I. Prudence of Process

As Harmon and Fisher note, with the development of Modern Portfolio Theory ("MPT"), the law governing trust investments underwent a dramatic shift away from the old "legal list" and "prudent man" rules that emphasized individual security selection and towards an approach which focused on risk management within the context of the total portfolio.[2] The Rule requires a trustee to invest and manage trust assets as a prudent investor would, considering the purposes, terms, distribution re-

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[1] Bryon W. Harmon & Laura A. Fisher, *The Prudence of Passivity: An Argument for Default Passive Management in Trust Investing*, 44 ACTEC L.J. 147 (2019).

[2] *See, e.g.*, Max M. Schanzenbach & Robert H. Sitkoff, *The Prudent Investor Rule and Market Risk: An Empirical Analysis*, 14 J. Empirical Legal Stud. 129 (2017).

quirements and other particular circumstances related to the trust.[3] Critical to this function is the development of "an overall investment strategy that incorporates risk and return objectives reasonably suitable to the trust."[4] Factors to be considered include (i) overall trust objectives, (ii) general economic conditions, (iii) possible effect of inflation or deflation, (iv) expected tax consequences, (v) role each investment plays within the overall portfolio, (vi) expected total return, (vii) liquidity needs, regularity of income and preservation or appreciation of capital and (viii) an asset's special value or relationship to the trust or beneficiaries.[5] In our view, a default, fully passive approach is in tension with the Rule's "strategy" requirement and these enumerated factors. The Rule's emphasis on process over prescription recognizes that a trustee cannot be judged on investment returns in hindsight, particularly in an industry continuously developing new approaches, vehicles, and products.[6]

II. The Premises Underpinning Passivity

We question several of Harmon and Fisher's fundamental premises, namely that (i) active management is the default approach employed by *most* professional trustees, (ii) professional trustees utilize active management for their own business considerations rather than for the benefit of the beneficiaries, (iii) most trustees seemingly begin with a blank slate of investments, and (iv) the only acceptable investment strategies are passive or active.

In an industry constantly introducing new investment products, it is critical to define what *passive investing* actually means. In some cases, Harmon and Fisher seem to allow passive strategies as appropriate if they are index funds tied to a particular benchmark within an asset

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[3] The Prudent Investor Rule is embodied in the Restatement (Third) of Trusts § 227 (Am. Law Inst. 1992), which was superseded by the Restatement (Third) of Trusts § 90 (Am. Law Inst. 2007) (the "Restatement") and the Uniform Prudent Investor Act (Unif. Law Comm'n 1994) [hereinafter UPIA]. The full text of the UPIA and a complete list of states that have adopted it are available at https://www.uniformlaws.org/committees/community-home?CommunityKey=58f87d0a-3617-4635-a2af-9a4d02d119c9 (last visited June 3, 2019). States which have not adopted the UPIA but have adopted their own prudent investor statutes include New York (N.Y. Est. Powers & Trusts Law § 11-2.3 (McKinney 2019)), Florida (Fla. Stat. § 518.11 (2019)); and Delaware (Del. Code Ann. tit. 12, § 3302 (2019)). A complete list of those states is included in the *FDIC Trust Examination Manual, Appendix C- Fiduciary Law* available at https://www.fdic.gov/regulations/examinations/trustmanual/appendix_c/appendix_c.html#_ toc497113667 (last visited June 3, 2019).

[4] Restatement (Third) of Trusts § 90(a); *accord* UPIA § 2(b).

[5] UPIA § 2(b); *accord* Restatement (Third) of Trusts § 90(a). This language has been adopted by many state statutes. *See, e.g.*, 760 Ill. Comp. Stat. 5/5(a)(6) (2019).

[6] Restatement (Third) of Trusts § 90 cmt. (b).

class.[7] In other cases, they acknowledge active strategies may be acceptable because they are akin to passive funds.[8] Under this malleable definition, the scope of passive investing, and thus the appropriateness of the fiduciary's behavior, is elusive. Is a trustee limited to investing in funds that match publicly-traded stocks or bonds tracked on widely-published index? Is a trustee prohibited from investing in a passive strategy designed to mirror a custom benchmark or offer exposure to a particular sector? Is a default passive standard not simply a return to the old legal list approach prescribing *per se* acceptable investments? The Prudent Investor Rule was carefully constructed to remedy the prohibitions, arbitrary limitations, and lack of flexibility resulting from the unworkable Prudent Man Rule.[9]

Even if the term "passive investing" could be better defined, commentators have noted that the wholesale endorsement of passive investment options is based "on the false premise that fiduciary oversight requirements are nearly eliminated" under a passive regime.[10] The proliferation of passive products in the marketplace still leaves trustees to decide among any number of products that may appear passive but might or might not be appropriate. Trustees should not be lulled into passivity without attention to appropriate indices, suitable benchmarks and ongoing monitoring.

III. Realities of Trust Administration

In advocating a default approach of entirely passive investments as *per se* prudent, the authors do not fully consider two factors that often play a critical role in practical trust administration: (i) the nature of the assets delivered to the trustee and (ii) the effect of taxes on overall investment returns. The standard of care embodied in section 2(b) of the Rule provides that "[a] trustee's investment and management decisions

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7 *See*, *e.g.*, Harmon & Fisher, *supra* note 1, at 149 (defining passive management as investing in mutual and exchange-traded funds that track and attempt to match major commercial stock exchanges or widely-published indices of publicly traded stocks or bonds).

8 *See, e.g.*, *id.* at 149 n.4 (acknowledging smart-beta funds as a form of active management but closely resembling passive funds enough to be considered passive for their purposes).

9 Restatement (Third) of Trusts pt. 6, ch. 17, intro. note (Am. Law Inst. 2007).

10 *See, e.g.*, Kevin Knowles, *Passive Management and the False Premise of Fiduciary Relief: Going Passive is an Active Decision*, Russell Invs. (2016), https://russellinvestments.com/us/insights/articles/passive-management-and-the-false-premise-of-fiduciary-relief (last visited June 3, 2019). Knowles notes that passive investments are driven almost completely by the index provider's methodology, so that even selecting among funds in the universe of passive investing requires active decisions by a trustee.

respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole."[11]

Many if not most wealthy families generate their wealth in large part from illiquid, concentrated, or closely-held investments.[12] Families often deliver these assets to a trustee, and increasingly, may direct or encourage the trustee to retain these assets. Often this practical reality can directly conflict with the Rule's emphasis on diversification. Absent express language in the governing instrument or a special relationship between the asset and the trust or trust beneficiaries, a trustee will be faced with the question of diversification.

Particularly when a trust holds a unique asset or concentration, a default passive approach may be difficult to square with the trustee's overall fiduciary duties. A diversification strategy "may be prudent, negligent, or grossly negligent, depending on the investments actually selected, the timing of asset sales or acquisitions, the goals of the trustor, and the factual circumstances surrounding the particular trust implicated by a specific diversification program."[13] Active or engineered investment solutions, such as an active strategy with a tax-harvesting component, may play a meaningful role in helping the trustee to diversify the initial funding assets in a tax-sensitive manner.[14]

A trustee must also navigate market conditions in developing an investment strategy. During periods of increased market volatility, a trustee may wish to hedge against market risk through the use of uncorrelated investments or strategies designed to blunt the effect of volatility. Depending on the other assets held in the trust, "the use of vigorous research and investigation to introduce assets from the less efficient

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[11] UPIA § 2.

[12] John C. Weicher, *The Distribution of Wealth in America, 1983-2013* at 6, HUDSON INST. (Dec. 2016), https://s3.amazonaws.com/media.hudson.org/files/publications/20170111WeicherTheDistributionofWealthinAmerica19832013.pdf.

[13] *In re* Scheidmantel, 868 A.2d 464, 487 (Pa. Super. Ct. 2005). There, a trustee's decision to unilaterally diversify a concentrated stock position was held to constitute gross negligence. The trustee failed to consider (i) loss of income, (ii) diminution in value of trust assets, (iii) additional mutual fund management fees, and (iv) timing of sales and corresponding loss of dividends. The court noted that "[a]n investment decision that might be prudent for one client may be imprudent for another, and could constitute gross negligence of a third client if the circumstances surrounding that trust are dramatically different from those of the other clients." *Id.*

[14] Steve Riley & Richard Furmanski, *Reexamining Tax-loss Harvesting: Better Results Through Enhanced Understanding*, TAX ADVISER: TAX INSIDER, Feb. 16, 2017, https://www.thetaxadviser.com/newsletters/2017/feb/reexamining-tax-loss-harvesting.html (last visited June 3, 2019); *see also* Ari I. Weinberg, *A Magical Tax-Loss Harvesting Machine?*, FORBES, Oct. 16, 2012, https://www.forbes.com/sites/ariweinberg/2012/10/16/a-magical-tax-loss-harvesting-machine/#317f02f747a5.

markets into the trust portfolio can be expected to contribute to its overall diversification and return objectives."[15]

With these practical realities in mind, the Rule provides that "[p]rudent investment principles also allow the use of more active management strategies by trustees."[16]

IV. Fees and Expenses

Harmon and Fisher rightly note that a trustee must consider the relative weight of expenses against associated return when embarking on any investment strategy. While the UPIA does not go so far as to require a trustee to *minimize* all costs, 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."[17] The Restatement encourages trustees to make "careful cost comparisons" among similar investment products, and also notes that "[c]oncerns over compensation and other charges are not an obstacle to a reasonable course of action using mutual funds and other pooling arrangements, but they do require special attention by a trustee."[18] A trustee's decision to proceed with a program of extra costs and risks involves judgements by the trustee that the following criteria are satisfied:

> (a) Gains from the course of action will offset the additional costs and risks;
> (b) The proposed course of action is reasonable, both economically and in terms of its role within the portfolio; and
> (c) The trustee or manager has the necessary skills or access to the competence necessary to carry out the program.[19]

Overall, the Rule emphasizes a trustee must consider the benefits of an active strategy in overall diversification, the costs and risks involved, the basis for selecting an active manager, and "suitability" of the strategy to the particular trust.[20] We interpret these comments to mean that trustees must be mindful of increased expenses, but should consider incremental costs as one of several factors in the context of the trust's overall strategy and cost.[21] Constraining trustees to select passive invest-

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15 Restatement (Third) of Trusts § 90, cmt. h(2) (Am. Law Inst. 2007).

16 *Id.*

17 UPIA § 7. The comments go further: "Wasting beneficiaries' money is imprudent. In devising and implementing strategies for the investment and management of trust assets, trustees are obliged to minimize costs."

18 Restatement (Third) of Trusts § 90, cmt. h(2).

19 *Id.*

20 *Id.*

21 As investors have flocked to low-cost, passive funds over the last decade, fees for both actively and passively managed equity and bond funds have declined substantially.

ments solely with an eye toward cost minimization is inconsistent with the Rule.

V. Conclusion

It is our view that fiduciary investment management cannot be isolated from the particulars of a given trust (*i.e.*, the bespoke governing instrument, applicable governing law, res, and beneficiaries), and we caution against the wholesale elimination of any investment category or style. Endorsing "passive investing" absolutely as a default approach in the fiduciary context raises additional questions, including whether a wholly passive strategy can fulfill a trustee's duty to diversify in every case, whether the term "passive investing" can have a standard or static meaning, and whether adopting any default approach truly aligns with the Rule's emphasis on developing a strategy appropriate for the trust presented. We endorse a more flexible approach.

See Timothy Strauts, *5 Charts on U.S. Fund Flows that Show the Shift to Passive Investing*, Morningstar Blog (Mar. 12, 2018), https://www.morningstar.com/blog/2018/03/12/fund-flows-charts.html.