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RETHINKING TRUST LAW REFORM: HOW PRUDENT IS MODERN PRUDENT INVESTOR DOCTRINE?

Stewart E. Sterk†

During the 1990s, modern portfolio theory provided the theoretical foundation for significant reforms in trust investment doctrine—reforms that freed trustees from a legal regime in which they faced potential liability for making "speculative" investments. The reforms enabled trustees to pursue investment policies that protected beneficiaries against inflation risk. But the reforms worked too well; they encouraged trustees to invest a higher percentage of trust assets in equities just in time for a decade that has seen two precipitous stock market declines.

Although no sensible investment strategy would have avoided losses during these periods of market turmoil, the doctrinal reforms endorsed in the Restatement (Third) of Trusts and the Uniform Prudent Investor Act made matters worse. By structuring trust investment doctrine as a regime of vague standards, both the Restatement (Third) of Trusts and the Uniform Prudent Investor Act provided trust beneficiaries with little protection against agency costs that would lead trustees to invest too heavily in equities. The current regime would be problematic even if its economic underpinnings—modern portfolio theory and, in particular, the efficient capital markets hypothesis—accurately described economic reality. But market behavior over the last ten years, combined with recent theoretical work, weaken the economic underpinnings of the current regime and make the current regime's bias toward equity investments even more questionable. A legal regime that replaces the current standard-based system with one that provides trustees with "safe harbors" for making investment decisions can give trustees more guidance and simultaneously provide beneficiaries better protection against excess market risk.

INTRODUCTION .................................................... 852

I. THE REFORM MOVEMENT .................................. 856
   A. Background Law .................................... 856
   B. Modern Portfolio Theory Arrives ................. 858
      1. Risk, Return, and Diversification .............. 858
      2. Efficient Capital Markets ....................... 859
   C. Trust Law Reform Incorporates Modern Portfolio Theory ........................................ 861

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INTRODUCTION

The recent banking crisis has shaken public confidence in investment strategies that many experts, including academics, have championed for years. The crisis has spawned calls for new regulation of
both the banking industry and the securities industry more generally. But if the crisis has cast doubt on the wisdom of commonly accepted investment strategies, that doubt also requires a reevaluation of the choices faced by another class of professional investor—the trustee—and of the legal doctrine that regulates trustee behavior.

Modern portfolio theory, which (perhaps unfairly) has shouldered some of the blame for the broader financial difficulties of the last two years, has revolutionized trust investing and trust law doctrine over the past quarter century. "Prudence" always has been the touchstone for trustee investment behavior, but modern portfolio theory generated a sea change in the legal system's conception of prudent investing. Before the advent of modern portfolio theory, prudent investing meant conservative investing. For a time, some states went as far as limiting trust investments to a "legal list" that excluded all investment in common stocks. Even as states abandoned the legal-list approach in favor of a "prudent man" or "prudent person" standard for investments, trustees were not to make "speculative" investments. Furthermore, agency costs plagued this traditional regime. Even if the trustee diversified risk, the trustee bore losses associated with any individual speculative investment while trust beneficiaries realized any gains from speculative investment.

Over the last two decades, the *Restatement (Third) of Trusts* (*Restatement (Third)*), the Uniform Prudent Investor Act (*UPIA*), and the Uniform Trust Code—all influenced by modern portfolio theory—reformulated the traditional approach to trust investing by jettisoning

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2. Compare *Restatement (Third) of Trusts* § 90 (2007) (entitled "General Standard of Prudent Investment" and requiring investment and management of trust funds "as a prudent investor would"), with *Restatement (Second) of Trusts* § 227 (1959) (requiring the trustee to make "only such investments as a prudent man would make of his own property"). When the American Law Institute set out to prepare the *Restatement (Third) of Trusts*, the drafters started with the prudent investor rule and, in 1992, first promulgated what is currently section 90 as section 227 (thereby maintaining the section numberings of the *Restatement (Second) of Trusts*). See generally Edward C. Halbach, Jr., *Uniform Acts, Restatements, and Trends in American Trust Law at Century's End*, 88 CAL. L. REV. 1877, 1918 n.183 (2000) (explaining that the prudent investor rule still retained the numbering of the *Restatement (Second) of Trusts* but would be renumbered in its final version). As preparation of the *Restatement (Third) of Trusts* progressed, the drafters renumbered former section 227 as section 90.

3. See Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule 12* (1986) (discussing how some state legislatures adopted such an approach and specified permissible investments). The leading case that took a "legal list" approach, leaving corporate securities off the list, was *King v. Talbot*, 40 N.Y. 76, 86–90 (1869).

4. See generally Longstreth, supra note 3, at 5–6 (discussing judicial antipathy to "speculative" investments).

its ban on speculative investing. Modern portfolio theory's central tenet is that the prudent investor should seek to diversify risk, not to avoid risk altogether. Modern trust law—the Restatement (Third), the UPIA, and the Uniform Trust Code—has implemented modern portfolio theory in a number of ways. First, it has eliminated trust law's prohibition on speculative investments. Second, it has imposed on trustees a duty to diversify. Third, to ensure that persons with an understanding of portfolio theory make investment decisions, modern trust law has abrogated the traditional prohibition on delegating investment responsibilities and has instead sought to encourage such delegation.

Professors Max Schanzenbach and Robert Sitkoff have demonstrated that these changes in trust law generated a significant shift in trust investment practices. Equities now represent a larger share of trust portfolios, just as modern portfolio theory suggests they should. In fact, the Restatement (Third) and the UPIA have been too effective in eliminating the bias in favor of conservative investments. In the new regime, trustees can compete for trust business by marketing their past investment successes while downplaying any investment losses, thus creating incentives for trustees to make riskier investments even when those investments may not serve the interests of beneficiaries. Moreover, the investment community's widespread belief that equities

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6 See Restatement (Third) of Trusts § 90 cmt. e (maintaining that, despite its requirement of caution, speculative investments may play a role in an investment strategy that complies with the caution requirement).

7 See Longstreth, supra note 3, at 12 (analyzing the positive effect of diversification).

8 See Unif. Prudent Investor Act § 2 cmt. (1994) (Abrogating Categoric Restrictions) ("Subsection 2(e) clarifies that no particular kind of property or type of investment is inherently imprudent."); Restatement (Third) of Trusts § 90 cmt. e(1) (stating that speculative investments "are not prohibited" and that "the prudent investor rule, despite its requirement of caution, does not classify specific investments or courses of action as prudent or imprudent").

9 Both the UPIA and the Restatement (Third) decline to impose a blanket rule requiring diversification in all instances. Thus, the Restatement (Third) provides that "the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so." Restatement (Third) of Trusts § 90(b). In a comment, the Restatement (Third) notes that departures from a diversified portfolio "may be justified by special circumstances or opportunities of a particular trust or by peculiar risks facing its beneficiary families." Id. § 90 cmt. f; see also Unif. Prudent Investor Act § 3 cmt. (identifying tax considerations as among the special circumstances justifying a failure to diversify).

10 See Unif. Prudent Investor Act § 9; Restatement (Third) of Trusts § 80(1).

11 Max M. Schanzenbach & Robert H. Sitkoff, Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Allocation?, 50 J.L. & Econ. 681, 682 (2007) (concluding in their study that, after a state adopted the prudent investor rule, stock holdings by trusts increased by 3–10 percent); see also Martin D. Begleiter, Does the Prudent Investor Need the Uniform Prudent Investor Act—An Empirical Study of Trust Investment Practices, 51 Me. L. Rev. 27, 73–75 (1999) (concluding, based on a survey of Iowa trust departments, that after the adoption of an Iowa statute attempting to liberalize traditional doctrine, more trust departments adopted the modern theory).
always outperform fixed-income investments undoubtedly exacerbated the shift to equities.\textsuperscript{12}

This shift to equity investments did not generate tangible benefits for trust beneficiaries. The 2008–9 stock market decline was dramatic. But even over a longer time horizon of ten years, equity investments have performed poorly: both the Dow Jones Industrial Average and the Standard & Poor's 500 Index (S&P 500) stood at lower levels in June 2009 than they did ten years earlier.\textsuperscript{13} In other words, trust law's implementation of modern portfolio theory appears to have left many trust beneficiaries worse off than if trust law had retained traditional principles of trust investing. This fact suggests that it is time to reassess the recent "revolution" in trust law doctrine.

Other articles ably describe both the premises that led to trust law reform and the reforms themselves,\textsuperscript{14} so this Article starts with only a brief account of modern portfolio theory and its connection to trust law reform. Part II then considers the implications of recent events for modern portfolio theory and concludes that some of the tenets of modern portfolio theory emerge unscathed from that assessment but that other tenets do not. In particular, decline in the value of a broad spectrum of investments does not cast doubt on the wisdom of diversification; recent market experience, however, does suggest rethinking the principle that every investment, in the right context, is a prudent investment. Part III then turns to trust law's implementation of modern portfolio theory and suggests that here the picture is even more troublesome. First, although the drafters of the Restatement (Third) and the UPIA accurately warned that diversification could not eliminate market risk, they inadequately accounted for the agency costs inherent in the trust relationship. As a result, modern trust law implemented no legal rules to provide trustees with appropriate incentives to consider market risks. Second, by abrogating the duty not to delegate, modern trust law has reduced the incentive for trustees to make careful investment decisions, and this reduced incentive undoubtedly has resulted in uncompensated losses for trust beneficiaries.

When promulgated, the Restatement (Third) and the UPIA were based on the best available empirical data and academic thought. Per-

\textsuperscript{12} See infra Part II.A.


haps coincidentally, the changes to trust law, in the aggregate, effectively reduced the liability of banks—institutions with significant political power—and other trustees for breaches of the duty of care with respect to trust investments. But with doctrinal changes, as with investment decisions, hindsight often is better than foresight. And the time now has come for changes in trust law doctrine that would better align the interests of trustees with those of trust beneficiaries, changes that would also hold trustees more accountable for imprudent decisions.

I

THE REFORM MOVEMENT

A. Background Law

During the nineteenth and early twentieth centuries, states embraced two different approaches to trust investment. Some states followed the rule of King v. Talbot, which prohibited trustees from investing in common stock or any enterprise where the trust property “is necessarily exposed to the hazard of loss or gain, according to the success or failure of the enterprise in which it is embarked.” These states developed, either by statute or case law, a “legal list” of permissible trust investments—usually real estate mortgages, government bonds, and, at times, corporate bonds—in which trustees could invest; any other investment constituted a breach of fiduciary duty. Courts that adopted the legal-list approach rejected the obvious argument that men of prudence often invest their own funds in common stock, noting that “[i]n their private affairs, [trustees] do, and they lawfully may, put their principal funds at hazard; in the affairs of a trust they may not. The very nature of their relation to [the trust] forbids it.”

Other states followed the rule of Harvard College v. Amory, which rejected the legal-list approach in favor of the principle that a trustee must “observe how men of prudence . . . manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.” This “prudent man” rule,

15 See Longstreth, supra note 3, at 11–12 (discussing states’ legal-list and prudent man approaches to trust investment).
16 40 N.Y. 76 (1869).
17 Id. at 88.
18 See Longstreth, supra note 3, at 12 (discussing states’ legislative responses to the varying standards).
19 Talbot, 40 N.Y. at 89. As the court noted, the English rule was even more stringent, permitting investment only in government debt or real estate mortgages. See id. at 83.
20 26 Mass. (9 Pick.) 446 (1830).
21 Id. at 461.
although considerably more permissive than the legal-list approach, nevertheless excluded investment in “speculative” enterprises.\textsuperscript{22}

Both of these traditional approaches mandated conservative investment strategies for trustees—strategies that worked better than heavy investment in equities during the Great Depression.\textsuperscript{23} But these approaches generated considerable dissatisfaction during the post–World War II era because equities typically generated higher returns than more traditional trust investments.\textsuperscript{24} That dissatisfaction intensified during the 1960s and 1970s when it became painfully apparent to many trust beneficiaries that conservative, “safe” investments bore a significant risk of their own—the risk that high inflation rates would erode the real value of trust principal.\textsuperscript{25} Equities, by contrast, provided an inflation hedge not available with real estate mortgages or government or corporate bonds.\textsuperscript{26} Yet, trustees who bore the risk of liability for investing in “speculative” equities stood to gain little by departing from traditional strategies.\textsuperscript{27}

\textsuperscript{22} Thus, the Restatement (Second) of Trusts appeared to treat as a speculative investment any investment in stock, unless such investment was in a company “with regular earnings and paying regular dividends which may reasonably be expected to continue.” See Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U. L. Rev. 52, 52–53, 61 (1987) (quoting Restatement (Second) of Trusts § 227 cmt. m (1959)) (categorizing the prudent man rule as imposing “an unfortunate constraint” on trustees that discourages trustees from making favorable investments).

\textsuperscript{23} See Mayo Adams Shattuck, The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century, 12 Ohio St. L.J. 491, 496 (1951) (observing that at the start of the Great Depression, the “deflationary decline” mainly affected the value of equities, whereas the value of bonds “tended to hold, even to improve”). Shattuck, however, notes that even such conservative investments were not invulnerable, as eventually “there arrived a period of depression so deep that the values of negotiable covenants of all sorts, secured and unsecured, were themselves grievously affected.” Id.

\textsuperscript{24} Cf id. at 507 (predicting that, because of inflation, trusts would “find dominant investment in equity participations, as contrasted with mortgages, bonds[,] and notes of hand,” in the latter half of the twentieth century).


\textsuperscript{26} Benjamin Graham, one of the leading investment thinkers of his time or of any time, wrote in 1973 that the recent inflation had led many financial authorities to conclude “that (1) bonds are an inherently undesirable form of investment, and (2) consequently, common stocks are by their very nature more desirable investments than bonds.” Benjamin Graham, The Intelligent Investor 47 (rev. ed. 2003). Graham himself rejected that conclusion, arguing that an investor could not afford to put all of his funds into either the bond basket or the stock basket. See id. at 48, 55–56.

\textsuperscript{27} See Dobris, supra note 25, at 445 (claiming that a sure way to establish trustee liability was for the beneficiaries to sue the trustee for speculation).
B. Modern Portfolio Theory Arrives

1. Risk, Return, and Diversification

At roughly the same time that inflation risk was eroding the real value of traditional trust investments, academic theory began to challenge the notion that prudent investing required avoiding all risky investments. Modern portfolio theory owes its genesis to a 1952 article by Harry Markowitz, Portfolio Selection—an article whose insights ultimately won Markowitz the Nobel Prize in Economics. Markowitz sought to explain the “observed and sensible” fact that many investors held diversified portfolios.

Markowitz started with the assumption that most investors have two basic objectives: they seek high returns and want those returns to be “dependable, stable, [and] not subject to uncertainty.” Due to investor preference for certainty, high-risk investments must offer higher expected returns than lower-risk investments. Modern portfolio theory, however, differentiates among risks. Some risks are firm specific or industry specific. A prudent investor need not avoid these risks; instead, the prudent investor can minimize these risks by diversifying among firms and industries.

An important implication of Markowitz’s work is that if a prudent investor believes that an individual investment has a sufficiently high expected return, the investor should include that investment in his or her portfolio regardless of risk. The investor should not avoid risk altogether but should reduce risk by investing in other high-expected-return securities with noncorrelated risks.

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28 See generally Harry Markowitz, Portfolio Selection, 7 J. Fin. 77 (1952) (introducing the modern portfolio theory as an alternative investment strategy).
29 Id.
30 Id. at 77.
32 Cf. Langbein, supra note 14, at 647 (“Investors demand to be paid to bear the greater risk.”).
33 These risks are also called unique, unsystematic, residual, or diversifiable risks. See RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 132 & n.12 (3d ed. 1988).
34 See id. at 131–33. Markowitz starts with the assumption that most investors would want to minimize variance of returns for a given level of expected return and to maximize expected return for a given level of variance. See Markowitz, supra note 28, at 82. Based on these assumptions, he concludes that, over a large range of probability beliefs, efficient portfolios generally will be diversified portfolios. See id. at 89 (concluding that the “E-V rule” leads to efficient portfolios, almost all of which are diversified).
35 See, e.g., Begleiter, supra note 11, at 35 (discussing reducing risk through investing in noncorrelated assets, as “no asset is inherently good or bad” or overly speculative and because even “an asset which is highly volatile and speculative in itself may actually reduce the risk of the total portfolio”).
At the same time, modern portfolio theory recognizes that not all risks are diversifiable. As Markowitz himself emphasized, the performances of individual investments often correlate with each other.\textsuperscript{36} Other scholars attach the labels "market risk" or "systematic risk" to risks that investors cannot diversify away.\textsuperscript{37} Modern portfolio theory teaches that in determining the content of an investor's portfolio the investor must assess the level of market risk he or she is willing or able to bear.\textsuperscript{38} The investor then should hold a mixture with two components—(1) a diversified portfolio of high-risk, high-expected-return investments and (2) a risk-free investment—proportioned in accordance with the investor's risk tolerance.\textsuperscript{39}

2. Efficient Capital Markets

In his influential article, Markowitz did not assert how one might determine the expected return of particular investments; indeed, he expressly reserved judgment on that issue.\textsuperscript{40} He emphasized only that if one could identify investments with a high expected return, diversification would reduce the systematic risk associated with those investments.\textsuperscript{41}

\textsuperscript{36} Markowitz wrote that in trying to make variance small it is not enough to invest in many securities. It is necessary to avoid investing in securities with high covariances among themselves. We should diversify across industries because firms in different industries, especially industries with different economic characteristics, have lower covariances than firms within an industry. Markowitz, supra note 28, at 89; cf. John H. Langbein & Richard A. Posner, Market Funds and Trust-Investment Law, 1976 Am. B. Found. Res. J. 1, 9 (observing that "the risks of most stocks are positively correlated").

\textsuperscript{37} See, e.g., Brealey & Myers, supra note 33, at 132 n.13, 156 ("Market risk is the average covariance of all securities. This is the bedrock risk remaining after diversification has done its work.").

\textsuperscript{38} See Markowitz, supra note 31, at 6–7 ("The proper choice among efficient portfolios depends on the willingness and ability of the investor to assume risk. If safety is of extreme importance, 'likely return' must be sacrificed to decrease uncertainty. If a greater degree of uncertainty can be borne, a greater level of likely return can be obtained.").

\textsuperscript{39} See Brealey & Myers, supra note 33, at 159 ("If investors can borrow and lend at the risk-free rate of interest, then they should always hold a mixture of the risk-free investment and one particular common stock portfolio."); see also Langbein & Posner, supra note 36, at 12 ("[T]he best method of achieving the desired risk/return combination is to adjust the proportions in which either relatively risk-free assets are included in the portfolio, or borrowed money is used to increase the portfolio's holdings.").

\textsuperscript{40} See Markowitz, supra note 28, at 91 (stating that, to use his principle for selection of securities, one must start with procedures for formulating beliefs about expected return and variance). Indeed, in his closing paragraph, Markowitz wrote:

In this paper we have considered the second stage in the process of selecting a portfolio. This stage starts with the relevant beliefs about the securities involved and ends with the selection of a portfolio. We have not considered the first stage: the formation of the relevant beliefs on the basis of observation.

\textit{Id.}

\textsuperscript{41} See id. at 89 (discussing the right way to diversify an investment portfolio).
By the 1960s, however, economists developed the efficient capital markets hypothesis (ECMH), which elaborated on the expected return of particular investments. In an efficient market, "prices provide accurate signals for resource allocation."\(^{42}\) If capital markets were efficient, prices of securities would reflect accurately the expected risk and return of those securities.\(^{43}\) But capital markets cannot be efficient if securities prices do not incorporate the best available information about those securities. If prices do not incorporate all available information, investors with less information will channel capital to firms that are not likely to make optimal use of that capital.\(^{44}\) More importantly, from an investment perspective, savvy investors would find opportunities to invest in underpriced securities and thus would generate higher returns than the market as a whole.

Economists conducted empirical studies of capital markets against this accepted theoretical background and concluded that securities prices quickly and fully reflected available information about those securities.\(^{45}\) This conclusion, which became known as the ECMH, has significant implications for investment theory. First, if the ECMH is correct, no individual investor or firm can develop an investment strategy that consistently beats the market because the market price already reflects the information on which the investor acts.\(^ {46}\) Second, if the ECMH is correct, no investment is a bad investment


\(^{43}\) See id. at 384–88.


\(^{45}\) See Fama, supra note 42, at 414–16 (discussing prior empirical work and concluding that "the evidence in support of the efficient markets model is extensive, and (somewhat uniquely in economics) contradictory evidence is sparse").

\(^{46}\) This statement reflects what Fama labels the "strong form" of the ECMH. Fama distinguishes among three forms of the ECMH: the weak form, the semistrong form, and the strong form. Id. at 388. The weak form holds that market prices fully reflect past price or return history. The semistrong form holds that market prices quickly reflect all publicly available information. The strong form holds that market prices reflect all information, even information to which some persons have "monopolistic access." Id. In evaluating the empirical data, Fama concludes that weak-form tests of the ECMH are "the most voluminous, and . . . the results are strongly in support [of those tests]," Id. at 414. He then reviews the semistrong-form tests and concludes that they "have also supported the efficient markets hypothesis." Id. at 415. With respect to the strong-form tests, he cites some contradictory evidence with respect to insiders and specialists on the New York Stock Exchange, see id. at 409–10, but concludes that "[f]or the purposes of most investors the efficient markets model seems a good first (and second) approximation to reality." Id. at 416. For a discussion of the mechanics of information flow that supposedly make the ECMH work, see Gilson & Kraakman, supra note 44, at 565–92.
because the investment's price already factors in the investment's risk.  

C. Trust Law Reform Incorporates Modern Portfolio Theory

Widespread acceptance of modern portfolio theory led to an inevitable question: how can trust law induce trustees to engage in investment behavior recommended by modern portfolio theory? Existing doctrine certainly provided the wrong incentives. The legalist approach precluded all investment in equities, effectively preventing trustees from investing in high-expected-return investments. Even the prudent man rule, with its ban on speculation, discouraged trustees from taking advantage of the insights of modern portfolio theory. Under the prudent man rule, a trustee who invested in a diversified portfolio including high-risk, high-return investments faced liability for breach of fiduciary duty. The prudent man rule required the trustee to evaluate prudence one investment at a time.

Academics embraced the lessons of modern portfolio theory and sought to integrate those decisions into trust law. Practicing lawyers, banks, and trust companies, all eager to generate higher returns for their trust clients, supported the changes. Trust law reformers used

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47 See Langbein, supra note 14, at 649 ("[Modern portfolio theory] teaches that the risk intrinsic to any marketable security is presumptively already discounted into the current price of the security.").

48 See supra Part I.A.

49 See id. Because trust settlors can expand the trustee's investment authority with appropriate language in the trust instrument, the common-law rule did not have as significant an impact as it otherwise could have had. See Langbein & Posner, supra note 36, at 5.

50 See RESTATEMENT (SECOND) OF TRUSTS § 227 (1959). The trustee also faced liability if the trustee invested in stocks whose expected return came in the form of increased stock price rather than dividends paid to investors. The income beneficiaries could then bring an action against the trustee because the trust investment benefitted remaindermen at the expense of the income beneficiaries. Section 104 of the Uniform Principal and Income Act has addressed this problem by permitting the trustee to "adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor." UNIF. PRINCIPAL & INCOME ACT § 104(a) (1994) (amended 2000). In light of the Uniform Principal and Income Act, a trustee making investment decisions need not concern itself with the effect of those decisions on trust beneficiaries who have potentially divergent interests. See Sitkoff, supra note 5, at 652–54.

51 See, e.g., In re Bank of New York, 323 N.E.2d 700, 703 (N.Y. 1974) ("The fact that this portfolio showed substantial overall increase in total value during the accounting period does not insulate the trustee from responsibility for imprudence with respect to individual investments for which it would otherwise be surcharged.").

52 The pioneering article was that of Langbein & Posner, supra note 36. See generally Gordon, supra note 22, at 56 (examining "doctrines of traditional trust law in light of modern portfolio theory").

53 Bevis Longstreth was a significant catalyst for doctrinal change. Longstreth, a partner at Debevoise & Plimpton, LLP, surveyed two hundred fiduciaries, including fifty bank trust departments, on their understanding of the constraints imposed by trust law doctrine. See LONGSTRETH, supra note 3, at 232. The survey revealed that many fiduciaries believed that existing doctrine sometimes constrained their investment options. See id. at 247. For a
two principal vehicles to remake trust investment law: the UPIA and the Restatement (Third). Subsequently, the Uniform Trust Code incorporated the provisions of the UPIA.54

When the American Law Institute (ALI) began the process of preparing the Restatement (Third), it started with the prudent investor rule, thus reflecting the relative importance of that topic to trust lawyers.55 The ALI approved and published a volume of the Restatement (Third) on the prudent investor rule in 1992,56 more than ten years before it published any other volume of the Restatement (Third). Two years later, the National Conference of Commissioners on Uniform State Laws (NCCUSL) adopted the UPIA, which explicitly acknowledged the influence of that draft Restatement.57

Modern portfolio theory was at the heart of both reform efforts. The introductory note to the proposed draft of the Restatement (Third) on the prudent investor rule catalogued criticisms of the prudent man rule and observed that "[m]uch but not all of this criticism is found in writings that have collectively and loosely come to be called modern portfolio theory."58 NCCUSL was even more explicit in recognizing the influence of modern portfolio theory:

The [UPIA] undertakes to update trust investment law in recognition of the alterations that have occurred in investment practice. These changes have occurred under the influence of a large and broadly accepted body of empirical and theoretical knowledge about the behavior of capital markets, often described as "modern portfolio theory."59

Thus, the American legal establishment's two leading agents of law reform—the ALI and NCCUSL—acted to transform trust law to conform to modern portfolio theory.

54 See Unif. Trust Code art. 8 general cmt. (1994) (amended 2005) ("States enacting the Uniform Trust Code are encouraged to recodify their version of the Prudent Investor Act by reenacting it as Article 9 of this Code rather than leaving it elsewhere in their statutes.").

55 For a discussion of trust investment law and recommended changes to the regime, see generally Restatement (Third) of Trusts: Prudent Investor Rule (Proposed Final Draft 1990).


The transformation involved three significant changes to existing trust law. First, both the Restatement (Third) and the UPIA abrogated categoric restrictions on trust investments; trustees would no longer bear liability for investing in "risky" or "speculative" investments. Second, both the Restatement (Third) and the UPIA imposed on trustees an affirmative obligation to diversify trust investments. Third, because modern portfolio theory requires a financial sophistication that many trustees—especially family member trustees—do not possess, both the Restatement (Third) and the UPIA reversed the traditional rule that prohibited trustees from delegating investment functions.

In abrogating categoric restrictions on trust investment, the Restatement (Third) and the UPIA go far beyond authorizing investments in common stock. Both documents make it clear that even the most risky investment often has a place in a trust portfolio. The Resta-
ment (Third) provides that "[t]he riskiness of a specific property, and thus the propriety of its inclusion in the trust estate, is not judged in the abstract but in terms of its anticipated effect on the particular trust's portfolio." The UPIA echoes the judgment that "no particular kind of property or type of investment is inherently imprudent." By eliminating the ban on risky investments, the Restatement (Third) and the UPIA make it possible for a trustee to invest in accordance with the teachings of modern portfolio theory. This approach contrasts markedly with the prudent man rule, which embraced diversification but nevertheless required trustees to evaluate the prudence of each investment in a diversified portfolio.

Although the duty to diversify trust investments is central to both the Restatement (Third) and the UPIA, courts and commentators had recognized that duty long before the advent of modern portfolio theory. Early common-law doctrine, by contrast, had good reason for failing to recognize a duty to diversify: if the trustee was not entitled to invest in equities, there was little reason to take advantage of the risk-reduction advantages of diversification. But the law started to change long before the ascension of modern portfolio theory. The Restatement (Second) of Trusts (Restatement (Second)), promulgated in 1959, recognized a duty to diversify, as did many courts. Indeed, the black letter of the Restatement (Third) hardly differs from the language of its predecessor Restatement; both qualify the duty by requir-

65 Restatement (Third) of Trusts § 90 cmt. f.
67 For a judicial statement on the traditional approach, see In re Bank of New York, 323 N.E.2d 700, 703 (N.Y. 1974):
   The record of any individual investment is not to be viewed exclusively, of course, as though it were in its own water-tight compartment, since to some extent individual investment decisions may properly be affected by considerations of the performance of the fund as an entity, as in the instance, for example, of individual security decisions based in part on considerations of diversification of the fund or of capital transactions to achieve sound tax planning for the fund as a whole. The focus of inquiry, however, is nonetheless on the individual security as such and factors relating to the entire portfolio are to be weighed only along with others in reviewing the prudence of the particular investment decisions.

68 See infra note 71.
69 See supra Part I.A.
70 See Restatement (Second) of Trusts § 228 (1959) ("[T]he trustee is under a duty to the beneficiary to distribute the risk of loss by a reasonable diversification of investments . . . .").
71 See, e.g., In re Trust of Mueller, 135 N.W.2d 854, 861–62 (Wis. 1965); Mandel v. Cemetery Bd., Dep't of Prof'l & Vocational Standards, 8 Cal. Rptr. 342, 344–45 (Cal. Ct. App. 1960). Nevertheless, other courts held that a fiduciary was not required to diversify. See, e.g., Estate of Knipp, 414 A.2d 1007, 1009 (Pa. 1980) (holding that the fiduciary did not act imprudently by retaining Sears Roebuck stock as 71 percent of the trust estate when the will authorized, but did not mandate, that the trustee retain the stock).
ing a trustee to diversify “unless, under the circumstances, it is prudent not to do so.”72 But although the language of the duty to diversify is nearly identical, the importance and scope of the duty is not. Because the Restatement (Third) and the UPIA, in embracing modern portfolio theory, permit (and even encourage) investments that would have been impermissible for trustees to make two decades earlier,73 diversification plays a more critical role in reducing risk to trust beneficiaries. As a result, comments to the Restatement (Third) suggest the need for “[b]roadened” and “thorough” diversification, effectively eliminating all risk other than “market” risk.74

Finally, in reversing the common law’s ban on delegation of discretionary trustee functions, the UPIA and the Restatement (Third) relied upon the “specialized investment skills” a trustee might obtain from the trustee’s agent.75 Traditional trust law required the trustee to perform all trust duties personally, and trust doctrine expressed this requirement by providing that a trustee was not entitled to delegate discretionary responsibilities.76 This duty not to delegate had two principal components. First, the trustee could not avoid liability by permitting someone else to perform critical trust responsibilities.77 Thus, if a trustee delegated investment responsibilities to an investment advisor with supposedly greater expertise and that advisor embezzled the trust funds, the trustee remained liable to trust beneficiaries.

72 Restatement (Third) of Trusts § 90(b); see also Restatement (Second) of Trusts § 228 (requiring diversification “unless under the circumstances it is prudent not to do so”). The duty to diversify is not absolute because countervailing considerations may make diversification imprudent. See Unif. Prudent Investor Act § 5 cmt. (1994) (emphasizing that tax considerations and preservation of family businesses may make it imprudent for a trustee to sell existing assets to acquire a diversified portfolio for the trust).

73 See supra Part I.A.

74 Restatement (Third) of Trusts § 90 cmt. g. The comment states that “[s]ignificant diversification advantages can be achieved with a modest number of well-selected securities representing different industries and having other differences in their qualities.” Id. Although that standard probably would suffice under the Restatement (Second), the drafters of the Restatement (Third) go on to note that “[b]roader diversification, however, is usually to be preferred in trust investing.” Id.

75 See Unif. Prudent Investor Act § 9 cmt. (Protecting the Beneficiary Against Unreasonable Delegation) (discussing advantages of delegation where the agent has “specialized investment skills”); Restatement (Third) of Trusts § 90 cmt. j (“Active investment strategies, for example, especially in low-efficiency markets such as real estate and venture capital, are likely to require the hiring of agents with special skills not possessed by many trustees, often not even by professional or corporate fiduciaries.”).

76 See, e.g., In re Will of Hartzell, 192 N.E.2d 697, 706 (Ill. App. Ct. 1968) (“Although purely ministerial powers or duties may be delegated by a trustee, generally a trustee may not delegate powers and duties involving an exercise of judgment and discretion.”).

77 See, e.g., id. at 709–10 (explaining that the trustee was liable for loss due to an attorney’s misappropriation where the trustee delegated to the attorney the obligation to obtain and maintain possession of the trust property).
beneficiaries for the resulting loss.\textsuperscript{78} Second, the trustee was not permitted to use trust funds to pay a third party for performing responsibilities encompassed within the trustee's duties.\textsuperscript{79} Thus, some courts held that because the trustee was responsible for managing trust property, a trustee could not pay an investment advisor for help in managing the trust portfolio.\textsuperscript{80} The doctrine recognized that a trustee might need professional help and did permit the trustee to use trust funds to pay lawyers\textsuperscript{81} and real estate brokers,\textsuperscript{82} but that right did not always extend to investment advisors.\textsuperscript{85}

The reformers, however, concluded that as the class of permissible trust investments has expanded, the likelihood has diminished that an individual trustee, or even a corporate trustee, has the expertise to evaluate each potential investment without outside assistance.\textsuperscript{84} As a result, to implement modern portfolio theory, trustees should be encouraged to rely on persons with expertise in making optimal investment decisions. That objective required freeing trustees from the shackles of the "no delegation" rule.

Taken together, the reformers designed these three doctrinal changes to afford trust beneficiaries the benefits associated with modern portfolio theory. In practice, however, the changes operated primarily by relieving trustees from liability for actions inconsistent with modern portfolio theory. The changes did not impose liability on trustees for failing to take affirmative steps to implement modern portfolio theory. Of the three major "reforms" to trust investment law, only the duty to diversify imposed liability on trustees, and that duty existed before the promulgation of the UPIA and the Restatement (Third). Significantly, neither the Restatement (Third) nor the UPIA developed liability rules to constrain trustees from assuming too much market risk despite modern portfolio theory's clear recognition that


\textsuperscript{79} See 3 \textsc{Austin Wakeman Scott} & \textsc{William Franklin Fratcher}, \textsc{The Law of Trusts} § 188.3, at 60–61 (4th ed. 1988) (stating that a trustee "is not justified in charging the trust estate with payments made to the agent if the agent is employed to do acts that are covered by the trustee's compensation").


\textsuperscript{81} See, \textit{e.g.}, Hanscom v. Malden & Melrose Gaslight Co., 125 N.E. 626, 628 (Mass. 1920); \textit{In re Foster's Estate}, 176 A. 156, 157–58 (N.J. Orphans' Ct. 1919).

\textsuperscript{82} See, \textit{e.g.}, Appeal of Burke, 108 A.2d 58, 64–65 (Pa. 1954).

\textsuperscript{83} See supra note 80 and accompanying text.

\textsuperscript{84} See supra notes 61–63 and accompanying text.
diversification alone would not effectively protect investors against market risk.  

II

Reexamining Modern Portfolio Theory as a Basis for Trust Investing

In the mid-1990s, when the UPIA and the Restatement (Third) were drafted, modern portfolio theory—together with its cousin, the ECMH—had become the accepted wisdom. The drafters of the UPIA and the Restatement (Third) took modern portfolio theory's insights as a given; the difficulty was incorporating those insights into trust law doctrine.

Since the mid-1990s, the stock market has endured two significant jolts. When the dot-com bubble burst in 2000, the S&P 500 plunged from a closing high of 1527.46 points on March 24, 2000, to a closing low of 776.76 points on October 9, 2002. As the subprime mortgage market disintegrated, the S&P 500 lost more than half of its value, its stock dropping from a closing high of 1565.15 points on October 9, 2007, to a closing low of 676.53 points on March 9, 2009.

In the ten-year period from June 1, 1999, through June 1, 2009, the S&P 500 fell from 1294.26 points to 942.87 points, more than 25 percent. Although these precipitous declines do not disprove the insights of modern portfolio theory, they do suggest that it is time to reexamine whether modern portfolio theory provides a solid foundation for trust investment practices.

Modern portfolio theory rests on three basic premises, each of which the Restatement (Third) comments explicitly endorse. First, riskier investments typically generate a higher expected return because investors will eschew such investments unless they are offered a risk premium. Second, diversification of investments can reduce risk.
without compromising expected return.\textsuperscript{91} A corollary of this premise applicable in the trust context is that any investment is a suitable trust investment so long as the investment is diversified appropriately.\textsuperscript{92} Third, a portfolio deals optimally with "market risk" or "compensated risk" by adjusting the percentage of the portfolio devoted to high-risk, high-return investments.\textsuperscript{93}

This Part starts by explaining that the first premise—that riskier investments will generate a higher expected return—depends more on investor psychology than it does on mathematical formulae or inevitable economic truth. In particular, if and when all investors believe that equities generate a higher expected return than other investments, the expected return of equities will decline. The second premise—that diversification reduces risk without reducing expected return—is mathematically true assuming there exists a reliable mechanism for ascertaining the risk and expected return of individual investments. Although many proponents of modern portfolio theory relied on market price as a mechanism for identifying risk and return, recent scholarship and market gyrations undermine the hypothesis that market price accurately reflects risk or expected return. Finally, the third premise—that a portfolio optimally deals with market risk by adjusting the percentage of high-risk, high-return investments—remains a sensible strategy in the face of market uncertainty.

A. Riskier Investments Generate Higher Returns

Modern portfolio theory's premise that "riskier" investments (particularly in common stocks) generate higher returns than less risky investments (e.g., corporate and government bonds) rests on some common-sense propositions. First, the premise assumes that investors are risk averse and that investors insist on a higher expected

\textsuperscript{91} See id. § 90 cmt. e(1) ("Because market pricing cannot be expected to recognize and reward a particular investor's failure to diversify, a trustee's acceptance of this type of risk cannot, without more, be justified on grounds of enhancing expected return.").

\textsuperscript{92} See id. § 90 cmt. f ("Specific investments or techniques are not per se prudent or imprudent. The riskiness of a specific property, and thus the propriety of its inclusion in the trust estate, is not judged in the abstract but in terms of its anticipated effect on the particular trust's portfolio.").

\textsuperscript{93} See id. § 90 cmt. e(1):

[N]o objective, general legal standard can be set for a degree of risk that is or is not prudent under the rule of this Section. Beneficiaries can be diserved by undue conservatism as well as by excessive risk-taking. Decisions concerning a prudent or suitable level of market risk for a particular trust can be reached only after thoughtful consideration of its purposes and all of the relevant trust and beneficiary circumstances. This process includes, for example, balancing the trust's return requirements with its tolerance for volatility.
return for a higher-risk investment than for a lower-risk investment.\textsuperscript{94} Second, the premise assumes that equity investments are inherently riskier than debt investments because bondholders enjoy priority over stockholders when companies go sour.\textsuperscript{95} From these two premises, it follows that investors will demand a higher return from stocks than from fixed-income investments. These common-sense propositions find support in historical returns. As the Restatement (Third) points out, "[h]istorically, corporate stocks have provided greater total return over the long term than bonds."\textsuperscript{96} Although common sense and history support the proposition that stocks generate higher returns than fixed-income investments, the proposition itself is far from inevitable.\textsuperscript{97}

1. The Contingency of Risk Aversion

Suppose investors in the aggregate were not risk averse but were risk preferring.\textsuperscript{98} If so, risky enterprises would not have to pay a risk premium to potential investors; instead, investors might flock to those enterprises even if the expected return on their investments were lower than the expected return on more stable investments. In this hypothetical circumstance, it would make no sense for risk-averse

\textsuperscript{94} See id. § 90 cmt. g ("Because investors are risk averse, they require extra compensation for increased risk. The investor's reward for accepting a greater likelihood of volatile returns follows from the lower market price at which the investor is able to purchase the investment.").

\textsuperscript{95} Cf. Langbein & Posner, supra note 36, at 7–8 ("[T]here is less risk to being a bondholder since he has the cushion of the equity shareholders, who would have to be wiped out completely before he could lose his interest.").

\textsuperscript{96} Restatement (Third) of Trusts § 90 cmt. i. The widely cited Ibbotson study calculates the average rates of return on common stocks, long-term corporate bonds, long-term government bonds, and treasury bills from 1926–87 and concluded that the average annual rate of return on the four investments was, respectively, 12.0, 5.2, 4.6, and 3.5 percent annually. Roger G. Ibbotson & Rex A. Sinquefield, Stocks, Bonds, Bills, and Inflation: Historical Returns (1926–1987) 72 (1989).

\textsuperscript{97} As Paul Haskell explained nearly twenty years ago, [t]he "laws" of economics are different from the laws of nature, such as gravity, for example. What happened yesterday in nature is an excellent predictor of what will happen tomorrow. The same assurance does not exist with respect to past economic experience. Contemporary portfolio theory is all a reflection of the immediate past, and it is uncertain that the future will be consistent with the immediate past.


\textsuperscript{98} Risk aversion and risk preference are crude labels for describing attitudes towards risk. Negative pangs from losses may exceed positive pangs from gains, supporting a psychological theory of risk aversion. See Nassim Nicholas Taleb, Fooled by Randomness: The Hidden Role of Chance in Life and in the Markets 67–68 (2d ed. 2004). But one hundred small gains may create emotional satisfaction that outweighs the risk of a single loss one hundred times as great, a result at odds with the "risk aversion" label. See id. at 192–93.
trustees to invest in risky enterprises. Is this hypothetical circumstance sufficiently plausible to merit consideration?

Robert Shiller, among others, has argued that risk aversion is, at least in part, a cultural phenomenon. The prevalence of gambling itself establishes that risk aversion is not an omnipresent phenomenon, and Shiller argues that the increased frequency of gambling makes it natural for people to “graduate to [gambling’s] more upscale form, speculation in securities.” Moreover, empirical evidence supports the proposition that investors do not always act with a risk-averse frame of mind. First, researchers have concluded that investors often act on a principle of “loss aversion”; rather than realizing losses on stocks, investors retain these stocks and expose themselves to risks greater than those justified by the expected future return on those stocks. Second, studies have established that when investors make significant investment profits, they often subject themselves to greater risk with these profits, or “found money,” than they would if they had not enjoyed recent successes. Neither of these findings supports the conclusion that investors generally are risk preferring, but the findings do undermine the conclusion that investors are universally risk averse.

2. The Feedback Problem: Does Widespread Acceptance of Modern Portfolio Theory Undermine Its Premises?

Assume now that investors as a group are risk averse. In a world of risk-averse investors, do common stocks offer investors a risk premium? According to modern portfolio theory, the risk of a particular firm performing poorly or failing altogether does not require that firm to pay investors a risk premium because that firm-specific risk is

99 See Robert J. Shiller, IRRATIONAL EXUBERANCE 54 (2d ed. 2005) (noting that the rise in gambling institutions and gambling acts over the past century has had cultural impacts on society).
100 Id.
102 See Langevoort, supra note 101; see also Nicholas Barberis & Ming Huang, Mental Accounting, Loss Aversion, and Individual Stock Returns, 56 J. Fin. 1247, 1249 (2001) (asserting that good recent performance of a stock will cause “the investor [to] perceive[ ] the stock to be less risky than before”). See generally Nicholas Barberis et al., Prospect Theory and Asset Prices, 116 Q. J. Econ. 1 (2001) (explaining that an investor’s loss aversion depends on the relative investment’s prior performance and that prior gain will make subsequent losses more bearable).
That is, if there were no market risk, given the premises of modern portfolio theory, common stocks would not command a risk premium. Any risk premium is purely the product of market risk—the risk that a particular firm will suffer because the market as a whole declines.

The risk premium associated with any stock, therefore, should depend on two factors: the likelihood that the market will decline and the sensitivity of the particular stock to market declines. If the risk of market decline did not exist, there would be no reason for any stock to require a risk premium. How, then, do investors measure the risk of market decline? Modern portfolio theory tends to minimize that risk. Although it informs of the risks associated with common stocks, it also emphasizes that the expected return on common stocks typically will be higher than the expected return on other investments. Investors also understand that fixed-income investments generate their own risks, particularly inflation risks. For any investor with a long time horizon, then, the message may well be that the risk associated with common-stock investment is no greater than the risk associated with other investment choices. If enough investors develop that belief, money will flow from other investments to common stocks, driving down or eliminating the risk premium associated with common stocks. Data supporting the proposition that stocks have outperformed bonds in every relevant span of time also support the proposition that stock-market investing involves little risk; in periods of steady rise in stock prices, investors are even more likely to underestimate the risks associated with market decline.

The ECMH suggests that any such risk is trivial. At its core, ECMH holds that the market price of securities fully reflects all availa-
ble information about the future prospects of those securities.\textsuperscript{110} If one accepts this hypothesis, it is not possible for investors as a group systematically to overvalue securities because no other "expert" opinion can provide a baseline for valuation that is superior to the baseline provided by the market collectively.\textsuperscript{111} Once lauded as "the best established fact in all the social sciences,"\textsuperscript{112} the ECMH has endured significant attack, and recent market turmoil has led many to rethink its premises.\textsuperscript{113} Gyrations in the stock market and in the housing market have led to suggestions that market prices have as much to do with the psychology of investors as with a close analysis of the prospects of individual securities or assets.\textsuperscript{114} The jury is still out on how efficient markets are. For present purposes, however, what is critical is that a key assumption embedded in the UPIA and the Restatement (Third)—the assumption that investments in common stock pay a risk premium that reflects market risk—is dependent on ECMH. In the absence of ECMH, it would be possible for investors as a group to underestimate the risks of market decline. If investors generally underestimate that risk, then for the risk-averse investor, stocks will be overpriced relative to fixed-income investments. That is, stocks will not generate sufficient return to warrant the risks not perceived by the investing community more generally.

B. Diversification Eliminates Concerns About Firm-Specific Risk

1. Market Declines Do Not Undermine the Case for Diversification

Modern portfolio theory teaches us that for each set of investments with a given expected return, an investor can reduce the risk associated with that return by diversification.\textsuperscript{115} If an investor identi-

\textsuperscript{110} See Fama, supra note 42, at 383–86 (defining an efficient market as one that fully reflects available information).

\textsuperscript{111} See Shiller, supra note 99, at 179 ("[ECMH] claims that the smartest people will not be able to do better than the least intelligent people in terms of investment performance. They can do no better because their superior understanding is already completely incorporated into share prices.").


\textsuperscript{113} For instance, ECMH does not assume that all investors are rational and informed but instead assumes that when zealots overpay for an asset, the "smart money" immediately seizes on an investment opportunity and corrects any mispricing. See Shiller, supra note 99, at 182 (discussing the work of Edward Miller on this topic). But short-sales constraints on markets often will prevent the smart money from acting to correct pricing errors. See id.

\textsuperscript{114} Shiller, for instance, argues that herd behavior plays an important role in setting market prices. See id. at 159–61. People who know better are unduly respectful of others in formulating their own judgments, and they then become so overconfident in those judgments that valuable information about fundamental values of securities is neither disseminated nor evaluated. See id.

\textsuperscript{115} See Brealey & Myers, supra note 33, at 131–32.
fies ten stocks with an identical expected firm-specific risk and an identical expected annual return of 8 percent, the investor can achieve that same 8-percent return with less risk by investing in all ten stocks rather than investing in any one of them. Diversification reduces risk because the ten stocks are unlikely to move in perfect lockstep. Optimal diversification requires more than purchasing many stocks with the same expected return; it also requires minimizing the covariance among those stocks.\footnote{Markowitz, supra note 28, at 89.} Purchasing ten different oil stocks, each with the same expected return and firm-specific risk, will reduce overall risk less than purchasing stocks in a variety of industries.\footnote{See id. (suggesting that investors diversify across industries because firms in different industries have lower covariances than firms within the same industry).} Markowitz built the mathematical foundations for these insights more than half a century ago.\footnote{See supra Part I.B.1.}

The technology-bubble burst in 2000 and the fallout from the subprime mortgage crisis in 2008–09 did not undermine Markowitz's mathematical model; these occurrences merely highlighted the model's limits. Markowitz's model did not assume that it was easy to determine expected return and covariance; indeed, Markowitz expressly reserved judgment about how best to develop relevant beliefs concerning those variables.\footnote{See Markowitz, supra note 28, at 91.} The precipitous NASDAQ decline underscored the high covariance among start-up companies, particularly those that were technology based. The more recent mortgage debacle revealed significant, but not previously transparent, covariance among disparate sectors of the economy. Expected return may be even more difficult to assess because, as many individuals now recognize, investment returns may depend as much on investor psychology as they do on economic fundamentals.\footnote{See George A. Akerlof & Robert J. Shiller, Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism 69–73 (2009) (concluding that the Great Depression endured for as long as it did in large measure because investor confidence was shattered and noting that many economists, "who generally see no advantage in contemporary assessments of market psychology that cannot be scientifically confirmed today," ignored the economic malaise of the era).} Difficulties in assessing variance and expected return, however, increase the importance even of imperfect diversification; if uncertainty is omnipresent, prudence suggests hedging one’s bets.

The principal challenge to diversification as an investment strategy comes from those individuals who believe that savvy investors can reduce risk and increase return more effectively by careful study of the "fundamentals" associated with a smaller number of investments. That is, an alternative strategy would be to heed advice variously attributed to both Andrew Carnegie and Mark Twain: "Put all your eggs
in one basket and watch the basket."\textsuperscript{121} Whether this strategy can beat a diversification strategy over time remains a subject of dispute in both academic literature and the financial press. The empirical evidence suggests that it will be a rare investor who can consistently "beat the market."\textsuperscript{122} In light of this evidence, the case for requiring diversification remains a strong one; it appears unlikely that trust beneficiaries as a whole would be better off if trust law doctrine relieved trustees of the obligation to diversify.\textsuperscript{123}

2. Diversification Does Not Make Every Investment Suitable

The \textit{Restatement (Third)} announces that "[s]pecific investments or techniques are not per se prudent or imprudent."\textsuperscript{124} The UPIA takes a similar position.\textsuperscript{125} Both documents claim to derive this position from modern portfolio theory's endorsement of diversification as a mechanism for reducing risk. Professor John Langbein's explanation and defense of these reforms makes explicit their connection to modern portfolio theory: "[t]he idea that some securities are intrinsically too risky for trust investors collides with the central findings of [m]odern [p]ortfolio [t]heory."\textsuperscript{126}

The connection between modern portfolio theory and the conclusion that any investment, in context, can be a prudent investment, is more complicated than suggested in both the \textit{Restatement (Third)} and the UPIA. Markowitz's seminal article demonstrated that when an investor located investments with high expected return and low variance, the investor could fare better by diversifying among those investments.\textsuperscript{127} Markowitz's article never suggested that every investment would be sensible if appropriately diversified; quite the contrary, it acknowledged that more work was needed to develop a strategy for


\textsuperscript{122} See generally Brad Barber et al., \textit{Can Investors Profit from the Prophets? Security Analyst Recommendations and Stock Returns}, 56 J. Fin. 531, 532-55 (2001) (analyzing data showing that individual investors can beat the market by following consensus recommendations by analysts, but suggesting that the transaction costs of such a strategy generally would wipe out any gains).

\textsuperscript{123} See Dobris, \textit{supra} note 25, at 485-86 (emphasizing that "[t]rusts outnumber competent-at-investing trustees" and suggesting that passive investing will generally do less harm to trust beneficiaries as a class).

\textsuperscript{124} \textit{Restatement (Third) of Trusts} § 90 cmt. f (2007).

\textsuperscript{125} \textit{Unif. Prudent Investor Act} § 2 cmt. (1994) (Abrogating Categoric Restrictions) (clarifying that no particular kind of property or type of investment is inherently imprudent).

\textsuperscript{126} Langbein, \textit{supra} note 14, at 649.

\textsuperscript{127} Markowitz, \textit{supra} note 28, at 82-90.
identifying the expected return and low variance of individual securities.\textsuperscript{128}

The ECMH attempted to fill the gap acknowledged by Markowitz. It was unnecessary (and largely pointless) to develop a strategy for identifying risk and return because the market price already reflected all the available information from which one could construct the strategy.\textsuperscript{129} If one accepts the ECMH in its strongest form, every investment is a suitable investment at its market price. By contrast, if the ECMH were not true, a prudent and diligent investor could identify some investments that were overpriced relative to alternative investments with comparable risk. Those overpriced investments would be imprudent for individual investors and certainly for trustees.

The behavioral economics literature challenges the ECMH, contending that the pricing of individual securities (and of the market generally) reflects investor psychology as much as it reflects economic fundamentals.\textsuperscript{130} A "herd" mentality causes many investors to bid up the price of securities (or to sell them off) without an economic foundation for their investment decisions.\textsuperscript{131} Even the most ardent proponents of the ECMH concede that some investors do not act rationally in incorporating available information into investment decisions, but they do suggest that more knowledgeable investors will engage in arbitrage that will ensure that market prices remain the best estimate of value.\textsuperscript{132}

Arbitrage, however, is difficult when a buying frenzy drives prices higher than fundamentals can justify. Arbitrageurs can cure overpricing only by short selling, which is often difficult.\textsuperscript{133} Robert Shiller offers the following example: Shortly after the initial public offering of stock in eToys in 1999, the value of the stock was $8 billion even though the company’s 1998 sales were only $30 million and its profits totaled negative $28.6 million.\textsuperscript{134} By comparison, Toys ‘R’ Us—a com-

\textsuperscript{128} See id. at 91.
\textsuperscript{129} See Fama, supra note 42, at 384.
\textsuperscript{130} Cf. Graham, supra note 26, at 200–03 (detailing the patent irrationality in the market pricing of Great Atlantic & Pacific Tea Co. shares, alternately based on public pessimism and on public optimism). See generally Shiller, supra note 99, at 157–60 (discussing the impact of social influence on stock market behavior).
\textsuperscript{131} See generally Langevoort, supra note 101, at 149 (citing evidence of a herd mentality even among investment professionals). Langevoort also provides some examples of the herd mentality among nonprofessionals. For example, he discusses a dramatic rise in stock prices of a licensing company following a New York Times story about a medical breakthrough that was already public information. See id. at 138. Another example concerns a fraud scheme in which investors purchased stock relying on tips posted on the Internet. See id. at 156.
\textsuperscript{132} See Shiller, supra note 99, at 179 ("[T]he smartest money has already mostly taken over the market through its profitable trading and has now set prices correctly . . .").
\textsuperscript{133} For a discussion about the constraints of short selling, see id. at 182.
\textsuperscript{134} See id. at 181.
pany with sales of $11.2 billion and profits totaling $376 million—had a stock value of only $6 billion.\(^{135}\)

Arbitrage is a particularly implausible solution to the mispricing of investments when there is little basis for assessing the investment’s expected return or risk, and this situation often will be the case for start-up companies.\(^{136}\) The eToys example is illustrative. The company’s stock price in 1999 was based not on current sales or profits but on exuberance about the future of Internet sales. But prospective purchasers—informed or uninformed—had little basis for assessing the risk or reward associated with eToys and had no economic basis (other than “irrational exuberance”) for concluding that the expected return justified an investment at the market price for the shares. Purchasing shares in eToys was much like purchasing a lottery ticket without knowing either the prize or the number of tickets that would ultimately be sold; in each case, the purchaser has no good way of assessing risk or return. Buying shares in many such entities (or buying many such lottery tickets) does not make the investment prudent.\(^{137}\)

Put another way, diversification is a mathematically optimal strategy for reducing quantifiable risk without sacrificing expected return. Given any portfolio, adding a stock with the same expected return and low covariance as other stocks in the portfolio preserves return while diminishing risk. Nevertheless with many stocks—particularly with new issues—the investor has no significant basis for determining expected return or covariance.\(^{138}\) As a result, there is no reason to believe that adding that stock will preserve expected return or reduce risk.\(^{139}\) Adding the stock does not accomplish the objectives of diversi-

\(^{135}\) See id.; see also Michael J. Cooper et al., *A Rose.com by Any Other Name*, 56 J. Fin. 2371, 2379 (2001) (observing that, during the technology bubble, changing a firm’s name to add “.com,” “.net,” or the word “Internet” caused an abnormal return of 53 percent over a five-day period and 89 percent over a sixty-one-day period).

\(^{136}\) A similar problem exists with closely held enterprises where the market may be particularly thin.

\(^{137}\) Of course, buying actual lottery tickets with a known negative expected return does not constitute an “investment” at all and would inevitably subject the trustee to liability. See Dobris, supra note 25, at 463–64.

\(^{138}\) Graham observed that the market is particularly likely to price new issues irrationally for two reasons. See Graham, supra note 26, at 142–43. First, unreliable salesmanship typically accompanies new issues. Second, and perhaps more important, companies release new issues more frequently in times when market conditions are particularly favorable to sellers (and therefore less favorable to buyers), that is, at times when “the large and quick profits shown by common stocks as a whole are sufficient to dull the public’s critical faculty, just as they sharpen its acquisitive instinct.” *Id.* at 142.

\(^{139}\) Even when a firm has an established track record, there is no mathematically precise way of determining the likelihood that the past will be prologue to the future. As Nassim Nicholas Taleb notes, “unlike a well-defined[,] precise game like Russian roulette, where the risks are visible to anyone capable of multiplying and dividing by six, one does not observe the barrel of reality.” Taleb, supra note 98, at 26. The probability that the firm
fication. Acceptance of the ECMH would ameliorate this problem by assuming that market prices provide significant evidence about expected return and risk and thus would provide a rationale for broad diversification. But if, for some stocks, market price provides suspect evidence about expected return or risk, diversification provides little justification for including those stocks in a portfolio—particularly in a trust portfolio.

C. A Trust Portfolio Optimally Deals with Market Risk by Adjusting the Percentage of High-Risk, High-Return Investments

Diversification minimizes firm-specific risk but does not protect investors (particularly trust investors) against market risk. Both the Restatement (Third) and the UPIA suggest that a prudent trustee must assess the risk tolerance of a trust and invest accordingly. Recent market reversals do not cast doubt on the wisdom of that conclusion. Before the Restatement (Third) and the UPIA, trustees typically dealt with risk tolerance by avoiding volatile investments. The Restatement (Third) and the UPIA sought to release trustees from that approach for two reasons: First, even “safe” investments generate significant inflation risk. Second, in light of the higher expected return on equity investments, a prudent trustee would be better advised to moderate the amount of the portfolio invested in equities rather than to avoid equities entirely. Among the ways in which the trustee might reduce the risk level of the trust would be to combine high-risk, high-expected-return investments with an appropriate proportion of low-risk investment—a strategy developed in finance literature and explicitly endorsed in the Restatement (Third). Recent market reverses establish that it is not inevitable that, over the long term, equities will outperform bonds or even treasury bills. But that fact does not suggest that it would be prudent for a trustee
with a long-term time horizon to avoid equities. Such a strategy generally would expose the trust beneficiaries to inflation risk. Furthermore, despite recent reverses, equities may outperform fixed-income investments. It would be irrational and imprudent to ignore the historical returns of equities in establishing a trust portfolio, just as it would be irrational and imprudent to ignore more recent market events. These recent events emphasize the standard caveat that past performance is no guarantee of future results. In the face of uncertainty, hedging one’s bets remains a sensible strategy.

D. Summary

Modern portfolio theory started with a mathematical insight that remains as true today as it was when first developed: if we can identify a number of investments with high expected return, we can achieve the same expected return with less risk if we diversify among those investments. If the risk associated with each investment is independent of the risk associated with the other selected investments, diversification will be a particularly effective mechanism for reducing risk.

The mathematics, however, say nothing about how to determine risk and expected return. Modern portfolio theory dealt with that gap by looking at historical data that revealed larger returns on equity investments and by explaining that data with the intuitively appealing idea that investors are generally risk averse and therefore demand a “risk premium” for investing in stocks. As a result, equities were essential for a portfolio that sought to maximize return; the only reason to temper investment in equities would be to reduce market risk. Moreover, the ECMH essentially made it unnecessary to focus on which equities belong in a trust portfolio because market prices would reflect the best available information about future return.

Recent scholarship and recent events suggest that faith in both the superior performance of equities and in the ECMH has been excessive. Whether investors are risk averse is a matter of psychology rather than economics. And even if most investors are risk averse, the accepted wisdom that inflation erodes fixed-income investments and that equities outperform other investments might lead many investors to conclude that equities are the least risky long-term investments, thus depleting the “risk premium” associated with equities. Because of the inflation risks associated with alternative investments and because prudence generally counsels against overconfidence in any one strategy in an uncertain world, equities retain an important role in prudent trust investing; this role is not the same role equities would play if it were clear that in the “long run” equities always outperform other investments. Finally, the notion that any investment can be a prudent
trust investment requires Herculean faith in the ECMH—faith not borne out by market data.

III

Putting Theory into Practice: Reexamining Doctrinal Implementation of New Learning About Investment Practice

As the preceding Part demonstrates, neither recent market reverses nor significant advances in scholarship require outright rejection of modern portfolio theory; they do, however, suggest that some aspects of modern portfolio theory—particularly the tenet that every investment is, in proper context, a suitable investment—cannot withstand careful scrutiny. This Part focuses on the doctrinal implementation of modern portfolio theory. Even if one were to accept all of the principles of the modern portfolio theory that the UPIA and the Re¬

statement (Third) endorse, the doctrinal structure that those enact¬
ments establish provides an inadequate framework for assuring that trustees apply those principles to their trust investments. And to the extent that modern portfolio theory underestimates particular investment risks, the doctrinal structure magnifies the risk to trust beneficiaries.142

A. Is Trust Investing Different from Individual Investing?

Common law courts concluded that trustees charged with investing trust funds should not approach trust investment decisions the same way they approach investment of personal assets. The prevailing wisdom that trustees should be more conservative with trust funds was based on the assumption that the settlor’s primary investment objective typically was maintenance of trust principal.143

Since it has become apparent that a “conservative” investment strategy subjects the trust portfolio to different risks144—risks that often are inconsistent with settlor objectives—is there any reason for trustees to invest more conservatively than individual investors would? Settlors create trusts for a myriad of different purposes, including tax avoidance, asset protection, and maintenance of family members.145 In many circumstances, the trust settlor would want the trustee to tolerate considerable volatility so long as expected return was high. In other circumstances, such as those in which the settlor’s primary objective is to provide for a family member for a limited time, volatility

142 See infra Part III.B.
143 See supra Part II.
144 See supra Part I.A.
would present more of a problem. Ultimately, the trust settlor should play the primary role in determining the trustee's investment policy. As a result, the primary issue for trust law doctrine is to devise default rules that sophisticated settlors and trustees can modify.

The more sophisticated that the settlor and the trustee are, the more likely it is that both parties will explicitly consider and agree on investment policies for the trust. Default rules, therefore, assume greater significance with smaller trusts that less sophisticated trust settlors create. In these cases, a conservative bias is more likely to reflect the settlor's preferences than is true among trust settlors more generally. With smaller trusts, the beneficiaries are more likely to need trust income or principal at a particular time; this situation could arise, for instance, where the individual who created the trust previously served as the trust beneficiary's primary source of support. For such a beneficiary, severe market fluctuations could cause sudden lifestyle disruptions that the trust settlor does not anticipate or want. As a result, there is good reason to develop a default rule that limits market risk even if a somewhat lower expected return will accompany that reduced risk.

B. The Agency-Cost Problem

Unlike individual investors, trustees do not reap the benefits or suffer the losses that result from their investment decisions. As a result, the trust relationship generates agency costs, raising questions about the role legal doctrine can and should play in addressing any mismatch between the interests of the beneficiaries and the agent (the trustee). Modern portfolio theory did not beget agency costs; the interests of trustees have never been aligned perfectly with the

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146 See Haskell, supra note 97, at 109 (mentioning that investing in high-volatility stocks "is inconsistent with the ultra-conservative purposes of the family trust").

147 See generally Melanie B. Leslie, Trusting Trustees: Fiduciary Duties and the Limits of Default Rules, 94 GEO. L.J. 67, 68-72 (2005) (discussing scholarly recognition of fiduciary duties as default rules and the ability to waive these rules, and introducing a framework to limit parties' powers to change these default rules).

148 See id. at 71 n.19 (citing UNIF. TRUST CODE § 1008 cmt. (2000)) (including sophistication of the settlor with respect to business and fiduciary matters as a factor in determining whether the modification of the trustee's duties was fair).

149 Similarly, asset allocation in 401(k) retirement plans varies considerably by employee salary. Employees with higher salaries tend to invest significantly more in equities and less in money-market and guaranteed income investment options. See JACK VAN DERHEI ET AL., EMPLOYEE BENEFIT RESEARCH INST., 401(k) PLAN ASSET ALLOCATION, ACCOUNT BALANCES, AND LOAN ACTIVITY IN 2007, 24 fig. 21 (2008), http://www.ebri.org/pdf/briefspdf/EBRI_IB_12a-2008.pdf.


151 See generally Sitkoff, supra note 5 (discussing the agency costs inherent in trust law).
interests of trust beneficiaries. Fiduciary duties—particularly the
duty of loyalty and the duty of care—operate in part to induce trustees
to act in the interests of trust beneficiaries.

Consider now the trustee's duties with respect to investment of
trust funds. Traditional theory starts with the premises that the trust
settlor's primary goal is preservation of trust principal and that trust
beneficiaries are best off when the trust generates maximum income
consistent with investments that minimize risk to trust principal. So
long as preservation of trust principal is treated as the trust's primary
objective, aligning the trustee's interests with those of the trust benefi-
ciaries is not difficult. Imposing liability on a trustee who makes in-
vestments that place trust principal at risk creates the right incentives;
because the trustee receives no personal benefit from the higher re-
turns generated from those investments but does bear the downside
loss associated with those investments, the trustee who is at all sensi-
tive to financial incentives will avoid risking trust principal—the hy-
pothesized goal of the trust settlor. As a result, both the "legal list"
approach and the traditional "prudent person" standard, with their
prohibition on "speculative" investments, were well calculated to mini-
mize agency costs.

Rejection of traditional theory complicated the agency-cost prob-
lem. Decades of inflation made it clear that no investment strategy
could avoid risk altogether because even government bonds were sub-
ject to a significant inflation risk. As a result, the "prudent" trustee
could look to no single talisman in making investment decisions be-
cause an investment strategy that balanced risk and return would best
serve the beneficiaries. How, then, should the legal system encourage
trustees to take appropriate risks?

One alternative would be to rely largely on the market to police
trustees. That is, doctrine could largely ignore the agency-cost prob-
lem by assuming that trustees who inadequately serve the interests of
settlers and beneficiaries will find it difficult to attract clients. This
assumption of market discipline, however, seems implausible.
Although Langbein argues that the prospect of repeat business from
trust lawyers acting on behalf of their clients may provide a market

152 See id. at 640 (highlighting the tensions that exist between a trustee and the trust
beneficiary).
153 See id. at 679 (analyzing litigious responses to breaches of fiduciary duty as incen-
tives for trustees).
154 See Shattuck, supra note 23, at 492 ("Text writers and observers of the fiduciary art
were wont to express the trustee's duties in terms of emphasis upon preservation of
principal.").
155 See Gordon, supra note 22, at 83–84 (noting that it would be improbable for trustee
to ignore liability risk).
156 See Langbein, supra note 14, at 645 ("Experience with inflation after World War II
taught that bonds placed significant inflation risk on the bondholder.").
incentive for trustees. Leslie and Sitkoff both note that the market forces that may act to discipline corporate officers and directors do not put nearly the same pressure on trustees. Few trust settlers will be repeat players who react to their own experience with the trustee’s investment decisions. And if a corporate trustee seeks to attract new trust business, potential settlers are likely to focus on the trustee’s past returns and not on the risks taken to generate those returns, thus creating an incentive for the trustee to take more risks than prudent. This mismatch is an especially serious problem if the focus is on trusts in which the settlor has not specified investment strategies because those trusts are the smallest and ones for which conservative investment strategies may best achieve the trust settlor’s objectives.

A second alternative is to develop liability rules designed to minimize agency costs. But even though the market may be an imperfect mechanism for inducing trustees to internalize agency costs, the wrong liability rules might induce trustee behavior that subsequently leaves beneficiaries worse off than they would be with no liability rules at all. A third potential alternative is to rely on a norm among trustees that counsels against speculation. Norms, however, can erode over time, especially in the face of new legal rules. The new prudent investor rule might cause that kind of erosion.

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158 For instance, unlike corporate officers, a trustee need not worry about raising capital, maximizing stock price, or responding to takeover threats. Leslie, supra note 147, at 83. And the difficulties associated with removal of trustees may reduce market pressure on a trustee. See Robert H. Sitkoff, Trust Law, Corporate Law, and Capital Market Efficiency, 28 J. CORP. L. 565, 571 (2003).
159 See Langbein, supra note 157, at 937 (“To be sure, the typical trust settlor is not a repeat player . . . .”).
160 See Gordon, supra note 22, at 84 (emphasizing competition in the market for trust assets and noting that “demonstrably superior performance of a common trust fund helps attract new assets to manage”).
161 Taleb emphasized that investors typically flock to managers with the best track records (creating an incentive to generate such a track record) but that a strong track record is often purely the product of randomness rather than investment skill and often will not be reproduced over a longer term. See generally Taleb, supra note 98, at 5–20 (discussing Nero Tulip’s experience with trading and also how “a large selection of businessmen with outstanding track records will be no better than randomly thrown darts”).
162 See generally Sitkoff, supra note 5, at 679–82 (discussing some behavior-inducing effects that liability rules have on trustees).
163 See Dobris, supra note 25, at 452 (discussing the idea of speculation under trust investment law today).
164 See Leslie, supra note 147, at 90–92.
C. The Restatement (Third) and the UPIA as Responses to the Agency-Cost Problem

The drafters of the Restatement (Third) and the UPIA accurately perceived an agency-cost problem—the strong disincentive for trustees to invest in equities, particularly equities of companies not regarded as “blue chips”—generated by the structure of then-prevailing doctrine. The drafters “solved” that problem.165 The solution, however, did not fully anticipate the impact that the new doctrinal structure would have on trustee incentives even assuming the truth of modern portfolio theory and the ECMH. The doctrinal solution is even more problematic if modern portfolio theory and the ECMH do not accurately capture economic truth.

1. The Approach Taken by the Restatement (Third) and the UPIA

The drafters of the Restatement (Third) and the UPIA did not operate on a blank slate. Trust law doctrine historically had been a jurisprudence that privileged standards over rules. The prudent man “rule” of the Restatement (Second) was the quintessential standard; it required trustees “to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived.”166 Repeated application of the standard-like prudent man rule, however, generated results that Austin Scott, among others, synthesized into at least one rule-like rule: a trustee acts imprudently if the trustee invests in common stock that does not pay regular dividends.167 Whether courts consistently have applied this prohibition is a matter of some dispute.168 But the prospect that a court might apply such a rule created a significant incentive for trustees to steer clear of equity investments that did not pay dividends; the trustee would enjoy little of the upside gain of such an investment but would take the risk of liability for the entire downside loss if a court were to find the investment imprudent.169

165 See Langbein, supra note 14, at 654 (noting that the Restatement (Third) and the UPIA were designed to liberate trust investors when making their investment decisions).
166 Restatement (Second) of Trusts § 227(a) (1959).
167 Id. § 227 cmt. m. In fact, Scott listed other categories of investments that were imprudent per se, such as junior mortgages. See Langbein, supra note 14, at 645 (citing 3 Scott & Fratcher, supra note 79, § 227[7], at 448–49). For a general discussion of Scott’s influence, see Gordon, supra note 22, at 57–67.
168 See Gordon, supra note 22, at 67–74 (discussing how courts applied this prohibition).
169 Cf. Sitkoff, supra note 5, at 656 (arguing that overly cautious trust management in part reflects a legal rule that generates too much deterrence).
As a result, the drafters of the *Restatement (Third)* and the UPIA focused their efforts on eliminating any inference that a trustee could be held liable for imprudence merely because the trustee invested part of the trust portfolio in high-risk, high-expected-return securities. The black letter of both documents emphasizes that the prudent investor standard should not apply to investments in isolation.\(^{170}\) The comments speak of the "abolition of categoric restrictions against types of investment"\(^{171}\) or provide that the prudent-investor rule "does not classify specific investments or courses of action as prudent or imprudent in the abstract."\(^{172}\) Indeed, the *Restatement (Third)* devotes separate comments to mortgages and other asset-backed securities,\(^{173}\) to real estate,\(^{174}\) and to venture capital,\(^{175}\) making it clear that a trust portfolio need not exclude any of these investments.

Once the drafters of the *Restatement (Third)* and the UPIA rejected categoric restrictions on types of investment, they largely were content with making marginal changes to the traditional standard-based prudent man rule. The reporter’s note to the *Restatement (Third)*, for instance, emphasized that nothing in the black-letter text of the *Restatement (Second)*’s prudent man rule was inconsistent with the new prudent investor rule.\(^{176}\) Both the *Restatement (Third)* and the UPIA stressed the importance of diversification, but the *Restatement (Second)* already recognized a duty to diversify.\(^{177}\) Both the *Restatement (Third)* and the UPIA recognized the importance of assessing the trust’s risk tolerance before making investments, but neither document provided any formula for the trustee to follow in assessing that tolerance\(^{178}\) or for taking that tolerance into account when formulating investment policy. The *Restatement (Third)*, in particular, went out of its way to indicate that a trustee should have broad discretion in formulating investment strategy.\(^{179}\) Neither the *Restatement (Third)* nor the UPIA identified areas for increased trustee liability.

\(^{170}\) See Unif. Prudent Investor Act § 2(b) (1994); Restatement (Third) of Trusts § 90(a) (2007).


\(^{172}\) Restatement (Third) of Trusts § 90 cmt. e(1) (2007).

\(^{173}\) See id. § 90 cmt. n.

\(^{174}\) See id. § 90 cmt. o.

\(^{175}\) See id. § 90 cmt. p.

\(^{176}\) See id. § 90 reporter’s notes (General Note).

\(^{177}\) See Restatement (Second) of Trusts § 228(a) (1959).

\(^{178}\) Unif. Prudent Investor Act § 2 cmt. (1994) (Risk and Return) ("A trust whose main purpose is to support an elderly widow of modest means will have a lower risk tolerance than a trust to accumulate for a young scion of great wealth."); Restatement (Third) of Trusts § 90 cmt. e(1) ("If a trust cannot tolerate adverse outcomes in the short run, the trustee should not adopt a high risk-reward strategy.").

\(^{179}\) The comments to the *Restatement (Third)* go on at great length to authorize both active and passive investment strategies. See Restatement (Third) of Trusts § 90 cmt. h.
Indeed, both the Restatement (Third) and the UPIA reduced trustee liability in one area: they abolished the traditional duty not to delegate investment functions. Under traditional trust law, as embodied in the Restatement (Second), a trustee who delegated investment functions to a person with supposed expertise remained liable for any losses resulting from the delegate’s imprudence. Responding to criticism suggesting that the traditional rule created a disincentive to delegation and thus deprived trust beneficiaries of expertise, the Restatement (Third) and the UPIA excused a trustee from liability unless the trustee acted imprudently in selecting the delegate or in monitoring the delegate’s performance.

2. Problems with the Approach Taken By Both the Restatement (Third) and the UPIA

The standard-based approach embodied in the UPIA and the Restatement (Third) provides little protection to beneficiaries against a trustee’s assumption of excess market risk—or, if the approach does provide protection, it does so at a relatively high cost. Prior trust law’s restrictions on particular categories of investments reflected a suboptimal approach to market risk. By prohibiting all investment in broad classes of securities, prior law made it difficult for a trustee to protect against inflation risk and also—based on the premises of modern portfolio theory—to generate optimal returns for any given level of risk.

The drafters of the UPIA and the Restatement (Third) sensibly cast aside these restrictions. The drafters, however, provided no black-letter substitute for the old regime’s protection against market risk. Instead, they exhorted trustees to consider the risk tolerance of the trust in assessing how much market risk to take. Whether that ex-

The comments then continue to discuss and authorize a variety of investments. See id. § 90 cmts. k–p.

180 See Unif. Prudent Investor Act § 9; Restatement (Third) of Trusts § 80; see also id. § 90 cmt. j (“The trustee is not required personally to perform all aspects of the investment function.”).

181 See Restatement (Second) of Trusts § 171.

182 See Unif. Prudent Investor Act § 9(a)(1) (requiring reasonable care in the selection of an agent); Restatement (Third) of Trusts § 80(2) (requiring prudence “[i]n deciding whether, to whom, and in what manner to delegate fiduciary authority . . . and thereafter in supervising or monitoring agents”); see also Unif. Prudent Investor Act § 9(a)(3) (requiring periodic review of “the agent’s actions in order to monitor the agent’s performance and compliance with the terms of the delegation”).

183 See supra Part I.A.

184 See supra Part I.C.

185 A comment of the Restatement (Third) of Trusts provides an example of the vaguely defined obligation imposed on trustees:

[N]o objective, general legal standard can be set for a degree of risk that is or is not prudent under the rule of this Section. Beneficiaries can be dis-
hortation provides beneficiaries with protection depends in part on how courts interpret the UPIA and the Re-2statement (Third)—an issue not yet free from doubt. Although the Restatement (Third) includes extensive comments, none of the comments addresses the standard of review courts should apply to trustee investment decisions. The Restatement (Third) and the UPIA allow two possible interpretations. First, courts might construe them to confer broad discretion on trustees with limited judicial review of a trustee’s investment judgments as long as the trustee adequately diversifies firm-specific risk. Second, courts might construe them as imposing on courts a responsibility to provide more substantive oversight of the prudence of the trustee’s decisions. Neither alternative is attractive.

a. A Deferential Approach

First, consider the deferential approach, which is akin to the business-judgment rule for corporate officers and directors. The deferential approach need not insulate the trustee from all liability. The trustee might, for instance, have to establish that he or she became familiar with the needs of trust beneficiaries before making investment decisions. The Pennsylvania Superior Court case of In re Scheidmantel is illustrative. In the face of a trust instrument that absolved the trustee of liability except for “actual fraud, gross negligence[,] or willful misconduct,” the court held a trustee liable for making significant investment decisions without attempting to ascertain the life tenant’s physical condition, prognosis, or current income needs. Even if courts defer to investment decisions once a trustee establishes adequate investigation, the Scheidmantel approach creates an incentive for trustees to conduct a factual investigation. Neverthe-

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186 See generally id. § 90 (omitting discussion of a standard of review for courts).
187 Although the Restatement (Third) itself does not discuss standard of review, Jeffrey Gordon, one of the intellectual leaders in the effort to abandon the old rule, explicitly rejects the notion that the standard of review for trustee imprudence should resemble the business-judgment rule. See Gordon, supra 22, at 94–96 (contrasting the potential for market monitoring of corporate fiduciaries with the reduced potential for market monitoring of trustees).
189 Id. at 483 (emphasis omitted).
190 See id. at 490 (holding the trustee liable for gross negligence when the trustee acquired assets with greater capital-gain potential and less immediate income without ever examining the circumstances of the life beneficiary, who was then in a nursing home and in deteriorating health).
less, once the trustee conducts the examination, the court still must decide whether to defer to the trustee's investment decisions or to engage in substantive oversight.  

Deference avoids embroiling courts in making investment decisions beyond their competence, but a deferential approach imposes little discipline on trustees. Under prior trust law, the prospect of liability for making speculative investments limited a trustee's incentive to take risks. Without a significant prospect of liability, a trustee seeking new business has an incentive to invest in enterprises that promise high returns even if significant risk accompanies the high expected return. The trustee will then be able to advertise high returns to attract prospective clients. Conversely, if the market drops, the trustee will not suffer significant comparative disadvantage because even more cautious trustees would be unlikely to advertise heavily that, over the previous years, their investment strategy lost relatively little of the trust's value. In other words, the trustee benefits more from the upside gain on a risky investment strategy than he or she suffers from any market losses. Moreover, because trustees generally are likely to be overly optimistic about their own investment skills, trustees, if unconstrained, are likely to invest too aggressively. As a result, market forces are unlikely to be adequate to constrain trustee behavior, and a highly deferential approach subjects a trustee to few constraints other than market forces.

Thus, even if one accepts the strongest version of the ECMH, a highly deferential approach might lead trustees to expose the trust portfolio to excessive market risk. But if one accepts the ECMH, trust beneficiaries will at least receive compensation with a greater expected return. If, however, one is skeptical of the ECMH, the agency-cost problem is more serious; the trustee has the same incentive to invest aggressively, but the aggressive investments do not necessarily compensate trust beneficiaries for excess risk by providing a greater expected return.

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191 For instance, if the trustee in Scheidmantel investigated the life beneficiary's circumstances and then decided to invest in assets with greater capital gain potential because the life beneficiary's future needs would be small and the potential gains to remaindermen significant, a deferential approach would insulate the trustee from liability, while a more active approach would result in the court's engaging in a de novo review of the prudence of the investment decision.

192 See Leslie, supra note 147, at 99 (discussing how applying a version of the business-judgment rule to trust law is not appropriate in the trust-law context); see also Sitkoff, supra note 5, at 656-57 (discussing how deference is not justifiable in the trust-law context as distinguished from the business-judgment-rule context).

193 See Gordon, supra note 22, at 82-83 (discussing the incentive structure trustees face).

194 See Dobris, supra note 25, at 500-01 (observing that humans, in particular investors, are naturally optimistic).
An alternative approach to the deferential approach—and similarly consistent with the language of the *Restatement (Third)* and the UPIA—would have courts examine the circumstances of the trust beneficiaries to determine their risk tolerance and then would evaluate the fit between the portfolio and the risk tolerance of the beneficiaries. If courts adopted this approach, concerns about liability now would induce trustees to be more careful in fitting the investment portfolio to the needs of the trust beneficiaries. But because the approach taken by the *Restatement (Third)* is standard based, greater attention to the needs of the beneficiaries would not provide complete protection against liability. First, in a standard-based regime, no course of action is completely “safe” for the trustee. Beneficiaries might bring an action against the trustee either for investing too conservatively or too aggressively. So long as the trustee’s actions are governed by a standard rather than a rule, no amount of care completely eliminates the trustee’s liability risk. The “hindsight bias” inherent in after-the-fact judicial review exacerbates the problem. Even if a course of action is prudent when chosen, it often looks imprudent to a decision maker who has information that was not available at the time the course of action was taken. Although the *Restatement (Third)* warns against the hindsight bias, the warning alone may be insufficient to make the bias disappear.

The problem with a regime in which a trustee faces liability that he or she cannot take reasonable steps to avoid is that trustees generally will charge higher fees to cover potential liability. This situation will price some trust settlors (particularly settlors of smaller trusts) out of the trust market even though there are no efficiency reasons for depriving those settlors of the power to create a trust. The natural response by trustees will be to include exculpatory clauses, which relieve the trustee of all responsibility for investment decisions and leave trust beneficiaries without an effective mechanism to police trustee investment decisions. Although cases citing the *Restatement (Third)* and the UPIA remain small in number, a few of these cases suggest

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195 See *Restatement (Third) of Trusts* § 90 (2007) (stating that the trustee must make “reasonably suitable” investments and implying a reasonable range between conservative and aggressive).


197 Cf. id. at 573–74 (arguing that the hindsight bias could “induce[] judges and juries to hold liable defendants who actually took reasonable care”).

198 *Restatement (Third) of Trusts* § 90 cmt. b.

199 For a discussion of the difficulties with excessively broad exculpatory clauses, see Leslie, supra note 147, at 100–04.
that exculpatory clauses have become a common approach for dealing with the uncertain liability facing trustees.\textsuperscript{200}

D. An Alternative: The "Safe Harbor" Approach

How can trust law doctrine improve on the approach to agency costs reflected in the UPIA and the \textit{Restatement (Third)}? That is, how can trust law induce trustees to be more responsive to the investment objectives of the trust settlor and to the financial needs of the trust beneficiaries? One answer is to develop a set of rule-like safe harbors that provide trustees with significantly more guidance than current law while simultaneously providing incentives for the settlor and the trustee to discuss and agree on a trust investment strategy at the time the settlor creates the trust.

If the UPIA and the \textit{Restatement (Third)} address the agency-cost problem at all, they do so by enforcing standards for trust investment behavior rather than by articulating hard-edged rules.\textsuperscript{201} The arguments for eschewing rules in the UPIA and the \textit{Restatement (Third)} echo some of the arguments against rules in other areas of law. First, even if all trusts had identical investment objectives, neither legislators nor legal scholars know enough about wise investment strategies to dictate rules to trustees.\textsuperscript{202} Second, trusts do not have identical objectives; in particular, trusts have very different risk tolerances.\textsuperscript{203} As a result, a uniform rule to govern all trust investment will generate bad investment decisions. Furthermore, the diversity of trust objectives makes it impractical to develop \textit{ex ante} rules that are optimal for the circumstances of each individual trust.\textsuperscript{204}

One cannot evaluate the objections to rules, however, without considering two alternative mechanisms for controlling agency costs: market-based discipline of trustee investment behavior and the standard-based approach taken by the UPIA and the \textit{Restatement (Third)}. Market discipline would require unrealistic assumptions, and the stan-

\textsuperscript{200} See, e.g., Ams. for the Arts v. Ruth Lilly Charitable Remainder Annuity Trust, 855 N.E.2d 592, 595 (Ind. Ct. App. 2006) (excusing the trustee from failure to diversify based on trust language providing that “any investment made or retained by the trustee in good faith shall be proper despite any resulting risk or lack of diversification or marketability and although not of a kind considered by law suitable for trust investments” (emphasis omitted)).

\textsuperscript{201} See supra note 2.


\textsuperscript{203} See \textit{Restatement (Third) of Trusts} § 90 cmt. e.

\textsuperscript{204} See Kaplow, supra note 202, at 595 (“[W]hen each instance (no one very likely to occur) is unique in important ways, substantial \textit{ex ante} analysis for each conceivable contingency would be a poor investment, whereas \textit{ex post} determinations under standards are made with the knowledge that the scenario has indeed arisen.”).
standard-based approach would generate uncertainty for trustees and potentially higher costs for settlors and beneficiaries. Against that background, a regime that creates some rule-like safe harbors appears quite attractive.

Assume for now that all of the tenets of modern portfolio theory and the ECMH are true; that is, assume that every investment is a suitable investment. The drafters of the UPIA and the Restatement (Third) recognized that even with those assumptions, the trustee must manage risk in a manner suitable to the particular trust. Suppose, however, that the UPIA and the Restatement (Third) were amended to include, either in black letter or in a comment, something similar to the following language: no trustee shall be liable for exposing the trust or its beneficiaries to excessive market risk if the trustee limits the trust's investment in equities to 60 percent of the aggregate trust portfolio. Adding this language would not expose trustees to additional liability but instead would create a "safe harbor" for trustees.

Consider the advantages of such an approach. First, the safe harbor would provide a blueprint for trustees seeking to avoid liability. A trustee who took advantage of the safe harbor would avoid both the expense of legal advice and the threat of liability that the trustee would face in a de novo review regime, under which a court would examine substantively the prudence of the trustee's investment decisions. Because these costs would otherwise be passed on to the trust settlor or the trust beneficiaries (or both), the safe-harbor approach would make trusts more affordable than they would be in a regime that imposed more risk on the trustee.

At the same time, superimposing a safe-harbor provision on a regime that otherwise carefully scrutinizes investment decisions mitigates agency costs far better than a regime in which courts defer to

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205 See Sunstein, supra note 202, at 976 (discussing planning advantages of rules); see also Kaplow, supra note 202, at 562–63 ("[S]tandards are more costly for legal advisors to predict or enforcement authorities to apply because they require later determinations of the law's content.").

206 See Restatement (Third) of Trusts § 90(a) (recommending that the prudent investment standard not be applied in isolation but should take into account the objectives of that particular trust).

207 Joel Dobris suggested that, as a matter of practice, trustees might be well-advised "to get a 60/40 portfolio and get some sleep." Dobris, supra note 25, at 504. In a 60/40 portfolio, the 60 percent could be equity or debt depending on how aggressive the investor chooses to be. Id. Graham earlier suggested that an intelligent investor should never place less than 25 percent or more than 75 percent of his or her investments in common stocks. Graham, supra note 26, at 89.

208 Some states have developed rules in related fields designed to provide similar blueprints. For instance, a Vermont statute governing a guardian's control of the assets of a minor provides that "not more than 50 percent of the cash resources may be invested in corporate bonds rated AAA by Moody and in common stocks listed on the New York Stock Exchange." VT. STAT. ANN. tit. 14, § 2653 (2002).
trustee decisions. If the primary concern in a regime regulated by only the market is that trustees will pursue high expected returns even if the risk associated with those returns is not in the interest of trust beneficiaries, a safe harbor regime addresses that concern by providing an incentive to limit equity investments to the amounts encompassed in the safe harbor. Because the trustee bears much of the risk associated with departing from the safe harbor and generates only a small percentage of the benefits, the incentive to use the safe harbor is strong.

The safe-harbor mechanism need not be restricted to investments that subject the trust to excess market risk. Another safe harbor might provide the following: no trustee shall be liable for exposing the trust or its beneficiaries to excessive inflation risk if the trustee invests at least 40 percent of the aggregate trust portfolio in equity investments. Again, the trustee seeking to avoid liability would be well advised to follow the safe harbor even if no formal rule requires it to do so.

Consider now the principal objections to such a safe-harbor regime (or one like it). One potential objection is that rule makers—particularly legislators, with the aid of experts and lobbyists—do not have enough information about optimal investment strategies to craft sensible rules. Were it not for the inadequacy of market discipline, the absence of reliable information about investment strategies might be a plausible argument for deference to the decisions of trustees. It is not, however, an argument that a standard-based regime would be preferable to the safe-harbor approach. In a standard-based regime, legal decision makers will ultimately have to evaluate the prudence of particular investment strategies. Typically, they will have a little more information about the prudence of particular strategies after the investments are made; namely, they will have more information about investment results, thus generating the potential for hindsight bias—a problem mitigated by a legal regime that provides trustees with ex ante safe harbors.

A second objection focuses on the inadequacy of one-size-fits-all safe harbors to account for the disparate needs and risk tolerances of trusts set up for a multitude of different purposes. A partial response to this objection is that if a trustee concludes that safe harbors are unsuitable for the needs of its trust, the trustee will not be held liable for losses resulting from a different strategy if the trustee can demonstrate why the safe-harbor strategy was unsuitable. The response is in-

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209 Even if the legal regime formally does not hold a trustee liable for losses resulting from departures from the safe harbor, the very existence of a safe harbor may, as a practical matter, impose on a trustee an obligation to explain why the trustee did not use it, thereby increasing the risk to the trustee who invests more in equities than the amount specified in the safe harbor.
complete, however, because whatever the needs of the trust, the trustee’s incentives will be to use the safe harbor and to avoid the prospect of liability. A better response is that the trustee can always protect against liability by ensuring that language in the trust instrument authorizes trust investment practices that differ from those qualifying for safe harbors. Courts should enforce such authorizations so long as their language is sufficiently definite to put the trust settlor on notice of the investment strategy the settlor is authorizing. Alternatively, the trustee can protect himself or herself by obtaining consent from the trust beneficiaries.

To recapitulate, traditional trust doctrine, in an effort to protect trust beneficiaries against excessive risk taking, ignored agency costs and thus created an incentive for trustees to ignore the inflation risk facing trust beneficiaries. The trust law reform movement—embodied in the Restatement (Third) and the UPIA—"solved" this problem by eliminating all categoric restrictions and by imploring trustees to consider the risk tolerance of their trusts. In doing so, the reformers inadvertently created a new agency-cost problem: they incentivized trustees to overemphasize potential return even at the cost of excessive risk. Two significant bear markets have made the effects of trust law reform all too concrete for many trust beneficiaries. A rule-based safe-harbor approach would not have shielded beneficiaries from all losses and will not prevent future losses, but such an approach has a greater potential to reduce agency costs than does the current version of the prudent investor rule.


The analysis so far has assumed that the standard-based prudent investor rule generates agency costs that a change in trust law doctrine might reduce. Even so, why would doctrinal change matter? If the Restatement (Third) and the UPIA generate agency costs, settlors and trustees will contract around those provisions and into a regime that maximizes their joint benefit (and derivatively, the benefit of trust beneficiaries). For the most part, the terms of the trust are subject to contract, and the provisions impose few constraints on the parties who seek to individualize the features of the trust relationship they create.

210 See supra Part I.A.
211 See supra Part I.B-C.
212 See supra Part II.B.
213 See generally Gordon, supra note 22, at 75–76 (discussing the increasing frequency of trust provisions contracting around the prudent man rule, and noting in particular that "large trusts are likely to receive sophisticated legal advice and thus will often contract out of the Rule").
The contract argument, however, proves too much. If default rules were indeed irrelevant, there would have been little need to promulgate the Restatement (Third) and the UPIA because parties could have contracted around the old prudent man rule. The Restatement (Third) and the UPIA would not have affected trust practice because the parties to any trust would have contracted for an individualized, optimal regime, regardless of the default regime in place. But Schanzenbach and Sitkoff have demonstrated persuasively that the change in law did generate a change in trust investment practice; when states adopted the UPIA, trustees invested a higher percentage of trust portfolios in equities than before the adoption of the statute.\footnote{See Schanzenbach & Sitkoff, supra note 11; see also Shattuck, supra note 23, at 501-04 (cataloguing the movement of states towards the Massachusetts prudent man rule in response to the more substantial investment returns available in those states as compared with "legal list" states).}

Default rules matter for a number of reasons.\footnote{Default rules help reduce transaction costs if they give the parties what the parties would have agreed to if forced to negotiate. See generally John H. Langbein, The Contractarian Basis of the Law of Trusts, 105 Yale L.J. 625, 653–57 (1995) (pointing out that default fiduciary rules allow settlors and trustees to control agency costs associated with trust asset management without having to dictate specific fiduciary behavior in advance).} First, legal norms help frame the decisions of affected parties. If parties are confronted with the content of legal norms, they are more likely to hew closely to those norms than if law provides no guidance.\footnote{Of course, as Melanie Leslie emphasizes, if norms are embodied only in default rules there is a greater danger of norm erosion than if those rules are mandatory. See Leslie, supra note 147, at 91–92. But if the default rule provides the trustee with a safe harbor, the trustee has reason to use the safe harbor rather than contract around it.} When the old prudent man doctrine frowned on equities, trustees and beneficiaries did not abandon conservative investments even though contract would have permitted them to do so; similarly, if doctrinal norms suggested a maximum percentage of equities permitted in trust portfolios, parties likely would treat that percentage as an indicator of prudent practice.

Second, default rules can redress information asymmetries and lead to agreements that better reflect the expectations of both parties. If one party to an agreement is a repeat player who is informed fully about the legal regime but the other party is not, a default rule that favors the uninformed party may induce the repeat player to disclose information he or she would otherwise not disclose.\footnote{See Ian Ayres & Robert Gertner, Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules, 101 Yale L.J. 729, 759–61 (1992); see also Sitkoff, supra note 5, at 643 (arguing that default trust-governance rules not only serve the protective and cautionary functions but also ensure that third parties who transact with the trustee can easily ascertain whether property in the possession of the trustee belongs to the trustee personally, is held in trust, or is held in some other limited form).} Thus, in the trust context, in which trustees are repeat players, a default rule that
relieves trustees from liability could lead trustees to withhold information about aspects of their behavior that might adversely affect trust beneficiaries.\textsuperscript{218} For that reason, any fiduciary-duty rule is likely to be preferable to a no-duty regime because it induces trustees to seek exculpatory clauses and increases the likelihood that the trustee will have to explain the need for such a clause to the beneficiary, thus reducing information asymmetries.\textsuperscript{219}

A standard-based fiduciary-duty rule, however, makes it easy for a trustee to paint with a broad brush and explain only that the clause is necessary to protect the trustee against the litigation risk that arises from doctrinal uncertainty. By contrast, with a regime of rule-based safe harbors, the trustee who seeks an exculpatory clause more likely will have to explain that the default rule would hold the trustee liable only if the trustee departed from established investment guidelines. That disclosure, in turn, could lead to a discussion about the merits of those investment guidelines and the scope of any exculpatory clause.\textsuperscript{220} As a result, even though free contract is possible under the current standard-based regime, the safe-harbor regime may reduce the incidence of overbroad exculpatory clauses and increase the protection available to trust settlors and beneficiaries.\textsuperscript{221}

F. What If Capital Markets Are Not Efficient?

The preceding subpart identified factors that are likely to lead trustees to take too much risk even assuming that risk generally correlates with return and that market price reflects a security's long-term

\textsuperscript{218} Cf. Melanie B. Leslie, Common Law, Common Sense: Fiduciary Standards and Trustee Identity, 27 Cardozo L. Rev. 2713, 2737 (2006) (arguing that a rule holding trustees strictly liable for the acts of their agents would encourage trustees to disclose information about potential delegation issues to the settlor during the negotiation process and seek beneficiary approval prior to delegating, whereas a negligence-based liability or a no-liability rule would exacerbate the information asymmetry).

\textsuperscript{219} If default rules were designed to duplicate the rules that parties select in actual agreements, one might conclude that the default rule should exculpate trustees from investment losses in order to save the parties the transaction costs of including an exculpatory clause. But, here, a default rule imposing liability on trustees serves as an information-forcing device. By making the rule one of liability, common law forces the trustee to come forward—at least with language in the trust instrument—and put the settlor (or the settlor’s lawyer) on notice of the rule.

\textsuperscript{220} Although one might expect a settlor’s lawyer to protect the settlor’s interests in all cases, trustees prepare some trust instruments, and settlors sign these trust instruments unrepresented; in other cases, a settlor’s lawyer may be concerned about maintaining a relationship with a trustee who might be a source of future business. See Leslie, supra note 147, at 85–87.

\textsuperscript{221} Although courts generally enforce exculpatory clauses in trust instruments, courts typically will construe those clauses strictly. See 3 Scott & Fratcher, supra note 79, § 222.2. For instance, a trust document that allows the trustee to “retain” assets that would not be suitable for trust investments may not be sufficient to overcome the trustee’s duty to diversify. See Wood v. U.S. Bank, N.A., 828 N.E.2d 1072, 1074, 1079–80 (Ohio Ct. App. 2005).
value. But the subpart also suggests that it would be more effective to approach those problems by providing trustees with incentives to limit the percentage of the portfolio invested in equities. Part II, however, identified problems with two of the basic premises of the trust reform movement. First, the supposed correlation between risk and reward does not flow inevitably from any mathematical axiom; depending on the psychology prevalent among investors at any given time and in any given place, risky investments may or may not have to promise higher returns to attract investors. Second, today’s market price of a firm’s stock reflects, at least in part, psychological biases of investors that have little relationship to the firm’s long-term value. Especially for firms that do not have a significant track record, risks and returns can be so uncertain that there is little basis for believing that adding the firm’s stock to the trust portfolio will increase the portfolio’s expected return or reduce the portfolio’s risk.

The uncertain correlation between risk and reward only strengthens the case for encouraging trustees to limit the market risk of trust portfolios. If increased risk were inevitably correlated with increased expected return, a prudent trustee always would want to assume as much market risk as the trust beneficiaries could tolerate. The reason for limiting the trustee’s ability to assume risk would rest entirely on the trustee’s business incentive to sacrifice safety for increased expected return. But if increased risk does not always correlate with increased expected return either because many investors are risk neutral or risk preferring or because investors systematically underappreciate some kinds of risk, then the reasons for limiting the trustee’s power to assume market risk extend beyond agency-cost reduction.

Attacking the correlation between market price and expected value presents a serious challenge for the modern theory of trust investing—a challenge that cannot be met merely by limiting the trust’s investment in equities. If, contrary to the teachings of the ECMH, a sensible and prudent investor can detect the market imperfections that lead the market to overvalue particular securities, then those securities do not belong even in a diversified trust portfolio. Similarly, if the prospects of some start-up firms are so uncertain that their impact on overall risk and return is impossible to assess, stock of such firms does not belong in a trust portfolio.

If one rejects the strongest forms of the ECMH, the problem is not merely one of excess market risk. Instead, with respect to some firms, the firm-specific risk is not worth taking. If the firm’s problem is overvaluation compared to other investments in the trust portfolio,

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222 See supra Part II.A.
223 See supra Part II.A.2.
224 See Graham, supra note 26, at 142–43.
adding the firm's stock to the trust portfolio decreases expected return compared to other investments that might also diversify the portfolio. If the problem is uncertainty about the firm's prospects, the investor has no adequate basis for concluding that the stock will either increase return or reduce the diversifiable risk of the total portfolio.

Trustees who engage in active management of the trust portfolio implicitly reject, at least in part, the ECMH.\textsuperscript{225} If they accepted the strongest form of the ECMH, there would be no reason to try to "beat the market" through active management. The Restatement (Third) and the UPIA both authorize active management by trustees.\textsuperscript{226} The text of the reform documents does not provide an adequate incentive for trustees who engage in active management to avoid overvalued investments and investments where past performance provides too little insight into risk and return. Perhaps, however, courts could construe the documents to provide such an incentive. The Restatement (Third) explicitly requires that the prudent investor standard "be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy."\textsuperscript{227} Because a trustee who actively manages the trust portfolio rejects the "buy the market" strategy consistent with the ECMH,\textsuperscript{228} the trustee must demonstrate how each investment in the portfolio contributes to the trustee's overall investment strategy. Even derivatives, often condemned for their speculative nature, can have a place in a trust portfolio if the trustee demonstrates that the derivatives play a role in hedging portfolio risk.\textsuperscript{229} If the trustee cannot demonstrate how adding a particular investment to the portfolio increases expected return or diminishes the risk of the remainder of the portfolio, then the trustee cannot demon-

\textsuperscript{225} Cf. Taleb, supra note 98, at 62–63 (describing the paradox of a supporter of efficient-markets theory's starting a hedge fund to take advantage of market opportunities).

\textsuperscript{226} See Restatement (Third) of Trusts § 90 (2007) ("The trustee has a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would . . . "); see also Unif. Prudent Investor Act § 1(a) (1994) ("[A] trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule . . . ").

\textsuperscript{227} Restatement (Third) of Trusts § 90(a).

\textsuperscript{228} See Taleb, supra note 98, at 62 (remarking on the inconsistency of a defender of efficient-markets theory's founding a hedge fund aimed at taking advantage of market inefficiencies).

\textsuperscript{229} See Robert J. Aalberts & Percy S. Poon, Derivatives and the Modern Prudent Investor Rule: Too Risky or Too Necessary?, 67 Ohio St. L.J. 525, 546 (2006) ("[D]erivatives can be used by fiduciaries to hedge the risk of trust investments because the future price of an investment can be predetermined in a derivative contract, thereby reducing the uncertainty of the future price of the investment."). Aalberts and Poon note, however, that not all derivatives are suitable for trust investments. See id. at 556–61 (concluding that forwards and swaps are not suitable trust investments because they are unregulated, present excessive default risk, raise issues about the duty of loyalty, and involve excessive trading cost).
strate the prudence of the investment.\textsuperscript{230} As a result, even if the trustee is not liable for incurring excess market risk (because the trustee used the "safe harbor" and invested enough in government securities and high-grade corporate bonds), the trustee may nevertheless incur liability for taking firm-specific risks without increasing expected return or decreasing the firm's overall diversifiable risk.

By contrast, even if the ECMH significantly overstates the accuracy of market valuation, the trustee who pursues a passive investment strategy—investing the trust portfolio in mutual funds or other pooled investments—should generally escape liability for indirect investments in securities that are undervalued or whose prospects are entirely uncertain. For many trustees, especially trustees of relatively small trusts, a passive strategy will be the only available path to adequate diversification of the trust’s portfolio.\textsuperscript{231} Even with larger trusts, the cost (including error cost) to investigate each holding in a mutual fund portfolio to excise inappropriate trust investments may make the strategy imprudent.\textsuperscript{232} Investing in mutual funds with mispriced securities will often be superior to the trustee's next-best alternative and should not subject the trustee to liability so long as the trustee selected the fund with care and also limited the total amount of his or her investment in equities. The courts should second-guess the trustee's individual investments only when the trustee pursues an active strategy, which would be prudent only if the trustee invests resources to investigate individual investments.\textsuperscript{233}

G. Delegating Investment Responsibility

Suppose a settlor appoints an individual trustee whose name happens to be Ezra Merkin. Merkin accepts appointment as trustee, but because he is less than confident of his own investment prowess, he turns the trust portfolio over to an individual named Bernard Madoff to make investment decisions. Madoff has a reputation as an invest-

\textsuperscript{230} See generally Haskell, supra note 97, at 109 ("It is inadvisable to allow trustees of family trusts to invest in volatile stocks in a small portfolio.").

\textsuperscript{231} Cf. id. at 110 ("[A] passive strategy of investing in a market fund... probably is safer than the selective diversification of low-risk stocks. In addition, it is likely to produce a greater return than the selection of stocks.").

\textsuperscript{232} See Barber et al., supra note 122, at 562 (suggesting that even if savvy investors could beat the market, transaction costs generally would dissipate the advantages of trying).

\textsuperscript{233} Graham warned against investors who sought to pursue a "middle ground" between passive and aggressive investing. Graham, supra note 26, at 175–76. He argued that successful pursuit of an active or aggressive investment strategy would require "considerable knowledge of security values." Id. at 175. For the investor who purports to have the knowledge that makes it plausible to obtain returns in excess of those available to a passive investor, liability should attach if the investor cannot offer a concrete justification for each component of a portfolio; the investor who rejects the premise that knowledge will generate higher returns has a more plausible explanation for holding a fund—particularly an index fund—that includes some components that appear imprudent.
ment genius and sends Merkin, as trustee, periodic statements of the trust's net worth. Years later, Madoff is exposed as the operator of a Ponzi scheme. Because he already paid out all of the money entrusted to him to investors who took their gains early, any remedy the trust has against Madoff is effectively worthless. As a result, the trust beneficiaries bring an action against Merkin for breaching his fiduciary duty. May the beneficiaries recover?

Under the common law of trusts, as reflected in the Restatement (Second), the answer was easy: Merkin improperly delegated his investment responsibility to Madoff and was liable to the trust beneficiaries as if he (Merkin) made off with the trust's money. The trust reform movement embodied in the Restatement (Third) and the UPIA reversed that result by expressly authorizing trustees to delegate investment decisions. That change was suspect when made and makes even less sense in light of recent history.

1. "Reform" and Its Rationale

As the range of permissible trust investments expanded and as persistent inflation made trust investment strategies more complicated, the prohibition on paying for investment assistance became problematic. Trustees became concerned that purchasing mutual funds—and thus paying for investment assistance with these funds—would violate the duty not to delegate trust duties. Trustees held this concern because others might construe fees associated with the mutual fund as "double dipping"—paying two different parties for investment assistance—because the trust paid the trustee's fee in addition to the mutual fund fee but the trustee's fee was supposed to include compensation for investing the trust portfolio. Many jurisdictions enacted statutes to deal with the mutual-fund problem, but the issue was broader. Many trustees needed investment advice, and that advice (like legal advice) was not likely to be available for free.

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234 See Restatement (Second) of Trusts § 171 (1959).
235 See Unif. Prudent Investor Act § 9(a) (1994) ("A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances."); Restatement (Third) of Trusts § 80(1) (2007) ("A trustee has a duty to perform the responsibilities of the trusteeship personally, except as a prudent person of comparable skill might delegate those responsibilities to others.").
236 See generally John H. Langbein, Reversing the Nondelegation Rule of Trust-Investment Law, 59 Mo. L. Rev. 105, 106-10 (1994) (discussing reasons underlying the nondelegation rule, including the concern about "double dipping").
237 See id. at 108 (describing "double dipping" as a concern that, because "the trustee is charging for investment services, the trust should not have to pay again to have an outside investment manager do the job").
238 See id. at 106-10 (explaining the prohibition on "double dipping" as a protection against overcharging).
Langbein, among others, recognized that the prohibition on double dipping was a silly way to control a trust's administration expenses.\textsuperscript{240} Especially as contract law replaced statutory law as the basis for setting trustee fees,\textsuperscript{241} a prohibition on double dipping served little purpose; the trustee could obtain the same compensation by increasing fees and paying investment advisors out-of-pocket.\textsuperscript{242} Thus, directly addressing any concern about the reasonableness of trustee fees is better than addressing that concern by prohibiting double dipping.

In addressing the problem, however, the Restatement (Third) and the UPIA went beyond authorizing trustees to pay for investment advice. Instead, they expressly authorized trustees to delegate investment responsibilities. The trustee no longer was responsible for the wrongdoing of his or her chosen delegate.\textsuperscript{243} The trustee could discharge his or her duty and avoid further liability by acting prudently in selecting the delegate and monitoring the delegate's activity.

2. Analyzing the Delegation Problem

Neither the Restatement (Third), the UPIA, nor the commentary that accompanied reform of the "no delegation" rule clearly stated the issue at stake: if a trustee delegates investment duties, who—the trustee or the trust beneficiaries—should bear the loss that results from

\textsuperscript{240} Langbein, supra note 236, at 108 (criticizing the prohibition on "double dipping" as a clumsy tool).

\textsuperscript{241} For instance, in New York, trustee fees generally are governed by section 2309 of the New York Surrogate's Court Procedure Act, which includes a statutory fee schedule. See N.Y. Surr. Ct. Proc. Act Law § 2309 (McKinney 1997). In 1984, however, the New York legislature enacted section 2312 of that act, which provides:

If the will or lifetime trust instrument makes provisions for specific rates for amounts of commissions . . . for a corporate trustee, or, if a corporate trustee has agreed to accept specific rates or amounts of commissions, a corporate trustee shall be entitled to be compensated in accordance with such provisions or agreement, as the case may be.


\textsuperscript{242} Indeed, today many legislatures and the Uniform Trust Code even authorize a corporate trustee to invest in the trustee's own proprietary mutual funds, a situation resulting in double compensation for the trustee. For criticism of these statutes, see Melanie B. Leslie, In Defense of the No Further Inquiry Rule: A Response to Professor John Langbein, 47 Wm. & Mary L. Rev. 541, 567-79 (2005).

\textsuperscript{243} The UPIA provides expressly that "[a] trustee who complies with the requirements of subsection (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated." Unif. Prudent Investor Act § 9(c) (1994). Subsection (a) requires the exercise of reasonable care in selection of the agent: "establishing the scope and terms of the delegation" and "periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation." Id. § 9(a)(2)-(3); see also Restatement (Third) of Trusts § 80 cmt. g (2007) (providing that a trustee who delegates a function to an agent and acts with prudence is not personally liable for decisions by the agent and discussing the trustee's duty to monitor the agent's performance).
the delegate’s wrongdoing if the delegate proves insolvent or unavailable? If the delegate is solvent and available, the delegate ultimately will bear the loss even under the common-law regime; the trustee has a claim against the delegate for conversion (if the delegate had misappropriated trust monies) or for breach of contract (if the delegate failed to comply with the trustee’s investment instructions). Of course, even a solvent delegate might avoid liability if the trustee failed to provide the delegate with sufficiently clear instructions, but in that case, under either regime, the beneficiaries should not bear a loss that the trustee easily could have avoided by providing proper instructions to the delegate.

If the principal risk at issue is the risk of delegate insolvency, the natural question to start with is which party—the trustee or the trust beneficiaries—was in a better position to assess and avoid that risk? The issue is an easy one: the trustee selected the delegate and had the opportunity to investigate the delegate’s background and financial condition, whereas the beneficiaries had no role in selecting or evaluating the delegate. Basic economic principles suggest placing the risk on the trustee—the party in the best position to avoid or to spread the risk.

By limiting the trustee’s liability for actions taken by the chosen delegate, however, the Restatement (Third) and the UPIA overreacted to a purported common-law rule that imposed strict liability on a trustee for all losses suffered by a beneficiary after an improper delegation. In their influential article, Langbein and Posner seized on language in Meck v. Behrens, a 1927 case suggesting that where an improper delegation has occurred, a trustee “becomes a guarantor and is responsible for any loss that may have resulted, whether or not such loss can be shown to be the result of the delegation.” Langbein and Posner then concluded that, “[a]s applied to trust investments, that theory would leave the trustee liable for every loss, however reasonable the investment when made. His breach of the duty of [nondelegation] would transfer the risk of the market from the trust to the trustee.” Langbein and Posner clearly were correct in condemning the broad principle articulated in Meck. The trustee is supposed to expose the trust to some degree of market risk, and, if the portfolio selected by

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244 Some cases have suggested that if the trustee’s delegate knew that the funds were trust funds and knew that the investments it selected were inappropriate trust investments, the beneficiaries have a claim against the delegate for aiding and abetting a breach of fiduciary duty. See City of Atascadero v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 80 Cal. Rptr. 2d 329, 342-43 (Cal. Ct. App. 1999).
245 See generally Leslie, supra note 218 (discussing trustee liability).
246 252 P. 91 (Wash. 1927).
247 Id. at 95, quoted in Langbein & Posner, supra note 36, at 19.
248 Langbein & Posner, supra note 36, at 19.
the delegate was a prudent one, neither the trustee nor the delegate should be liable for market losses because no wrongful action by either party caused the losses to the trust. Furthermore, to hold either party liable would generate significant agency-cost problems whenever the trustee delegates investment responsibilities: the beneficiaries would reap the benefits of investment gains while the trustee would suffer investment losses. This situation would cause the trustee not to delegate even though the trust beneficiaries would benefit from the delegate's supposed investment expertise.

*Meck*, however, did not involve losses from prudent investments. In *Meck*, the trial court found that the trustees had been "careless and negligent in their duties" and that the carelessness—not market risk taken by the delegate—caused the beneficiary's loss.\(^{249}\) Moreover, the cases relied on by *Meck* involved the core problem posed by delegation: who should bear the risk of insolvency of the trustee's chosen delegate? In each of those cases, the delegate breached a duty to the trust, and the court correctly concluded that the trustee, not the beneficiaries, should bear the loss.\(^{250}\) And in each of those cases, the delegation was a cause of the loss; the trustee, not the beneficiary, chose the insolvent delegate.\(^{251}\)

Langbein and Posner, then, made a persuasive case for absolving the trustee from liability for market losses when neither the trustee

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\(^{249}\) *Meck*, 252 P. at 93. In *Meck*, the complaining beneficiary held a 1/28 interest in a trust corpus valued at more than two hundred thousand dollars. See id. at 93–94. The trust property was ready for distribution, except that the trust instrument directed that distribution be delayed for ten years. See id. at 92. The trustees then entered into a contract with a trust company for management of the assets, and, ultimately, the trustee distributed less than six hundred dollars to the beneficiary, leading to the beneficiary's lawsuit. See id. at 93. The trial court, as noted in the text, concluded that the loss resulted from carelessness and negligence of the trustees. See id.

\(^{250}\) The *Meck* court relied on four American cases. See id. at 95. In the first of those cases, *McCollister v. Bishop*, 80 N.W. 1118 (Minn. 1899), the court ultimately relied on a statute absolving the assignee of an insolvent corporation from liability for depositing monies in an authorized depository. See id. at 1119. In the other three cases, where the court found liability for improper delegation, the delegate breached its obligation to return deposited funds to the fiduciary. In each case, the delegate was a bank that became insolvent. And in each case, the court held that the fiduciary was liable to its beneficiary for the loss of the deposited funds. See *In re Wood's Estate*, 114 P. 992, 993–94 (Cal. 1911); *Fid. & Deposit Co. of Md. v. Butler*, 60 S.E. 851, 852, 859 (Ga. 1908); *U.S. Fid. & Guar. Co. v. Taggart*, 194 S.W. 482, 482–83 (Tex. Civ. App. 1917).

\(^{251}\) See *Shriners Hosps. for Crippled Children v. Gardiner*, 733 P.2d 1102, 1106 (Ariz. Ct. App. 1986) ("Generally, a court will not surcharge a trustee if there is no causal connection between the breach of duty and the loss."), vacated, 733 P.2d 1110 (Ariz. 1987). The court held, however, that when trustee delegates to a delegate who embezzles, the trustee is liable because the trustee has offered "no evidence indicating how the loss would have occurred without her breach of trust." See id.
nor the delegate takes any wrongful action. Their criticism of Meck, though, does not explain why the beneficiaries should bear the liability when the delegate acts wrongfully. Are there countervailing reasons to place the risk of loss on the trust beneficiaries rather than on the trustee? The limited commentary on the liability issue emphasizes two incentives the new rule would generate. First, persons without investment expertise would be more willing to accept appointment as trustees. Second, trustees would become more willing to delegate investment responsibility to those with greater expertise.

Consider first the argument that the "modern" rule embraced by the Restatement (Third) and the UPIA provides appropriate incentives for trustees to employ investment advisors with greater expertise. Freedom from liability for the advisor's wrongdoing is not necessary to provide that incentive. Even if the trustee who hires an investment advisor remained liable for the advisor's wrongdoing, the trustee would still hire the advisor if the trustee believed the advisor's assistance would reduce the trustee's own expected liability. That is, where the trustee is unsure of his or her own investment prowess and is fearful to make errors that could cause losses to the trust that subject him or her to liability, the trustee has personal incentives to seek advice that reduces that liability. So long as the trustee is free to pay for the advisor's services out of the proceeds of the trust, the trustee has every reason to hire the advisor.

Moreover, freeing the trustee from liability encourages trustees who do have investment expertise to delegate investment responsibilities. By delegating, the trustee shifts liability risk to the delegate—and, in the case of the delegate's insolvency, to the trust beneficiaries—without losing the right to collect commissions. That is, under the Restatement (Third) and the UPIA, there is every reason for even a professional trustee to delegate investment responsibility to the detriment of trust beneficiaries.

Relieving the trustee from liability has another potentially pernicious effect: the investment advisor, by inclination and training, may be less cautious than the trustee and more willing to embrace an investment strategy that seeks higher returns at higher risks. The invest-

252 Cf. Langbein & Posner, supra note 36, at 19 (discussing the unfavorable result under the duty not to delegate that the trustee's "breach of the duty of nondelegation would transfer the risk of the market from the trust to the trustee").
253 See generally Langbein, supra note 236, at 110 (discussing reasons for allowing trustees to delegate certain aspects of trust administration).
254 See generally id. (discussing how the nondelegation rule prevented "open discussion of the standards and safeguards appropriate to delegation").
255 See Leslie, supra note 218, at 2736 ("[I]f the trustee knows it lacks the skills to handle particular investment duties, delegating will be a superior choice to not delegating, even if the trustee will face liability for the agent's acts.").
256 See id.
ment advisor is even more likely than the trustee to market his or her services by emphasizing past returns and to take risks that have the potential to generate those returns. Moreover, norms within that industry may differ from norms among lawyers or other professional trustees and thus may exacerbate the incentives to take an aggressive approach with trust funds created by the Restatement (Third) and the UPIA.

The second argument for the “modern” rule that absolves trustees of liability if they prudently delegate trust responsibilities is that the rule will encourage family members to serve as trustees if they are reluctant to risk personal liability for imprudent investment decisions. This argument is, at first glance, more plausible because, by accepting appointment as trustee, a family member does assume a risk of liability he or she otherwise would not bear. Nevertheless, that concern can be addressed easily in other ways. First, the settlor who anticipates the problem instead can name a professional trustee and can direct the professional trustee to abide by the family member’s instructions with respect to distribution decisions—the area in which the settlor presumably wants the family member’s judgment.257 Second, the settlor could name co-trustees and provide expressly that the professional trustee and not the family member has power to make investment decisions.258 Third, even if the settlor does not anticipate the problem, if the family member expresses concern about taking on trust responsibilities, a court (rather than appointing a substitute trustee) can appoint a co-trustee and can relieve the family member of investment responsibility.259 In light of these other potential solutions, it is difficult to justify a rule that absolves all trustees from liability for delegating investment responsibility on the theory that without such absolution family members are reluctant to serve.260

257 In effect, the settlor could give the family member a power of appointment over trust income or corpus. See generally Restatement (Third) of Property: Wills and Other Donative Transfers § 17.1 & cmt. f (Tentative Draft No. 5, 2006) (discussing the power to direct a trustee to distribute income or corpus to another party).

258 See Restatement (Third) of Trusts § 81 cmt. b (2007) (“[T]rust provisions may and often should allocate roles and responsibilities among the trustees, or relieve one or more of the trustees of duties to participate in particular aspects of the trust’s administration.”).

259 Cf. Restatement (Third) of Trusts § 34 cmt. e (2003) (authorizing a court to appoint additional trustees, even when there is no vacancy, when the appointment of additional trustees would promote better administration of the trust).

260 A more plausible approach would be to authorize explicitly family member trustees, but not professional trustees, to delegate investment decisions. See Leslie, supra note 218, at 2738. As Leslie points out, that approach probably reflects the rule most settlors would prefer. See id. In addition, family members are less likely to have the background knowledge to insist on trust language that qualifies the default rule. See id. The principal disadvantage of such a bifurcation would be a line-drawing problem: should the family friend or family lawyer (who also happens to be a family friend) be exempt from liability for delegations that generate losses to the trust?
Although the justifications advanced for the rule authorizing delegation of investment responsibilities were all focused on the family member-trustee, the rule itself was broader in scope, applying equally to professional trustees and individual trustees. No persuasive reasons have been advanced for permitting professional trustees to avoid liability to trust beneficiaries by the device of delegating investment responsibility to investment advisors. Yet the *Restatement (Third)* and the UPIA sanction that result.

In a stable or rising market, most beneficiaries are unlikely to be hurt substantially by the *Restatement (Third)* rule. Actions for imprudent investing tend to be less frequent. Fewer investment advisors become insolvent—especially those prudently selected by the trustee. As a result, the *Restatement (Third)* rule does little harm. By contrast, in a falling market, in which investors are losing money and investment firms that cut corners to generate high returns now find themselves in serious financial straits, the *Restatement (Third)* rule does threaten to harm innocent beneficiaries without generating any obvious social benefits. The time has come to abandon that rule and replace it with one that entitles a trustee to seek and to pay for investment advice but leaves the trustee as a guarantor for any breaches committed by the investment advisor.

**Conclusion**

The reformers who drafted the *Restatement (Third)* and the UPIA took on a serious problem that badly needed a solution. The solution that they devised relied on and promoted academic theories with impeccable pedigrees; the theories generated Nobel Prizes for their proponents. The solution appeared to promise better returns and less risk for trust beneficiaries who were the principal victims of the straitjacket placed on trustees by traditional trust doctrine. And the solution—coincidentally or not—appeared to benefit banks and trust companies by reducing their exposure to liability for imprudent investments.

Unfortunately, like many of the investments made by trustees under the new regime, the doctrinal solution proved too good to be true. The academic theory needs revision, the beneficiaries need additional protection, and even the banks may discover that the new regime leaves them exposed to liability. My goal with this Article was to start the debate about how to construct such a substitute regime.