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From the Desk of the President

Thank you for the honor of representing the National College of Probate Judges as president this year. The canceling of the 2020 NCPJ Spring Conference was disappointing, albeit necessary. Though this year, the COVID-19 pandemic caused a widespread shutdown of courts, businesses, and gatherings of every sort, it enabled us all to draw our focus toward our families, our health, and perhaps even learning new skills.

Ironically, this highly contagious, sinister virus challenged us all to come together with the goal of keeping our distance. Social distancing created obstacles to the operation of courts everywhere. As you will read in this Journal, NCPJ members, Judge Tim Grendell and his staff attorney, Michael Hurst, along with Judge James Dunleavy, wrote about how the courts they oversee have continued to operate in compliance with social distancing guidelines. Drawing upon the diverse experiences of other judges and forging strong relationships with judicial colleagues is at the heart of NCPJ's mission. This esprit de corps greatly deepens our knowledge base, expands our range of experience, and enhances our ability to serve.

With optimism, we look forward to a time when the virus is in our rear-view mirror and we will once again enjoy the fellowship, support, and education that the National College of Probate Judges has offered its members since 1968.

Hon. Christine Butts, President of NCPJ

Christine Butts

Challenges For Probate Judges: Trust Investments and Diversification

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Financial markets and investments rise and fall over time, creating questions and concerns about the diversification of investments held by trusts. This is often complicated by a settlor's direction to maintain specific investments in the trust. When the amounts at stake are large enough, however these questions and concerns usually end in litigation for resolution by the courts.

The American Law Institute has adopted the *Restatement (Third) of Trusts* and the Prudent Investor Rule to present a more generalized standard governing trustees' investments. The drafters of the Prudent Investor Rule intended to modernize trust investment law and to restore the generality and flexibility of the original doctrine.

The thrust of the Prudent Investor Act is that the fiduciary shall invest and manage the trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the fiduciary shall exercise reasonable care, skill, and caution. The main innovation of the

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Prudent Investor Act is its incorporation of the "modern portfolio theory." The Act specifies that a fiduciary's investment and management decisions respecting individual assets shall not be evaluated in isolation but in the context of the trust portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

The Prudent Investor Act does impose an affirmative duty upon a fiduciary to diversify the investments of the trust unless the fiduciary reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying. See also *Restatement (Third) of Trusts* § 227(b): "In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so." These provisions depart from the former Prudent Person Rule, under which each particular investment made by a trustee could be subjected to scrutiny without regard to a trustee's overall investment strategy.

Thus, the duty to diversify is not absolute. The duty to diversify may be set aside if the objectives of prudent risk management and impartiality can be satisfied without diversifying. The duty to diversify may be set aside if the special considerations of a particular trust situation make it undesirable to diversify. *Restatement (Third) of Trusts* § 227 cmt. g. A common example stems from the transaction costs and tax consequences of diversification - *i.e.*, where the sale of assets for diversification might necessitate enormous tax or transaction costs. *Restatement (Third) of Trusts* § 229 cmt. a.

The Prudent Investor Act is a default rule that may be altered by the express provisions of the trust instrument, or in most states a court authorization.

The generality of these standards is best considered by assessing a sampling of cases from around the United States, especially in the context of diversification of investments - or the lack thereof.

Diversification without specific notice or approval led to significant damages in a recent New Jersey case.

***In re Trust of Post*, No. A-0929-16T1, 2018 WL 3862756 (N.J. Super. Ct. App. Div. Aug. 15, 2018).**

Plaintiff Valley National Bank ("VNB") filed an application for approval of a formal accounting. The remainder beneficiaries objected, complaining, *inter alia*, that VNB violated the terms of the trust by diversifying the trust portfolio in violation of the language of the trust.

The trust was a two-page document created in 1975. The grantor specifically provided that the trustee was to retain the assets deposited into the trust, free of any liability for such retention. The income from the trust was payable to the grantor for his lifetime, then to the grantor's wife. On the death of the grantor's wife, the remainder was to be paid to the grantor's two granddaughters.

The grantor predeceased his wife, who lived until 2008. Meanwhile, the original trustee was acquired by VNB in 1993. In or about May 2000, VNB became concerned that the trust assets were not properly diversified. As a result, the bank had the matter reviewed by counsel, who advised that the bank had four options: do nothing if it was satisfied that the trust assets were acceptable; diversify the portfolio; notify the beneficiaries and seek consent to diversification and seek court approval of the decision to diversify.

VNB chose to simply diversify. The evidence at trial indicated that the bank never explicitly notified the beneficiaries that it had chosen to disregard the specific instructions of the trust and diversify the portfolio. A few months after his initial letter, in an unsolicited follow-up letter, the bank's attorney advised that, based on a recent judicial decision, VNB should seek instruction from the court before diversifying or else it "was acting at its own peril." VNB never did so and continued to diversify.

The bank's defense was that the Prudent Investor Act superseded a grantor's express direction in a trust regarding investments. The trial court rejected that argument based on the plain language of the statute. The bank's secondary argument was that the remainder beneficiaries were estopped from objecting because they knew or should have known of the bank's actions, despite the fact that VNB never expressly notified the beneficiaries of its course

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of action. This argument was based on the fact that the beneficiaries began receiving statements prior to the diversification, which began in the year 2000, and according to the bank, had full knowledge of the terms of the trust at that time.

The trial court held that the bank violated its fiduciary duty by disregarding the terms of the trust and failing to obtain either the consent of the beneficiaries or judicial approval for its actions. It accepted in part, however, the bank's equitable defense, finding that since the bank sent the trust to the beneficiaries in 2008, and since the beneficiaries had been receiving statements prior to that time regarding the trust investments, the beneficiaries should have objected in 2008, and thus their damages were measured from that date.

The trial court determined that, had the bank followed the grantor's directions and retained the assets, the value of the trust portfolio in 2008 would have been $520,000 more than the value of the actual diversified portfolio. Therefore, the trial court entered judgment against the bank and in favor of the beneficiaries, in the amount of $520,000, plus prejudgment interest. The court disallowed commissions to the bank after May 2008, finding that it had stopped managing the assets as of the date of death of the income beneficiary.

The Appellate Division affirmed in all respects. *See also In re Estate of Gehrke*, No. A-2499-17T2, 2020 WL 3493524 (N.J. Super. Ct. App. Div. June 29, 2020) (executors are bound as fiduciaries to act in the best interests of the estate's creditors and beneficiaries, but are not liable for mere mistakes; New Jersey's Prudent Investor Act states that fiduciaries of trusts are not liable to beneficiaries for investment decisions made in reasonable reliance on the trust provisions and that they thought would most benefit the beneficiaries).

In an older New Jersey Supreme Court case, however, it was held that diversification was not necessary.

***Commercial Trust Co. of New Jersey v. Barnard*, 27 N.J. 332 (1958)**

The settlor died in 1922 but had created the trust at issue before his death. The settlor had named his personal secretary, George Mason, and Commercial Trust Company of New Jersey as the trustees. The settlor himself had retained the power to control investments and directed that, after his death, his brothers and nephews had the power to veto investments.

In the meantime, as of 1927, the corpus was solely invested in tax-exempt securities. This investment had been approved by the appropriate family members.

When the trustees sought approval of their account, through 1955, certain beneficiaries sought a surcharge for the low-yield investments, arguing that the trustees had failed to exercise any judgment as to the investments. The trustees argued that the policy of investing in the tax-exempt vehicles was formulated by the members of the settlor's family, and not vetoed by them (per the terms of the trust). The trustees also pointed out that the income beneficiaries received substantial sums ($1.3 million) from other family trusts, and were wealthy and in high-income tax brackets, such that the concentration in tax-exempt securities made sense. The trial court agreed with the trustees.

The New Jersey Supreme Court determined that the facts did not sustain a finding that the trustees failed to exercise judgment with respect to investments, but rather, supported the conclusion that they were alert to the relative advantages to be derived from the investment policy pursued and that diversification was not necessary. The Court noted that the trustees were in possession of sufficient knowledge of the beneficiaries' high tax brackets to exercise a reasonable judgment with regard to investments. In addition, the initial trust policy of investing in tax-exempt assets was formulated by the members of the settlor's family, during the period in which they exercised their veto power over investments.

Moreover, the individual trustee had served as personal and financial secretary to the settlor from 1906 until the time of his death and had an intimate acquaintance with the settlor's financial affairs. He knew that the settlor left an estate of $11,000,000. He was also trustee for another *inter vivos* trust established by the settlor for the benefit of his wife, Carrie Guggenheim, the remainder on her death to his daughters. He knew that the instant life income beneficiaries each received $1,300,000 from that trust after Carrie Guggenheim's death and were of substantial means.

In sum, the Court found that this knowledge afforded a basis for a reasonable inference that the life income beneficiaries all were in high-income tax brackets and that generating tax-free income from the trust was a prudent investment decision. Investment in a closely-held corporation and the

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restrictive structure thereof led a New York court to approve a decision not to diversify.

***In re Hyde*, 845 N.Y.S.2d 833 (App. Div. 2007), appeal denied, 881 N.E.2d 1197 (N.Y. 2008)**

Charlotte P. Hyde and Nell Pruyn Cunningham were the daughters of Samuel Pruyn, who was a founder of Finch, Pruyn & Company, Inc. ("Finch Pruyn"), a large manufacturer. There was a set of family trusts, with each trust funded with large concentrations of Finch Pruyn common stock. Finch Pruyn was a closely held family corporation, whose stock was not publicly traded. Each trust instrument granted the trustees absolute discretion in managing trust assets and contained no directions concerning the disposition of the Finch Pruyn stock.

Accounting actions were filed by the trustees, and the beneficiaries sought damages due to lack of diversification.

The appellate court approved the decision not to diversify. It stressed that Finch Pruyn was a closely held corporation with an unusual capital structure. For example, under Finch Pruyn's capital structure, the class A shareholders held all of the voting rights and, therefore, controlled whether the corporation could be liquidated. However, class A shareholders would only receive $0.01 per share upon liquidation of the corporation. Class B shareholders would receive all the remaining proceeds upon liquidation, but, without any voting rights, they had no power to effectuate a liquidation. This capital structure engendered a state of "gridlock," which may have been intended by Finch Pruyn's founders in order to sustain Finch Pruyn as a family business.

In addition, several experienced trust officers testified that, because Finch Pruyn was a closely held corporation, there was no market for its stock and, as a result, it would only be possible to sell the stock at a speculative price. The trial testimony showed that the Finch Pruyn stock did not attract buyers; in fact, Finch Pruyn itself was not interested in purchasing the stock, except in small quantities at less than book value. A fair price for the stock could only be obtained via a sale of the entire company. Thus, the unusual capital structure made the stock particularly unmarketable.

In addition, the trustees determined not to diversify upon consideration of other factors, such as the general economic situation of the trust assets, the expected tax consequences of investment decisions, and the needs of the beneficiaries. The trustees determined that the Finch Pruyn assets incurred a low tax cost. Compared to the high capital gains taxes that would result from a sale of the stock, the trustees determined that retention of the stock was the most advantageous means of maintaining the trust.

Finally, the trustees concluded that the needs of the beneficiaries outweighed diversification. The Finch Pruyn stock paid out considerable dividends, such that selling the shares at a discounted price, for the sake of diversification, may have been imprudent. More importantly, there was an indication that the settlors of the trust wanted the ownership of Finch Pruyn to remain in the family and that the trusts were used as vehicles to achieve such a result. The trustee's decision not to diversify was based on the family nature of the corporation.

Language of the governing document can relieve a trustee from the duty to diversify, as seen in an Indiana case involving charitable trusts.

***Americans for the Arts v. Ruth Lilly*, 855 N.E.2d 592 (Ind. Ct. App. 2006)**

This case addressed the lack of diversification of two charitable trusts created by National City Bank ("National City'), as conservator of Ruth Lilly's estate. The trusts were established in January of 2002 and initially invested exclusively in Eli Lilly & Co. stock. National City drafted plans to diversify these investments in March of 2002 and began implementing the plans in July. The desired asset portfolio was achieved by October 2002 — too late, however, to avoid the negative impacts of a sharp decline in the value of Eli Lilly stock.

"The documents regarding the trust were sufficient to allow National City to retain the existing trust assets and that the bank's good faith reliance on the retention clause was not a breach of fiduciary duty"

Two of the charitable beneficiaries, Americans for the Arts and The Poetry Foundation, filed an action alleging that National City's failure to diversify sooner caused the trusts to lose value and constituted a breach of fiduciary duty. Id. National City objected to the charges, arguing that the language of the trust instruments was sufficient to relieve them of a duty to diversify.

The instruments for both trusts contained identical language, providing the right to "retain indefinitely any property received by the trustee and invest and reinvest the trust property" and further stating 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." Id. at 595.

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Focusing on this text, the trial court determined that this instrument unquestionably relieved the trustee from the duty to diversify. The Indiana Court of Appeals affirmed, and held that the documents regarding the trust were sufficient to allow National City to retain the existing trust assets and that the bank's good faith reliance on the retention clause was not a breach of fiduciary duty.

Likewise, in a Kansas case, the trustee was shielded from liability as a result of the language of the trust instrument and subsequent letter from the grantor.

McGinley v. Bank of Am., 109 P.3d 1146 (Kan. 2005)

In 1990, the grantor, then 79 years old, established a revocable trust funded primarily with Enron stock and with Bank of America serving as trustee. The trust agreement gave Bank of America some boilerplate discretionary powers, but another section severely restricted the trustee's discretion. The grantor expressly reserved "the exclusive power to control all purchases and sales of trust assets" unless the grantor was incapable of managing her affairs. Id. at 1149.

Seven months after the trust was established, the grantor sent a letter to Bank of America stating, "I hereby direct you to continue to retain the following securities as assets of the above-referenced account: 1,541 shares Enron Corp." Id. The letter further went on to "exonerate, indemnify and hold the Bank harmless..." and "relieve the Bank from any responsibility for analyzing or monitoring these securities in any way." Id. at 1150. By its express terms, the letter was to remain effective until the grantor's death, disability, or revocation of the letter.

Bank of America allegedly did nothing, and when Enron imploded approximately 10 years later, the grantor sued anyway, claiming a loss in value of her Enron stock, which went from a high of $789,687.50 to below $4,800. Id.

The trial court granted summary judgment in favor of Bank of America, citing the letter. Id.

On appeal, the Kansas Supreme Court framed the issue as to whether the language in the trust instrument and subsequent letter shielded Bank of America from liability, and distilled certain rules from the Kansas statutes that had evolved over the relevant time period. The court rejected the argument that the exculpatory provisions of the letter were ineffective because the trustee failed to adequately communicate and explain them to her. The grantor's intent was to require Bank of America to abide by her decisions on buying and selling trust assets. This language found in the trust and the subsequent letter was plain, unambiguous, and therefore controlling. Id. at 1154. The trustee complied with the prudent investor rule as a matter of law. Id. at 1155. Nonetheless, in dicta, the court stated the better practice would have been for Bank of America to communicate the letter's contents and legal effect before the grantor signed as well as periodically advise her of Enron's decline. Id. at 1156.

Given the language of a trust to restrict the sale of stock, except in the event of compelling circumstances, a trustee's decision to retain stock holdings was determined to be appropriate.

In re Chase Manhattan Bank, 809 N.Y.S.2d 360 (App. Div. 2006).

The New York Supreme Court, Appellate Division, ruled on a trust diversification conflict in which the trust instrument required that the trustee retain the trust's concentration of Eastman Kodak Co. stock holdings, providing that the trustee was only permitted to sell this stock in the event of compelling circumstances. The instrument specifically stated that neither the executors of the decedent's will nor the trustee were permitted to "dispose of such stock for the purpose of diversification of investment and neither they [n]or it shall be liable for any diminution in the value of such stock" with the exception that the sale of all or part of the Kodak stock was permitted where there was some "compelling reason other than diversification of investment for doing so." Id. at 362. The trust was initially created by Charles G. Dumont in 1951 for the purpose of providing income to his daughter, Blanche, until the time of her death, when it would become a source of income for her children.

This action was filed in 1998, after Blanche's 1972 death, by one of her children. The complaint alleged that the modest performance of Kodak stock became a compelling reason to alter the investment structure in January of 1973 because it produced a relatively low-income yield for the trust, and sought to recover the difference in value had 95 percent of the stock been sold in 1973. Id.

The trustee, Chase Manhattan Bank ("Chase"), countered that the trust always met the income needs of the beneficiaries and that therefore, the small growth rate was not a compelling reason for selling the stock. Chase conceded that a compelling reason to restructure emerged in December 2001, when Kodak instituted fundamental changes in their line of products, whereupon the trustee did begin to sell the Kodak stock. Id. at 363.

The court determined that Chase's decision to retain the Kodak stock holdings was within the prudent person standard, and as there were no compelling reasons to sell, maintaining the stock did not violate the fiduciary duty. Id. at 364. The court stressed that the trustee is not responsible for predicting unforeseeable market

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fluctuations, nor is it required to make perfect investment decisions regarding long-term performance forecasts. Id.

A number of other cases have addressed the issue of diversification and considered a myriad of facts and circumstances:

In re Saxton, 712 N.Y.S.2d 225 (App. Div. 2000)

A trust was created and funded in 1962 entirely with IBM stock. The corporate trustee did not diversify the trust in any manner, on the rationale that a diversified portfolio was not necessary because IBM stock was on the fiduciary's "buy list." The trustee also obtained a purported written consent by the beneficiaries as to the retention of the IBM stock. Nevertheless, the court refused to allow the trustee to use the "consent of the beneficiaries and held that diversification should have occurred in August 1987. By October 1987, the trust had lost much of its value. See also In re Rowe, 712 N.Y.S.2d 662 (App. Div. 2000) (under Prudent Person Rule, trustee acted negligently and imprudently in retaining certain stock and failing to diversify).

In re Janes, 681 N.E.2d 332 (N.Y. 1997)

The Saxton decision in New York was preceded by In re Janes. There, the bank trustee was deemed to have violated its duties when it did not diversify a trust, the stock portion of which consisted of 71 percent of Kodak stock. The court found that the trustee did not consider the investment in the stock in relation to the entire trust portfolio, did not pay attention to the needs of the income beneficiary, and failed to analyze the estate and follow its own trustee review protocol (which advised against portfolio concentration of more than 20 percent).

In re Estate of Donner, 626 N.E.2d 922 (N.Y. 1993)

The trustees claimed that they retained assets in the trust (80 percent of which were interest-sensitive securities) because they wanted to wait for favorable market conditions before selling. The court did not excuse the $786,000 loss incurred and found that the trustees took no action with respect to the investments except to raise cash for advance payment of their own commissions and legal fees. Their "indifference and inaction" was a violation of their fiduciary duties and was grounds for imposing a surcharge on them for the losses. Id. at 927.

First Alabama Bank of Huntsville v. Spragins, 515 So.2d 962 (Ala. 1987)

The bank/trustee's concentration of trust property in its own stock (70-75 percent of the value of the trust) was determined to be a violation of the trustee's duty to the trust beneficiaries, even though the trust instrument granted the power not to diversify. The court noted that the trustee's own bank advisory service recommended that investment in bank stock be limited to five percent of a trust's portfolio. Id. at 964.

Stevens v. Nat'l City Bank, 544 N.E.2d 612 (Ohio 1989)

The decedent died in 1952, leaving an estate of approximately $4.5 million. About $2.6 million of that value was held in Dow Chemical stock and about $1.4 million in Union Carbide stock. The trust granted the trustee the power to retain the shares of Dow and Union Carbide. Nonetheless, from 1958 to 1976, the trustee sold blocks of these stocks to diversify. The beneficiaries argued that the trustee should not have diversified, because the assets would have been worth more had the stock been held. The court upheld the trustee's decision to diversify, finding that the trustee acted in good faith when the trustee considered its own diversification policy, questioned holdings in excess of 30 percent of the total trust account, and implemented a prudent and gradual diversification program. The court held that the settlor merely authorized the trustee to retain the shares of Dow and Union Carbide stock, rather than directing the trustee to do so.

Donato v. BankBoston, 110 F. Supp.2d 42 (D.R.I. 2000)

The trustees held stock that escalated dramatically in value, such that by 1994 the stock comprised approximately 70 percent of the value of the corpus. However, as the stock increased in value, the trustees sold blocks of the stock and attempted to diversify. The beneficiaries raised a number of attacks, including the assertion that the trustees should have sold the stock earlier and should not have let the stock comprise such a large portion of the trust. The court held that the trustees did not violate the duty to diversify, because the trust instrument included a provision authorizing the retention of investments and an exculpatory provision that relieved the trustees of liability in case of retention unless there was an abuse of discretion. The court also found that the trustees vigilantly monitored the stock throughout the period and sold portions as the stock price began to fall. Id. at 53.

Atwood v. Atwood, 25 P.3d 936 (Okla. Civ. App. 2001)

On a motion for summary judgment, the court determined that a genuine issue of material fact existed as to whether the trustee's retention of 70-80 percent of the trust corpus in one stock was prudent. The court stated that, because a trust instrument can limit the Prudent Investor Rule, the court could not decide as a matter of law that the trustee had a duty to diversify. Id. at 944.

In conclusion, with money (and often large amounts of money) at stake, issues concerning investments and diversification will continue to present challenges for courts and probate judges. The Prudent Investor Rule provides a generalized standard governing investments to apply when conflicts are presented to courts concerning investments and diversification. ■