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THE PUZZLING PERSISTENCE OF THE CONSTRAINED PRUDENT MAN RULE*

JEFFREY N. GORDON**

Professor Gordon examines a seeming paradox: How did a rule named for the "prudent man," with its connotations of wisdom and judiciousness, become a constraint that discourages trustees and other fiduciaries from making investments now regularly favored by prudent investors? He argues that the current understanding of the Prudent Man Rule, the standard governing investments by trustees and other financial fiduciaries, is founded on a narrow conception of risk and safety that has been superseded by contemporary understanding of markets and investments, and in particular, portfolio theory. He identifies three factors that have prevented the Rule from evolving in response to modern investment theory: an authoritative treatise that has inhibited the normal common law process of reinterpretation and change; potential litigants who are poorly situated for litigation or who are unable to contract out from under the Rule's strictures; and the difficulty courts have in assimilating complicated economic theories that seem to involve sweeping doctrinal change. Professor Gordon concludes by arguing that, contrary to courts' fears, the only significant clash between portfolio theory and trust doctrine arises in the allocation of returns between life beneficiaries and remaindermen, and he analyzes ways of resolving the conflict.

INTRODUCTION

The "Prudent Man Rule" is the standard that the law now commonly prescribes for investment management by trustees and many other financial fiduciaries. Although "prudence" ordinarily conjures up images of judiciousness and wisdom, the received understanding of the Prudent Man Rule operates as an unfortunate constraint on sound investment management. This constrained conception of the Rule discourages trustees (and other fiduciaries) from making many investments now regularly favored by prudent investors including start-up enterprises, venture capital pools, many kinds of real-estate-based investments, for-

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* With a tip of the hat to Laurence H. Tribe. See 89 Yale L.J. 1063 (1980).

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This Article originated as part of a study of investment management by financial fiduciaries directed by Bevis Longstreth in collaboration with the Salomon Brothers Center for the Study of Financial Institutions and with the financial support of five foundations. A different version of the Article appears as an appendix in B. Longstreth, Modern Investment Management and the Prudent Man Rule 195-231 (1986). Further financial support was provided by the Filomen D'Agostino and Max E. Greenberg Research Fund of New York University.

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eign stocks, short sales, and options and futures.[1] Some of these investments permit greater diversification across the investment spectrum.[2] Others, such as futures and options, lower the risks from volatile stock prices and interest rates.[3]

Because of the received understanding of the Rule, called here the

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[1] A recent survey of the 50 largest bank trust departments, university endowments, foundations, and corporate pension funds indicates that these institutions regard themselves as significantly constrained by current legal standards of prudence from pursuing optimal investment practices. See B. Longstreth, Modern Investment Strategy and the Prudent Man Rule app. C (1986). The majority of respondents reported that the following investments and techniques were either legally precluded or questionable: commodity futures, short selling, margin purchases, and certain uses of options. The bank trust departments and the foundations were particularly apprehensive about futures, options, and other innovative instruments and techniques. Nearly two-thirds of the bank trust departments stated that investment in new and untried enterprises or venture capital pools was either legally precluded or questionable. Nearly two-thirds of the banks reported that they were sometimes precluded by the applicable standard of prudence from investment opportunities they would otherwise have pursued. See id.

The wariness of these financial fiduciaries is not surprising in light of the legal advice that many of them apparently receive. A 1978 report on innovative investment strategies by the Committee on Investments by Fiduciaries of the American Bar Association Section of Real Property, Probate and Trust Law repeatedly emphasizes the risks associated with instruments or strategies that lack adequate seasoning or judicial support. See Current Investment Questions and the Prudent Person Rule, 13 Real Prop. Prob. & Tr. J. 650, 654, 657, 662, 670-71 (1978).

[2] Real estate portfolios, for example, provide a long-term average rate of return comparable to, if not higher than, bond portfolios. But real estate returns respond differently than bond returns to economic factors such as inflation, permitting diversification of investment. See R. Ibbotson & J. Siegal, Real Estate Returns: A Comparison with Other Investments (1986); Irwin & Landa, The Use of Real Estate, Futures and Gold on Portfolio Assets, J. Portfolio Mgmt., Summer 1986; Zerbst & Cambon, Real Estate: Historical Returns and Risks, J. Portfolio Mgmt., Spring 1984, at 5. Similarly, the addition of securities of foreign companies increases the diversification of a portfolio; the returns from foreign firms respond to different economic factors than the returns from U.S. firms.

For a more specific account of the benefits of diversification in increasing portfolio returns for a given level of risk, see note 6 infra.

[3] Both futures and options permit the investor to reshape the risk associated with owning a particular security. A fiduciary can enter into a hedging transaction that reduces the risk of adverse price or interest rate movement; the risk is absorbed by the party on the other side, a speculator.

Take the simple example of the covered call option. Assume the trust corpus contains 100 shares of IBM selling at $100. The trustee has done research that suggests to him that it is far more likely that IBM shares will fall to $90 rather than rise to $110 within the next six months. The trustee sells a call option that gives the purchaser the right to acquire the 100 shares from the trustee at a strike price, say $110. Assume the trustee receives payment of $5 per share for the option. If the IBM stock price does drop to $90, the trustee has recovered half the loss through the sale of the option. The technique helps the trustee maintain the value of the corpus.

Another simple example of hedging is the futures contract. Assume the trust corpus contains Treasury bills that will mature in two months and that the trustee is concerned about the possibility of significantly lower interest rates at the time of reinvestment. The trustee can lock in current interest rates by purchasing a Treasury bill futures contract with a delivery date two

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"constrained" Rule, trust beneficiaries are denied investment management that could raise returns and lower risks. Moreover, although directly applicable only to private trusts, the Rule is an important source of law for the regulation of other financial fiduciaries, and thus has far-reaching influence on investment management in many spheres.[4]

Attacks on the constrained Prudent Man Rule are not new; legal academics have persuasively argued that the constrained Rule is founded on a narrow conception of risk and safety that has been superseded by contemporary understanding of markets and investments.[5] In particular, they argue that modern portfolio theory presents a better account of risk and safety, and thus a better guide to prudent investment.[6] An appropri-

months hence. Declining interest rates will increase the value of the futures contract, offsetting the lower yield of the reinvested funds.

The use of options and futures may be thought of as a kind of insurance. The value of the asset is the thing insured; the transaction costs are the premium. For a useful, simple account of the use of options and futures in a portfolio, see Federal Reserve Bd., Commodities Futures Trading Comm'n & Sec. & Exch. Comm'n, A Study of the Effects on the Economy of Trading in Options and Futures (1984) [hereinafter Options and Futures]. For a discussion of the use of futures in a portfolio, see J. Merrick & S. Figlewski, An Introduction to Financial Futures (New York University Occasional Paper No. 6, 1984) (on file at New York University Law Review).

4 The extensive historical and doctrinal development of the trust law standard makes it the starting point for virtually all efforts to define "prudence." Even statutes that purport to establish a different standard, such as the Uniform Management of Institutional Funds Act (1972), and the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001-1461 and scattered sections of 5, 18, 26, 31, and 42 U.S.C.), begin with the trust standard as a point of departure. See Uniform Management of Institutional Funds Act § 6 (1972); ERISA, 29 U.S.C. § 1104 (a)(1982). Cautious regulators may take refuge in the trust standard. See note 8 infra.

5 A useful presentation of the case against the constrained Rule is provided in B. Longstreth, supra note 1. A particularly influential article is Langbein & Posner, Market Funds and Trust Investment Law, 1976 Am. B. Found. Res. J. 1. See also Bines, Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine, 76 Colum. L. Rev. 721 (1976); Note, Fiduciary Standards and the Prudent Man Rule under the Employment Income Security Act of 1974, 88 Harv. L. Rev. 960 (1975); Note, The Regulation of Risky Investments, 83 Harv. L. Rev. 603 (1970); Note, Prudence in Trust Investment, 8 Mich. J.L. Reform 491 (1975); Note, Trustee Investment Powers: Imprudent Application of the Prudent Man Rule, 50 Notre Dame L. Rev. 519 (1975); Note, Regulating Risk-Taking by Mutual Funds, 82 Yale L.J. 1305 (1973).

6 See authorities cited in note 90 infra. Modern portfolio theory can be understood as making the following claims: investors care about the risk and return of assets; indeed, they prefer the greatest return for the least risk and insist on being compensated in proportion to the risk. The risk from owning any particular asset can be lowered if the investor also owns other assets the returns on which respond to different firm-specific and general economic factors. In a familiar simple example, the risk from owning stock in an umbrella manufacturer is lower if the investor also owns stock in a suntan lotion manufacturer; abnormally sunny or rainy weather will enhance one firm's profits even while it hurts the other firm.

Portfolio theory posits that the risk from owning any particular asset is best measured in terms of the risk that the asset adds to a well-diversified portfolio of assets. Three conclusions follow. First, an investor should look to the risk to and return on his portfolio when making an investment decision. Second, an asset that is very risky viewed in isolation may not be

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ately unconstrained Rule should embody sufficient flexibility to allow fiduciaries to adapt to the prevailing theories of markets and investments.

Nevertheless, the traditional Prudent Man Rule, the constrained Rule, lives on. A series of recent court decisions[7] and even administrative rulings[8] suggests that the traditional trust law notions of what counts as "prudence" have great staying power. More important, the constrained Rule continues to influence the behavior of financial fiduciaries, many of whom report that they have been blocked from pursuing what they regard as optimum investment strategies.[9] It is their beneficiaries who bear the costs.

This Article operates on three levels. On one level it seeks to explain a paradox in the history of the law: how a rule founded on the adaptable wit of the prudent man has become a hindrance to sound fidiciary investment management. In explaining the paradox, the Article presents the case for an unconstrained Rule in terms of portfolio theory and in discourse suitable for adoption by a common law court. The temptation is to think that mere survival demonstrates the virtue of a rule; however, if courts come to understand why the constrained Rule has unnaturally persisted, they will be more receptive to the argument for its unconstraining. Thus, this Article is an exercise in law reform.

Understanding the persistence of the constrained Rule may release many fiduciaries from its grasp. Although a direct source of authority only for the trustees of private trusts, the Prudent Man Rule influences the behavior of all financial fiduciaries. It is currently the best developed

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particularly risky when viewed as part of the investor's portfolio. In the example, it is misleading to say that the umbrella manufacturer's stock is risky if the portfolio produced by adding the suntan lotion manufacturer's stock yields stable returns. Third, because investors compete to assemble efficient portfolios (greatest return for least risk), they will be compensated for bearing only that risk that cannot be eliminated through diversification. In the example, the market returns on the suntan lotion manufacturer's stock will correspond not to the firm's variable earnings viewed in isolation, but to that risk that cannot be eliminated by holding the stock in combination with the umbrella manufacturer's stock. Thus, an investor holding only the suntan lotion manufacturer's stock takes on additional risk without the compensation of greater expected returns.

For a good overview of the current understanding of portfolio theory and its limits, see Elton & Gruber, The Lessons of Modern Portfolio Theory, in B. Longstreth, Modern Investment Strategy and the Prudent Man Rule app. A (1986); see also Gordon & Kornhauser, Efficient Markets, Costly Information, and Securities Research, 60 N.Y.U. L. Rev. 761, 796-810 (1985) (discussing policy implications of efficient market hypothesis on regulation of institutional investors); sources cited in note 5 supra (providing more elaborate and mathematically formal accounts of portfolio theory).

[7] See, e.g., First Ala. Bank v. Martin, 425 So.2d 415 (Ala.), cert. denied, 461 U.S. 938 (1983); Chase v. Pevear, 383 Mass. 350, 419 N.E.2d 1358 (1981); see also notes 70-88 and accompanying text infra.

[8] See Federal Reserve Bd. Letter and Memorandum, Trust Dep't Uses of Options and Futures Contracts, 3 Fed. Banking L. Rep. (CCH) ¶ 35,318 (Jan. 11, 1983).

[9] See note 1 supra.

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body of law governing fiduciary investment management.[10] It provides answers and analogies. Nevertheless, many fiduciaries act in service of goals different from those of the private trustee, whose charge is to provide reasonable income to the life beneficiaries and transmit wealth intact to the remaindermen. To the extent that the constrained Prudent Man Rule survives because of the special role of the private trustee, it need not apply to a differently situated fiduciary.

On a second level, the Article attempts to comprehend common law processes of change in the context of the institutions of trust law. What *does* account for the survival of the constrained Prudent Man Rule? The answer is complicated, but three distinct elements have figured significantly: first, an authoritative treatise and Restatement that have inhibited the customary common law process of reinterpretation and change; second, a group of potential litigants poorly situated to litigate against established doctrine or in other cases able to avoid litigation by contract; and third, the difficulties courts have when receiving complicated social science theory that apparently entails sweeping doctrinal change. These three factors recur in other common law contexts. Thus, this Article should increase our ability to predict and understand other occasions of "stickiness" in the development of the common law.

Finally, on a third level, the Article is a substantive examination of certain investment management doctrines of traditional trust law in light of modern portfolio theory. Which doctrines can be reconceptualized in terms of modern portfolio theory and which require substantive change? It turns out that the only significant clash between portfolio theory and trust doctrine arises in the allocation of returns between life beneficiaries and remaindermen. Statutory formulas allocate "income" (interest and cash dividends) to the former and "principal" (including capital gains and losses) to the latter. Such formulas are inconsistent with portfolio theory, which analyzes investment performance in terms of "total returns"—dividends, interest, and capital gains (or losses)—during the relevant holding period. After canvassing several alternatives, the Article proposes an approach based on the adjusted real yield of the portfolio and calls for further investigation of the economic and legal specifics by a team of financial economists and lawyers. The fruits of their collaboration should be embodied in uniform statutes or model trust clauses.

10 The standards of prudent investment promulgated by the Department of Labor under ERISA may eventually become a more extensive source of law. See 29 U.S.C. § 1135 (1982); Fiduciary Responsibility under ERISA, 29 C.F.R. §§ 2550.401b-1 to .414c-4 (1986).

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I

The Rule and Its Constrained Formulation

A. *The Original Formulation*

The Prudent Man Rule derives from the 1830 case, *Harvard College v. Amory*,[11] in which the Supreme Judicial Court of Massachusetts, rejecting the English rule requiring investment in government securities, refused to surcharge a trustee for investing in common stocks. The original formulation, which has been adopted by decision or statute in thirty-nine states and the District of Columbia,[12] is a model of flexibility. In investing trust funds, the trustee was enjoined to exercise "sound discretion" and

> to observe how men of prudence, discretion and intelligence 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.[13]

The rule had two key elements. First, there was a substantive standard of safe investment. The trustee was to acquire investments appropriate for permanent disposition of his own funds, not for speculation. The court realized that absolute safety of investment was impossible. "Do what you will, the capital is at hazard."[14] But it required that within the limits of permanent disposition the trustee consider the factors of safety and income. Second, there was a process standard. In making investment judgments, the trustee was subject to the prevailing standard of how prudent men handle their own affairs.

B. *The Restatement, the Treatise, and the Constrained Rule*

The modern understanding of the Prudent Man Rule was shaped by

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[11] 26 Mass. (9 Pick.) 446 (1830).

[12] See G. Bogert & G. Bogert, The Law of Trusts and Trustees § 613, at 57-58 (rev. 2d ed. 1980 & Supp. 1986). Arkansas, California, Colorado, Connecticut, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Louisiana, Michigan, Minnesota, Mississippi, Nebraska, Nevada, New Jersey, New York, North Carolina, Oklahoma, Oregon, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, and Wyoming have adopted the prudent man standard by statute. See id. at 57 & n.15. Maryland, Massachusetts, Missouri, Rhode Island, and Vermont have adopted the prudent man standard by court decision. See id. at 57-58. The District of Columbia has adopted the prudent man standard by rule of court. See id.

Until the early 1940s, most states had required trustees to select investments from a statutory list (called a legal list) of the (supposedly) safest investments, primarily limited to government bonds, mortgages, and occasionally fixed income securities of the most stable companies. The Depression showed that virtually no instrument was immune from default or payment moratorium. See notes 144-46 and accompanying text infra (describing course of change from legal lists to Prudent Man Rule).

[13] 26 Mass. (9 Pick.) at 461.

[14] Id. at 460.

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that great figure in the law of trusts, the late Professor Austin Wakeman Scott. Scott was the reporter of the first[15] and second[16] *Restatement of Trusts* (the Restatement) completed in 1935 and 1959, respectively, and the author of the leading treatise on trusts, *The Law of Trusts* (the Treatise), first published in 1939 and successively revised and updated.[17] Scott's work has played a pivotal role in the legal understanding of the trustee's investment management duties. Most cases and commentaries in the area cite as authoritative either the Treatise or the Restatement,[18] or rely on formulations derived from those two sources. Moreover, Scott's teachings on investment management by trustees have remained virtually unmodified over a fifty-year period. The relevant sections and comments of the second Restatement are virtually identical to those of the first Restatement[19] and continue to be regarded as authoritative today.

The investment management sections of the Treatise and the Restatement can be read as an attempt to interpret and apply the *Harvard College v. Amory*[20] formulation through more specific rules and examples. But Scott's rules and examples are more constraining, and less flexible, than *Harvard College* required. Perhaps initially useful, these rules and examples no longer conform to our best understanding of prudent investment strategy and thus unwisely restrict trustees. Far more serious, no one has successfully carried forward Scott's project of providing the "better view" in the law of trusts.[21] In a sense Scott has become

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15 Restatement of Trusts (1935).

16 Restatement (Second) of Trusts (1959).

17 A. Scott, The Law of Trusts (1st ed. 1939) [hereinafter Treatise (1st ed.)]. Scott produced subsequent editions in 1956 [hereinafter Treatise (2d ed.)] and 1967 [hereinafter Treatise (3d ed.)], and updated the third edition with pocket parts until a few years before his death in 1981. The publisher has continued the updates. Parallel citations to each edition are given, where appropriate, to demonstrate constancy.

18 So closely allied are the Treatise and the Restatement that they share the same section numbering.

19 The most critical sections are § 213 (Balancing Losses against Gains), § 227 (Investments Which a Trustee Can Properly Make), and § 228 (Distribution of Risk of Loss).

20 26 Mass. (9 Pick.) 446 (1830).

21 Many would regard Scott as a modernizer in the investment management area, citing, in particular, his endorsement of common stocks as prudent investments (depending on the stock). See Restatement of Trusts § 227 comment 1 (1935); 2 Treatise (1st ed.), supra note 17, § 227.11. At times Scott indicates awareness of the need for flexibility in defining prudence, see, e.g., Restatement (Second) of Trusts § 227 comment e (1959) (noting that it is "impossible to lay down a hard-and-fast rule as to what is a prudent investment"), despite the investment rules elsewhere presented as per se and immutable. The third edition of the Treatise in particular reflects awareness of the problem. "When a certain investment is held in one case to be improper, the courts are likely to treat the case as a precedent holding that no investment of that type is proper. . . . Undoubtedly in recent years there has been a more scientific study of investments, but the results of this study are not always reflected in the cases." 3 Treatise (3d ed.), supra note 17, § 227, at 1808-09.

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"Scott," too authoritative to revise. Since the publication of the last editions of the Treatise and the second Restatement, there has been an explosion of theoretical and empirical work by financial economists, leading to new conceptions of investor and market behavior.[22] None of this progress is reflected in "Scott"; indeed, what has been learned contradicts much of what "Scott" states on investment management. It is hoped that this Article provides notes toward a revision that Scott himself would have embraced.

Three key decisions in the Treatise and the Restatement transformed the flexible standard of *Harvard College* into what has become the constrained Prudent Man Rule.[23] First, Scott altered the Rule to require a more conservative benchmark of prudence than *Harvard College*. Instead of the prudence of persons seeking "permanent disposition of their funds,"[24] Scott prescribed the prudence of one seeking primarily the "preservation of the estate."[25] An investment strategy designed to preserve principal will presumably be more cautious than one aimed at permanent disposition, which could include a buy-and-hold portfolio of common stocks at a higher level of risk and expected return. Moreover,

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[22] See, e.g., Studies in the Theory of Capital Markets (M. Jensen ed. 1972) (collection of papers presented at 1969 conference on modern capital theory); see also authorities cited in note 90 infra. In addition, the first Restatement of Trusts (1935) was written against the backdrop of the Depression and pre-Depression financial environment. The securities legislation of the 1930s transformed securities markets, but Scott never undertook revision to reflect these dramatic changes. See Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1982); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1982); Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (1982); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64 (1982). See generally J. Seligman, The Transformation of Wall Street (1982).

[23] The Restatement provides:

> In making investments of trust funds the trustee is under a duty to the beneficiary . . . to make such investments and only such investments as a prudent man would make of his own property having primarily in view the preservation of the estate and the amount and regularity of the income to be derived.

Restatement of Trusts § 227(a) (1935). The Restatement (Second) of Trusts § 227(a) (1959) is identical except that it omits the word "primarily".

In all editions of the Treatise, Scott elaborates on the standard governing trustee investment with identical language.

> [I]t is not sufficient that the trustee should exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property, since men of prudence may well take risks in making investments which trustees are not justified in taking. A trustee must use the caution in making investments which is used by prudent men who have primarily in view the preservation of their property, of men who are safeguarding property for others.

3 Treatise (3d ed.), supra note 17, § 227, at 1806; 3 Treatise (2d ed.), supra note 17, § 227, at 1661; 2 Treatise (1st ed.), supra note 17, § 227, at 1198.

[24] *Harvard College*, 26 Mass. (9 Pick.) at 461.

[25] Restatement (Second) of Trusts § 227(a) (1959); Restatement of Trusts § 227(a) (1935); accord 3 Treatise (3d ed.), supra note 17, § 227, at 1805-06 (seeking "preservation of their estate"); 3 Treatise (2d ed.), supra note 17, § 227, at 1660 (same); 2 Treatise (1st ed.), supra note 17, § 227, at 1197 (same).

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in inflationary times, a mandate to preserve the estate becomes confounding; to preserve the estate in nominal terms may well defeat the testator's objective of transferring wealth to the next generation, but to preserve the estate in real terms requires investment that may risk the loss of principal.

Second, instead of an investment standard based on how prudent men conduct their own affairs, Scott prescribed the more constraining norm of "men who are safeguarding property for others."[26] Thus, instead of the prudent man test, we have the prudent trustee test.[27] The implication is that a trustee must use especially safe means to attain the desired level of investment safety, rather than ordinarily prudent means.[28] So, making the debatable assumption that preservation of capital ought to be the trustee's primary goal, Scott tells us that a prudent *trustee* may not pursue this goal in ways acceptable to a prudent *investor*. Scott's dubious distinction confuses the setting of appropriately safe in-

[26] 3 Treatise (3d ed.), supra note 17, § 227 at 1806; 3 Treatise (2d ed.), supra note 17, § 227 at 1661; 2 Treatise (1st ed.), supra note 17, § 227, at 1198.

[27] It is unclear why Scott moved away from a prudent investor standard to a prudent trustee standard. At the time of the Restatement of Trusts (1935), most states were legal list states. See note 12 supra. The Restatement formulation suggests an attempt at compromise between the liberal Massachusetts rule and the conservative rule followed elsewhere. A leading member of the Massachusetts trusts and estates bar criticized Scott for this prudent investor/prudent trustee distinction. See 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, 515 (1951) ("There is no warrant for that distinction under the language of *Harvard College v. Amory*, and there is no logical reason for it if all the words of the Prudent Man Rule are given full effect, but there is nevertheless a constant temptation, backed by British precedent, to fall into that error.").

This dispute illustrates Scott's influence in comparison with other treatise writers. The first edition of G. Bogert, The Law of Trusts and Trustees, the other important modern trust law treatise, was published in 1935, preceding Scott's first edition by four years. Bogert described the Prudent Man Rule as requiring the trustee to "display the same care and judgment that would be shown by an ordinarily able businessman in managing his own affairs for the purpose of accomplishing ends similar to those of the trust." 3 G. Bogert, The Law of Trusts and Trustees § 612, at 1940-41 (1st ed. 1935). Not only did Bogert focus on how a prudent man conducts his own affairs, but he also clearly declared that the trustee's conduct is to be evaluated in light of the ends of the trust. With Bogert's view as a starting point, it would be easier to distinguish between safety as an investment objective and safety as an artificial constraint on investment techniques. Such a distinction is blurred by a prudent trustee test. Scott's view has generally prevailed, however, and a trend toward the prudent trustee standard is acknowleged in the most recent edition of Bogert's treatise. See G. Bogert & G. Bogert, supra note 12, § 612, at 14-15.

[28] The first Restatement merely states that the trustee should make "only such investments as a prudent man would make of his own property having primarily in view the preservation of the estate and the amount and regularity of the income to be derived." Restatement of Trusts § 227(a) (1935). This establishes the investment objective (a certain level of safety) and the process of investing (that of a prudent man with such goals for himself). The precept is muddled by the overlay of the Treatise, which suggests that the trustee must use especially safe means to attain this goal of safety, as opposed to the appropriate means. See notes 23-25 and accompanying text supra.

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vestment objectives with the process of investing. The confusion creates a special problem for a financial model like portfolio theory, in which investments (and investment techniques) designed to achieve greater safety may nevertheless appear risky viewed in isolation.[29]

Third, and most serious, Scott, in separating "prudence" from "speculation," set hard and fast rules that now stymie the trustee's ability to adapt to prevailing circumstances in the financial markets. On the forbidden investment list are, for example, margin purchases of securities, "speculative" stock, discount bonds, securities in new and untried enterprises,[30] and second mortgages.[31] "Speculative stock" seems to refer to all companies except those "with regular earnings and paying regular dividends which may reasonably be expected to continue."[32]

The effect of the constrained Prudent Man Rule is to inhibit trustee investment in investment vehicles and instruments that did not exist a generation ago, that prudent persons now believe will enhance effective trust fund management, but that are arguably analogous to forbidden investments. For example, a trustee may be unable to attain optimum portfolio diversification because it cannot invest in unseasoned securities or stocks that do not pay dividends. It may be difficult for a trustee to participate in a venture capital pool, even one that invests across a wide spectrum, because of the ukase against new and untried enterprises. Or a trustee may be unable to participate in certain real estate investment pools because the form of the investment looks subordinated (like the forbidden second mortgage), even though a permissible first mortgage construction loan may in fact present much greater risk.[33] Similarly, a trustee may be prohibited from acquiring or forced to divest discount bonds (known today as "junk bonds"), even though a well-diversified pool of such bonds may provide greater return for the risk than gilt-edged bonds.[34]

A trustee may also be unwilling to use options as a hedge against adverse stock market movements because of the likelihood that a Scott-

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[29] See note 6 supra.

[30] Restatement (Second) of Trusts § 227 comment f (1959); Restatement of Trusts § 227 comment f (1935); 3 Treatise (3d ed.), supra note 17, § 227.6, at 1816-17; 3 Treatise (2d ed.), supra note 17, § 227.6, at 1670-71; 2 Treatise (1st ed.), supra note 17, § 227.6, at 1206-08.

[31] Restatement (Second) of Trusts § 227 comment h (1959) (improper unless necessary to settle a claim or sell land); Restatement of Trusts § 227 comment h (1935) (same); 3 Treatise (3d ed.), supra note 17, § 227.7, at 1818-19 (same); 3 Treatise (2d ed.), supra note 17, § 227.7, at 1672-73 (same); 2 Treatise (1st ed.), supra note 17, § 227.7 at 1208-09 (same).

[32] Restatement (Second) of Trusts § 227 comment m (1959); Restatement of Trusts § 227 comment *l* (1935).

[33] See B. Longstreth, supra note 1, at 110-46.

[34] See, e.g., Fons, The Default Premium and Corporate Bond Experience, 42 J.Fin. 81, 89, 92, 96-97 (1987) (holders of diversified portfolio of low-rated corporate bonds appear to be rewarded for bearing default risk).

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influenced court would regard such instruments as speculative, even though appropriate use of options may provide, at much lower cost, the same economic protection as strategies that are legally unassailable.[35] Similarly, futures look speculative and involve purchases on margin, yet appropriate futures transactions can lower exposure to fluctuating interest rates.[36]

In sum, if prudence embodies the idea of earning the maximum possible return for the chosen level of risk, then a modern trustee is constrained to act imprudently. How is that the modern trustee should be found in such a position? If the constrained Prudent Man Rule is indeed obsolete, why has it persisted? At least part of the answer lies in the constraining influence authoritative commentary can have on the development of the common law. This influence arises from the effects the commentary has on two important sets of lawsuit participants: judges and potential litigants.

C. The Influence of Authority on Common Law Change

1. On Judges

Although there are many theories about the common law tradition, most rest on the capacity and willingness of judges to interpret precedent in light of change.[37] Cases rarely set down their own black letter law; the holding of a case is bound up with complicated facts. Indeed, much of legal education is spent showing students how factual distinctions may

[35] A trustee who believed that a particular stock would soon decline in price could sell the stock without legal objection; however, selling a call option on the stock might well provide equivalent protection at lower cost. See note 3 supra. The use of a protective put option, which gives the holder the option to sell (or put) the stock to another party, would also allow a trustee to immunize the portfolio (in whole or in part) against anticipated downward price movements, again without a possibly more costly (but legally unobjectionable) sale of the underlying stock. See Pozen, The Purchase of Protective Puts by Financial Institutions, Fin. Analysts J., July-Aug. 1978, at 47.

A more complicated example is the "90/10 Treasury bill/option strategy." Ninety percent of the assets earmarked for the strategy are invested in Treasury bills and the remaining 10% are used to purchase puts and calls on individual stocks or stock indices. This strategy combines the leveraged profit potential of options with the safety of Treasury bills, significantly limiting exposure to adverse stock market movements. "Accordingly, even though it involves the speculative purchase of options, a 90/10 strategy is conservative, involving relatively low risk exposure. Its major advantage over S&P 500 stock returns [a legally unobjectionable investment] is that it avoids substantial losses during bear markets." Options and Futures, supra note 3, app.IV-A, at 9 (footnote omitted); see also L. McMillan, Options as a Strategic Investment 354-63 (1980); note 3 supra.

[36] See note 3 supra.

[37] See, e.g., O. Holmes, The Common Law (M. Howe ed. 1963); K. Llewellyn, Jurisprudence: Realism in Theory and Practice (1962). A debate over the role of judges in improving the law has arisen in the law and economics literature. Compare Rubin, Why is the Common Law Efficient?, 6 J. Legal Stud. 51 (1977) (the challenge of inefficient rules by litigants, rather than the wisdom of judges, brings about evolutionary pressure) with Cooter & Kornhauser,

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alter an outcome and how deeply "the law" is embedded in "the facts." A court believing that circumstances have changed or that it has a more profound understanding of the policies to be served can often alter the governing legal standard without overruling precedent. Interpretations, when derived from cases, can be distinguished, narrowed, and broadened, as may seem appropriate to the analysis. By contrast, an authoritative commentary exerts a powerful stabilizing effect on the common law precisely because it purports to crystallize cases into clear legal rules.[38] Restatements and other such commentary implicitly claim to set forth the rules properly derived from the cases.[39] These rules, divorced from the factual context that gives them shading and texture, stand as an abstract set of instructions.[40] Rules are much harder for a court to negotiate than a line of precedent. With cases one can hearken to the underlying principles that might have led to a particular decision. A

Can Litigation Improve the Law Without the Help of Judges?, 9 J. Legal Stud. 139 (1980) (only modest improvement from selective litigation effect alone). See note 44 infra.

For an interesting account of how a major commentator can help persuade courts of the desirability of change, see Waters, The Property in the Promise: A Study of the Third Party Beneficiary Rule, 98 Harv. L. Rev. 1109, 1148-72 (1985) (modern third party beneficiary rule gained acceptance because of sustained effort of Arthur Corbin).

[38] Ronald Dworkin has developed a metaphor of law as a chain novel that evocatively illustrates this point. See R. Dworkin, How the Law is Like Literature, in A Matter of Principle 146 (1985). In Dworkin's metaphor, each successive author is obligated to continue the chain, rather than starting over—to integrate prior legal experience in deciding the next case, rather than discarding it. See id.; see also Lane, The Poetics of Legal Interpretation (Book Review), 87 Colum. L. Rev. 197 (1987) (discussing Dworkin's metaphor). It is much harder to integrate a restatement that has crystallized prior cases into now-obsolete rules than to reinterpret the cases themselves.

[39] Grant Gilmore describes the movement beginning in the 1920s to restate the law as the legal establishment's attempt to refute the charges of the legal realists that the case method gave judges vast discretion to decide cases according to their prejudices. See G. Gilmore, The Death of Contract 58-59, 67 (1974); Gilmore, Legal Realism: Its Cause and Cure, 70 Yale L.J. 1037 (1961); see also L. Friedman, A History of American Law 582 (1973) (criticizing restatements as a conservative influence). The draftsmen believed and intended that the abstraction of cases into common law rules would constrain the law. See G. Gilmore, supra, at 67-78. For a critique of Gilmore and a discussion of the role of the restatement movement in the history of American law reform, see Crystal, Codification and the Rise of the Restatement Movement, 54 Wash. L. Rev. 239 (1979).

[40] See Gordley, European Codes and American Restatements: Some Difficulties, 81 Colum. L. Rev. 140, 149, 153-56 (1981) (discussing problems of clarity and uncertainty); see also Clark, The Restatement of the Law of Contracts, 42 Yale L.J. 643, 646 (1933) (criticizing Restatement of Contracts as attempt "to force a black letter sentence [to] do what it can never do—state pages of history and policy and honest study and deliberation"). For a general critique of the project of restating the law, see H. Hart & A. Sacks, The Legal Process 758-66 (tent. ed. 1958).

Those who draft restatements and write authoritative treatises are not unaware of these problems. Corbin, for example, criticized Samuel Williston for his excessive reliance on theory unresponsive to the actual facts. See Corbin, Book Review, 30 Yale L.J. 773 (1921); Corbin, Book Review, 29 Yale L.J. 942 (1920). The Restatement (Second) of Contracts (1979) has been described as shifting from "rules" to "standards" in the processes of contract formulation

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treatise, and particularly a restatement, frequently suggests the law is simply there to be applied.[41]

An authoritative commentary may also have impact because of its effect on judicial opinion writing. Judges presumably want to justify their decisions through a cogent analysis of the applicable law. But even an energetic judge, aided by energetic law clerks, would face an impossible workload if she had to synthesize complex bodies of law from scratch for every opinion. Rather than rely on an account of the law provided by one of the parties, a judge is likely to turn to a disinterested source. The authoritative commentary provides precision and analytic refinement.[42] Reliance on it serves in appearance, and perhaps in fact, the judicial virtues of consistency and coherence.[43] Even if reversed, the judge is in some sense beyond reproach.

2. *On Litigants*

The influence of an authoritative commentary is derived also from its impact on potential litigants. The ability of courts to change the law is constrained by the willingness of litigants to press suits first to judgment and then to appellate decision. Litigation is the means by which parties attempt to persuade judges that a particular rule is unfair or obsolete. Even if a particular challenge fails, a steady drumbeat of litigation may have a cumulative effect; important distinctions and qualifications may emerge, eventually leading to a new rule.[44]

Litigants are significantly influenced by the calculus of probable out-

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and interpretation. Speidel, Restatement Second: Omitted Terms and Contract Method, 67 Cornell L. Rev. 785, 786-92 (1982).

On the other hand, authoritative commentary may help clarify—and stabilize—parties' legal entitlements, facilitating planning, bargaining, and settlement.

[41] By contrast, note the efforts of the Massachusetts courts, which had a hundred years of experience applying the Prudent Man Rule prior to the Restatement of Trusts (1935), to avoid fixed rules about prudence. Two analyses contemporaneous with the first Restatement indicate that the courts had preserved much greater flexibility than the commentator. See Robinson & Robinson, Trustee's Investments in Massachusetts, 14 B.U.L. Rev. 88 (1934); Walker, The Investment of Trust Funds Under the So-Called "Massachusetts Rule," 13 Conn. B.J. 237 (1939); see also Shattuck, The Massachusetts Prudent Man in Trust Investments, 25 B.U.L. Rev. 307 (1945).

[42] See, e.g., Speidel, supra note 40, at 785 (describing Restatement (Second) of Contracts (1979) as "blueprint for judicial reasoning in the adjudication of contract disputes").

[43] See generally Kornhauser & Sager, Unpacking the Court, 96 Yale L.J. 82 (1986) (discussing values of consistency and coherence).

[44] A sophisticated body of scholarship debates the extent to which a selective litigation effect makes the common law efficient, even without the help of judges. In brief, the claim is that the common law evolves toward efficiency because parties are more likely to litigate inefficient rules, which will eventually "mutate" under repeated judicial reexamination. The claim is qualified by the recognition that for efficiency to result "parties to particular disputes must represent symmetrically all future interests in such disputes." Rubin, Common Law and Statute Law, 11 J. Legal Stud. 205, 206 (1982). For a summary of this controversial thesis and its

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come. Parties often bring suits, and refuse settlement offers before adjudication, because of their expectation of gain. Particularly in trust investment, the calculus of litigation is likely to be an economic one: Will the payoff from a more efficient investment rule justify the costs of the litigation? An authoritative commentary changes the calculus, not only because it may change the probability of a particular outcome, but also because it is likely to reduce the extent to which parties disagree as to the probable outcome. Litigation challenging the established rule then becomes less likely, in turn reinforcing the authority of the commentary.[45]

Imagine that a particular group of beneficiaries feels that management of their trust is hampered by a narrow conception of prudence that bars investment of part of the portfolio in a promising venture capital pool. Assume that a successful declaratory judgment action would increase the net present value of each beneficiary's interest in the trust by $100,000. With a given line of cases on speculation (but no authoritative commentary), the beneficiaries, each receiving different legal advice, might assess the chances of success as ranging from thirty-five percent to sixty-five percent. The estimates of expected return will therefore vary from $35,000 to $65,000. If litigation fees are $50,000, the beneficiaries who assess the chances of success as greater than fifty percent will regard the expected return of litigation as positive, and thus will press the court to reexamine its view of speculation.[46]

An authoritative commentary may change this picture radically. First, its stabilizing (or ossifying) effect may significantly reduce the chances of success. For example, because of Scott's criticism of investment in new and untried enterprises,[47] the probability of judicial confirmation of the prudence of a venture capital pool is diminished. Second, again because of the stabilizing effect, an authoritative commentary reduces the variation in individual estimates of success. All parties to a

criticism, see Elliott, The Evolutionary Tradition in Jurisprudence, 85 Colum. L. Rev. 38, 62-71 (1985).

This Article looks to judges to help change an obsolete rule. The litigation effect claim here is modest; a pattern of judicial decisions altering an outdated, inefficient rule is more likely to emerge if judges are repeatedly pressed on the rule.

[45] See Priest, Selective Characteristics of Litigation, 9 J. Legal Stud. 399 (1980); Priest & Klein, The Selection of Disputes for Litigation, 13 J. Legal Stud. 1 (1984). Other economic models of litigation are in substantial agreement on this point. See, e.g., Cooter, Marks & Mnookin, Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior, 11 J. Legal Stud. 225 (1982); Gould, The Economics of Legal Conflicts, 2 J. Legal Stud. 279 (1973); Landes & Posner, Adjudication as a Private Good, 8 J. Legal Stud. 235 (1979).

[46] The example makes a number of simplifying assumptions: each beneficiary has a uniform stake in the outcome of litigation (a potential gain of $100,000); all beneficiaries are risk neutral; no mechanism exists for pursuing the action collectively or forcing others to contribute; and litigation costs are fixed and borne by the beneficiary. These assumptions are discussed in greater detail in text accompanying notes 98-122 infra.

[47] See text accompanying notes 30-33 supra.

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dispute are likely to be in closer agreement as to the probable outcome. These two factors reduce the chances of litigation by requiring a much higher potential payoff to justify the litigation and by reducing the likelihood of maverick estimates of success.

Authoritative commentary may also influence the conduct of a lawsuit. Expecting the judge to be influenced by the commentary, the litigants will conform their factual presentations to the categories set forth in the commentary. In anticipation of a possible lawsuit, the parties may fashion their behavior so as to be able to adduce the facts made legally important by the commentary. Thus, the particular influence of Scott in trust law,[48] as opposed to authorities in other fields, may be partly attributable to the premeditation with which trust parties can establish the facts. Unlike an accident giving rise to a tort action, for example, investment management strategy is presumably the result of conscious design, particularly where a professional trustee is involved. If authoritative commentary announces the ground rules, the facts can be preplanned. The facts and theories presented in a lawsuit will often have been tailored to fit the commentary. Thus, if the potential litigants are risk averse, the rules and categories of authoritative commentary will prove self-reinforcing.

The effects of authoritative commentary are powerfully evident in Scott's case. It is striking to see contemporary courts, citing the Restatement, the Treatise, or authority derived from those two sources, haul professional trustees over the coals for investment policies that few financial economists would find exceptionable.[49] Equally remarkable is the paucity of modern cases raising the question of investment prudence.[50]

D. The Cases Reinterpreted

How might things be different if Scott were suddenly regarded as obsolete on investment management? The core of the Prudent Man Rule, as derived from the cases, is the distinction between prudence and speculation. This Article argues that what counts as prudence must be understood in light of our best current understanding of market and investor behavior. The principle underlying the Restatement and the Treatise, and subsequent judicial analysis, is a particular idea of safety: only if each investment is safe, measured in isolation, will the collection of in-

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48 See text accompanying notes 15-19 supra.

49 See, e.g., First Ala. Bank v. Martin, 425 So. 2d 415 (Ala.), cert. denied, 461 U.S. 938 (1983); Chase v. Pevear, 383 Mass. 350, 419 N.E.2d 1358 (1981); In re Bank of N.Y. (Spitzer), 35 N.Y.2d 512, 323 N.E.2d 700, 364 N.Y.S.2d 104 (1974); In re Morgan Guar. Trust Co., 89 Misc. 2d 1088, 396 N.Y.S.2d 781 (Sur. Ct. 1977); see also text accompanying notes 70-88 infra.

50 As is evident from the citations in this Article, there are perhaps ten cases after 1965 giving serious consideration to the trustee's investment management.

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vestments (the portfolio) be safe. The central principle of portfolio theory, by contrast, is that the risk of a portfolio is wholly distinct from the risk of any particular investment contained in the portfolio. The risk of a portfolio is a function of the interrelation of its component investments. Thus, a trustee can use securities and instruments that are highly risky viewed in isolation to assemble a portfolio that is safe. Indeed, this portfolio may earn a significantly higher return than one constructed on earlier notions of safety.[51]

Portfolio theory justifies the inclusion, in appropriate amounts, of stocks thought to be risky.[52] It also justifies the use of financial instruments, highly volatile in themselves, that may be deployed so as to lower portfolio risk or to attain a portfolio of a given risk at a lower cost.[53]

What is remarkable is that, in applying this contemporary vision to the distinction between prudence and speculation, a court need not overrule a single case on which Scott relies; rather, it need only reinterpret the cases in light of a different conception of market and investor behavior.[54] For example, consider the cases supporting one of Scott's pivotal assertions, that a trustee may not "properly purchase speculative shares of stock."[55] In *Kimball v. Reding*,[56] the trustee invested one-third of a $3000 fund in the stock of a start-up railroad. On the court's theory, the stock was speculative. Even under portfolio theory, however, the investment of so large a percentage of the portfolio in such a security would be

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[51] See note 6 supra. Beginning with the first edition in 1939, the Treatise advised the trustee to "consider each [individual] investment not as an isolated transaction but in its relation to the whole of the trust estate. Thus . . . he should so diversify the investments as to diminish the risk of serious losses." 2 Treatise (1st ed.), supra note 17, § 227.12, at 1223. This familiar advice is connected to portfolio theory in only a rudimentary way. It is not elaborated upon in subsequent editions of the Treatise, and does not appear in either of the Restatements.

[52] See note 6 supra.

[53] See note 3 and accompanying text supra.

[54] The cases discussed are all drawn from the Treatise. The Restatement of Trusts (1935) cites no cases. Instead of using the format of more recent restatements, in which reporters' notes follow the black letter law and comments, the American Law Institute arranged for state bar groups to annotate the Restatement in light of their respective local law. In some cases, the annotators indicated clearly whether the text of the Restatement was consistent with state law. See, e.g., Massachusetts Annotations to the Restatement of Trusts 7 (1936) (prepared by M. Shattuck) (noting, however, that statement of substantial agreement "deserves to be regarded with suspicion."). Of further interest is an unusual practice pertaining to tentative drafts of the first Restatement; for most sections the reporter circulated an appendix citing cases, research memoranda, and the like, generally in support of the black letter law. For § 219, the predecessor section to § 227 (Investments Which a Trustee Can Properly Make, see note 23 supra), there is no appendix entry. See Restatement of Trusts (Tent. Draft No. 4, 1933).

[55] 3 Treatise (3d ed.), supra note 17, § 227.6, at 1816; 3 Treatise (2d ed.), supra note 17, § 227.6, at 1670; 2 Treatise (1st ed.), supra note 17, § 227.6, at 1207.

[56] 31 N.H. 352 (1855), cited in 3 Treatise (3d ed.), supra note 17, § 227.6, at 1816 n.2; 3 Treatise (2d ed.) § 227.6, at 1670 n.2; 2 Treatise (1st ed.), supra note 17, § 227.6, at 1207 n.2.

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regarded as imprudent speculation, because it would make the *portfolio* too risky.

The same analysis applies to the other cases Scott relied on. In *In re Estate of Cady,*[57] the trustee invested half of a $25,000 fund in oil and automobile stocks, solely on a stockbroker's recommendation. The trustee had previously made substantial investments in the stocks for his own account, and there was some suggestion that he had initially purchased the trust stock for his own account as well. The court characterized the stocks, "unlisted on any market," as "wild cat" stocks.[58] In *St. Germaine v. Tuttle,*[59] Scott's last case on speculative stocks, the trustee invested more than one-third of an $8000 fund in a heavily indebted company owned by his family, of which the trustee was an officer, director, and shareholder. None of the results in these cases would change with a portfolio theory approach, which would regard concentration of a portfolio in a single security as exposing the portfolio to unacceptable risk.

To emphasize the point, consider the cases that underpin Scott's rule against investments in new and untried enterprises.[60] In *In re McDowell,*[61] the trustee had invested half of a $124,000 fund in bonds of three railroads, two water companies, and a lumber company. All of these ventures had been organized shortly before the trustee's purchase; some had not yet commenced to do business. In *Cornet v. Cornet,*[62] the objectionable new venture investments, representing nearly half of a $25,000 fund, consisted of bonds in a Mexican water company and a Mississippi River bridge company. In *Randolph v. East Birmingham Land Co.,*[63] the trustee exchanged the sole trust asset, certain real estate, for shares of a sham land development company under an agreement that

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[57] 211 A.D. 373, 207 N.Y.S. 385 (1925), cited in 3 Treatise (3d ed.), supra note 17, § 227.6, at 1816 n.2; 3 Treatise (2d ed.), supra note 17, § 227.6, at 1670 n.2; 2 Treatise (1st ed.), supra note 17, § 227.6, at 1207 n.2.

[58] Id. at 375, 207 N.Y.S. at 386-87.

[59] 114 Vt. 263, 44 A.2d 137 (1945), cited in 3 Treatise (3d ed.), supra note 17, § 227.6, at 1816 n.2; 3 Treatise (2d ed.), supra note 17, § 227.6, at 1670 n.2.

[60] See 3 Treatise (3d ed.), supra note 17, § 227.6, at 1816; 3 Treatise (2d ed.), supra note 17, § 227.6, at 1670; 2 Treatise (1st ed.), supra note 17, § 227.6, at 1207.

[61] 102 Misc. 275, 169 N.Y.S. 853 (Sur. Ct.), aff'd in pertinent part, 184 A.D. 646, 172 N.Y.S. 658 (1918), cited in 3 Treatise (3d ed.), supra note 17, § 227.6, at 1816 n.4; 3 Treatise (2d ed.), supra note 17, § 227.6, at 1670 n.4; 2 Treatise (1st ed.), supra note 17, § 227.6, at 1207 n.4.

[62] 269 Mo. 298, 190 S.W. 333 (1916), cited in 3 Treatise (3d ed.), supra note 17, § 227.6, at 1816 n.4; 3 Treatise (2d ed.), supra note 17, § 227.6, at 1671 n.4; 2 Treatise (1st ed.), supra note 17, § 227.6, at 1207 n.4.

[63] 104 Ala. 355, 16 So. 126 (1894), cited in 3 Treatise (3d ed.), supra note 17, § 227.6, at 1816 n.4; 3 Treatise (2d ed.), supra note 17, § 227.6, at 1670 n.4; 2 Treatise (1st ed.), supra note 17, § 227.6, at 1207 n.4.

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let the promoters sell off all their shares. In *In re Executor of Hurlbut*,[64] more than two-thirds of a $12,000 fund was invested in the bonds of a start-up shipping company. None of these cases would come out differently under a modern portfolio theory approach to prudent investment. In each case the portion of the portfolio devoted to risky investments rendered the *portfolio* too risky under the substantive standard of safety appropriate for the trustee.[65]

In a process familiar to the common law lawyer, Scott derived his rules defining prudence by connecting up the points represented by the decided cases, using as his lens the understanding available to him. Scott did not have the conceptual framework to distinguish effectively between some risk, which he thought permissible, and too much risk.[66] Portfolio

[64] 210 A.D. 456, 206 N.Y.S. 448 (1924), cited in 3 Treatise (3d ed.), supra note 17, § 227.6, at 1816 n.4; 3 Treatise (2d ed.), supra note 17, § 227.6, at 1671 n.4; 2 Treatise (1st ed.), supra note 17, § 227.6, at 1207 n.4.

[65] Among cases not cited by Scott, virtually all of the nineteenth and early twentieth century surcharge cases purporting to apply a Prudent Man Rule are consistent with a portfolio theory approach. A majority of the cases clearly involve a "speculative" investment comprising a disproportionately large portion of the portfolio. See, e.g., In re Jenkins' Estate, 260 Mich. 518, 245 N.W. 508 (1932) (75% of trust fund in loan to single corporation, secured by mortgage on real estate of limited value); Michigan Home Missionary Soc'y v. Corning, 164 Mich. 395, 129 N.W. 686 (1911) (entire trust fund in note of lumber business); Durant v. Crowley, 197 A.D. 540, 189 N.Y.S. 385 (1921) (approximately 50% of trust fund in start-up rubber recycling business, secured by mortgage on real estate without substantial value unless business proved successful), aff'd, 234 N.Y. 581, 138 N.E. 455 (1922); English v. McIntyre, 29 A.D. 439, 51 N.Y.S. 697 (1898) (entire trust fund in heavily margined stock trading account); Appeal of Pray, 34 Pa. 100 (1859) (50% of trust fund in start-up enterprise); Murphy-Bolanz Land & Loan Co. v. McKibben, 236 S.W. 78 (Tex. Comm'n App. 1922) (nearly 50% of trust fund in leveraged real estate purchase).

In a few other surcharge cases, the facts and circumstances of the impermissible investment suggest consistency with portfolio theory, but are too scanty for a definitive conclusion. See, e.g., White v. Sherman, 168 Ill. 589, 48 N.E. 128 (1897) (investment in widely fluctuating railroad shares); Mattocks v. Moulton, 84 Me. 545, 24 A. 1004 (1892) (investment of approximately $3000 in stocks and bonds of highly leveraged new business), cited in 3 Treatise (3d ed.), supra note 17, § 227.6, at 1816 n.4; 3 Treatise (2d ed.), supra note 17, § 227.6, at 1670 n.4; 2 Treatise (1st ed.), supra note 17, § 227.6, at 1207 n.4; Steele v. Leopold, 135 A.D. 247, 120 N.Y.S. 569 (1909) (investment in heavily margined stock trading account), aff'd, 201 N.Y. 518, 94 N.E. 1099 (1911). In the pre-Scott era, only one case surcharging the trustee under the Prudent Man Rule seems to involve a challenged investment comprising a relatively small portion of the portfolio. See Morris v. Wallace, 3 Pa. 317 (1846) ($650 invested in stock of troubled bank, balance in mortgage).

[66] The predicament is evidenced by Scott's somewhat inconsistent position on the risk/return tradeoff. Scott asserts that the "primary purpose of a trustee should be to preserve the trust estate, while receiving a reasonable amount of income, rather than to take risks for the purpose of increasing the principal or income." 3 Treatise (3d ed.), supra note 17, § 227.3, at 1811; 3 Treatise (2d ed.), supra note 17, § 227.3, at 1666; 2 Treatise (1st ed.), supra note 17, § 227.3, at 1203. And in the Restatement, he criticizes as improper "a disposition which is speculative in character with a view to increasing his property instead of merely preserving it . . . because it is not a disposition which makes the preservation of the fund a primary consideration." Restatement (Second) of Trusts § 227 comment e (1959); Restatement of Trusts § 277 comment e (1935). Yet in both the Treatise and the Restatement Scott countenances invest-

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theory has given us that framework, enabling us to redraw the line of prudence to fit more precisely the objectives of trustee investment management. Unfortunately, the authority of Scott's work has hindered what would otherwise be a natural development in the common law: the reanalysis of prior case law in light of what we now believe to be a better understanding of markets and investments. Ironically, one of the cases Scott cited to proscribe investment in new ventures could well serve as a linchpin for such reanalysis. In *Appeal of Dickinson*,[67] the questioned investment was stock in the then expanding Union Pacific Railroad. The trustee made two purchases, the first amounting to approximately twenty percent of a $16,000 fund, the second adding another fifteen percent. Despite the investment in a new venture, the court surcharged the trustee for the second purchase only, finding that the trustee was not "justified in investing in such stock as this *so large a proportional part of the property*."[68] The case thus turns on the risk added to the trust estate by such a disproportionately large investment in the railroad stock, not the risk of the stock per se. The court's insight could be read into a more general portfolio theory approach.[69]

E. The Distorting Impact of Scott's Work

The influence of the Treatise and the Restatement have distorted the development of the law. Scott extracted his rules against speculative investment from egregious cases. Recent cases purporting to rely on Scott's rules have applied them to situations that, measured by the cases Scott cited, are relatively unproblematic, and that, from the perspective of portfolio theory, are virtually unexceptionable. For example, in *Chase v. Pevear*,[70] the trustee was put to the test, in an appeal of a surcharge, of justifying investments of approximately four percent of portfolio assets in

ments other than government bonds, based on a risk/return tradeoff that is foreign to his system of capital preservation. "There are other securities which yield a higher return as to which the element of risk is sufficiently small so as to make them proper trust investments." 3 Treatise (3d ed.), supra note 17, § 227.3, at 1811; 3 Treatise (2d ed.), supra note 17, § 227.3, at 1667; 2 Treatise (1st ed.), supra note 17, § 227.3, at 1204. Scott had the intuition but lacked the necessary conceptual framework to quantify risk in a useful way.

[67] 152 Mass. 184, 25 N.E. 99 (1890), cited in 3 Treatise (3d ed.), supra note 17, § 227.6, at 1816 n.4; 3 Treatise (2d ed.), supra note 17, § 227.6, at 1670 n.4; 2 Treatise (1st ed.), supra note 17, § 227.6, at 1207 n.4.

[68] Id. at 189, 25 N.E. at 100 (emphasis added).

[69] *Dickinson* is not the only case so reasoning. In Appeal of Davis, 183 Mass. 499, 67 N.E. 604 (1903), the court permitted an initial investment of approximately 20% of a $30,000 trust in stocks and bonds of a railroad company, but not a subsequent investment of an additional 20%. In Thayer v. Dewey, 185 Mass. 68, 69 N.E. 1074 (1904), the court permitted investment of a "small part" of a "very large" trust fund to be invested in Illinois real estate. Id. at 70, 69 N.E. at 1075.

[70] 383 Mass. 350, 419 N.E.2d 1358 (1981).

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four publicly listed companies in the housing industry. The surcharge on two of the investments was sustained on the grounds that the trustee failed to sell soon enough.[71] The court seems to have assumed that the trustee should have outguessed the market in foreseeing the decline in the value of those investments. For other investments (including Penn Central), the critical fact that persuaded the court against a surcharge for speculation was the widespread holding of the stock by other financial institutions.[72] The court did not consider the proportion of the questioned investments either to the trust as a whole or to the other investments in the portfolio.

In *First Alabama Bank v. Martin*,[73] a bank trustee was surcharged for including in a well-diversified common trust fund seventeen publicly traded stocks and the bonds of six real estate investment trusts that the court regarded as not meeting certain fixed criteria for safety.[74] The court adopted a security-by-security approach, assessing company size, market capitalization, credit rating, and seasoning[75] by standards that would exclude most publicly traded securities. The court seemed indifferent to the proportion of the challenged investments in the portfolio and to the makeup of the portfolio as a whole. The court also sustained a surcharge for the trustee's sale of other securities[76] at what, in hindsight, was the bottom of the 1970s bear market, effectively demanding prescience by the trustee.

In a more complicated case, *Estate of McCredy*,[77] the trustee was not surcharged for investing six percent of the portfolio in three common stocks deemed risky by the court, but only because the court did not apply the Prudent Man Rule. Instead, the court deferred to the testator's approval of the trustee's "personal investment philosophy,"[78] one that explicitly sought the appreciation of principal.[79] The court examined the challenged investments in isolation; among the stocks it regarded as too risky (in the 1960s and early 1970s) under the Prudent Man Rule was Chrysler Corporation, " 'a businessman's risk stock' in a cyclical industry."[80]

In *Steiner v. Hawaiian Trust Co.*,[81] the trustee was surcharged for an

[71] Id. at 366-67, 419 N.E.2d at 1367-68.
[72] Id. at 369-70, 419 N.E.2d at 1369.
[73] 425 So. 2d 415 (Ala.), cert. denied, 461 U.S. 938 (1983).
[74] Id. at 426-28.
[75] Id. at 419-20.
[76] Id. at 428.
[77] 323 Pa. Super. 268, 470 A.2d 585 (1983).
[78] Id. at 287, 470 A.2d at 595.
[79] Id. at 278, 470 A.2d at 590.
[80] Id. at 283, 470 A.2d at 593.
[81] 47 Haw. 548, 393 P.2d 96 (1964).

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$1100 investment in a "speculative" sugar company stock, out of a fund of $106,000. Finally, in a case where diversification might have been legitimately questioned, *In re Newhoff*,[82] trustees were surcharged for investments in real estate investment trusts, but simply because they were not seasoned securities with long histories of earnings. The court cited *Martin* with approval.[83]

Even cases that are generally viewed as protecting trustees demonstrate the distorting effects of the constrained Rule. In *In re Morgan Guaranty Trust Co.*[84] and *Stark v. United States Trust Co.*,[85] the courts rejected surcharge claims respecting certain equity securities, principally because of the prudent process of formal review, research, and decision making performed by the professional trustees.[86] In both cases, the court

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82 107 A.D.2d 417, 486 N.Y.S.2d 956 (1985).

83 Id. at 427-28, 486 N.Y.S.2d at 963.

In addition to their effect on individual investments, Scott's flat declarations about speculation have also had a negative impact on the use of leverage in designing the optimum portfolio. The Restatement designates the purchase of stock on margin as clear speculation. Restatement (Second) of Trusts § 227 comment f (1959); Restatement of Trusts § 227 comment f (1935); see also 3 Treatise (3d ed.), supra note 17, § 227.6, at 1816; 3 Treatise (2d ed.), supra note 17, § 227.6, at 1670-71; 2 Treatise (1st ed.), supra note 17, § 227.6, at 1206-07. The case cited in support of that proposition, In re Estate of Hirsch, 116 A.D. 367, 101 N.Y.S. 893 (1906), aff'd, 188 N.Y. 584, 81 N.E. 1165 (1907), cited in 3 Treatise (3d ed.), supra note 17, § 227.6, at 1816 n.1; 3 Treatise (2d ed.), supra note 17, § 227.6, at 1670 n.1; 2 Treatise (1st ed.), supra note 17, § 227.6, at 1207 n.1, would have had the same result if decided on portfolio theory grounds. The trust fund was leveraged to such an extraordinarily high degree that payment of $52,000 out of a fund of $80,000 was necessary to meet a margin call. The degree of leverage made the portfolio far too risky for a trust fund. In the third edition of the Treatise, 3 Treatise (3d ed.) supra note 17, § 227.6, at 1816 n.1, Scott also cites Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bocock, 247 F. Supp. 373 (S.D. Tex. 1965). *Bocock* found short sales and margin accounts equivalent and "speculative to the extent that they can be termed 'rank gambles.'" Id. at 379. The court gave no clear indication of the size of the trust, but it is likely that the extent of the short selling left the fund highly leveraged. See also Shaner Estate, 26 Pa. D. & C.2d 450, 450 (1961) (citing Restatement (Second) of Trusts § 227 comment f (1959)). These cases, following Scott, ignore the trustee's failure to monitor the investment position and cut losses at a particular point. If we assume that a trustee can invest an appropriate portion of portfolio assets in a particular stock on the basis of securities research that suggests the stock will hold a steady value or perhaps increase, then it follows that the trustee should be able to capitalize on research showing the opposite by selling the stock short. The problem arises where, as in *Hirsch* and *Bocock*, the trustee's failure to monitor exposes the portfolio to excessive risk of loss.

By condemning all uses of margin and short sales, Scott proscribes techniques that can be employed in a manner entirely consistent with a low level of portfolio risk. See, e.g., Elton & Gruber, supra note 6. Moreover, in categorically condemning these instances of leverage, Scott calls into question new techniques, such as writing uncovered call options or using financial futures, that enhance the trustee's capacity to manage a portfolio at the lowest possible cost. See notes 3, 35-36 and accompanying text supra.

84 89 Misc. 2d 1088, 396 N.Y.S.2d 781 (Sur. Ct. 1977).

85 445 F. Supp. 670 (S.D.N.Y. 1978).

86 In *Morgan Guaranty*, the court refused to surcharge a bank for transactions involving four securities (including Penn Central) made in its administration of a common trust fund. The securities in question probably represented only a small percentage of a highly diversified

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considered each challenged security in isolation, not in relation to the portfolio as a whole.[87] Indeed, it is impossible to determine from the opinions what percentage of each portfolio was represented by any security. The courts' method, detached from any substantive standard, invites analysis of paper trails rather than investment rationales and may well encourage expensive formal procedures that do not contribute to beneficiary welfare.[88]

The approach of these courts to prudent investment is remarkable in several respects. The courts failed to consider portfolio theory rationales for the trustees' behavior,[89] even though the theory has been accepted by investment managers since the late 1960s and has been a commonplace of legal academic discussion since the early 1970s.[90] By contrast, in other

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fund, but the court focused instead on the structure and procedures of the trust department. See 89 Misc. 2d at 1093-95, 396 N.Y.S.2d at 785-87.

In *Stark*, the court refused to surcharge a bank for retention of three particular securities in four private trusts. Although it is impossible to determine from the opinion the percentage of the fund represented by the three stocks, it is unlikely that the trusts were highly diversified. The three stocks had been included in the trusts on the grantor's initiative, and the trust instrument empowered the trustee to retain the stocks without regard to a claim of alleged overrepresentation in the fund. 445 F. Supp. at 672. The court focused on the research procedures of the bank and the decision-making process of the bank trust officer in reviewing the fund's holdings. See id. at 672-77, 680-82.

[87] See *Morgan Guaranty*, 89 Misc. 2d at 1092-95, 396 N.Y.S.2d at 785-87; *Stark*, 445 F. Supp. at 674-77.

[88] See note 159 infra.

[89] This failure may be partly explained by the timidity of the lawyers. There is some indication of a hesitance to use the portfolio theory argument. See, e.g., American Stock Exch., Options for Institutions: The Prudent Man Rule (1978), which argues for the prudence of covered call writing using traditional trust principles.

> If the stock goes up in price, the only sacrifice . . . is an opportunity for even greater profits. Since trust assets are not held for speculation and the highest profit, this possibility may be irrelevant. If the stock declines in value, writing covered calls . . . reduces the loss which would have been incurred on the underlying stock had the calls not been written. Therefore, such an investment technique acts to conserve principal. If the price of the stock remains constant, the premium income adds to the yield on the investment, thus increasing the productivity of the property.

Id. In Hamilton v. Nielson, 678 F.2d 709 (7th Cir. 1982), the court suggested that the plaintiff had missed a potential basis for surcharge by failing to make a portfolio theory argument. Id. at 712-13 (Posner, J.). In evidencing receptivity to modern portfolio theory, however, *Hamilton* is a unique judicial opinion in trust law.

[90] The initial theoretical work on portfolio theory was done by 1965. Among the seminal contributions were Markowitz, Portfolio Selection, 7 J. Fin. 77 (1952); H. Markowitz, Portfolio Selection: Efficient Diversification of Investments (1959); Sharpe, Capital Asset Prices: A Theory of Market Equilibrium Under Condition of Risk, 19 J. Fin. 425 (1964); Linter, The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets, 47 Rev. Econ. & Statistics 13 (1965). By 1969 work on portfolio theory was carried on throughout the finance community. See Jensen, The Foundations and Current State of Capital Market Theory, in Studies in the Theory of Capital Markets 3-46 (M. Jensen ed. 1972) (summarizing 1969 conference on current state of capital market theory). Investment managers began to apply the theory in the late 1960s; by the 1970s, it had become commonplace. See Treynor, How to Rate Management of Investment Funds, Harv. Bus. Rev., Jan.-

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areas of the law the claims of modern finance theory have been absorbed rapidly into the judicial reasoning process.[91]

The question remains: Why have the Restatement and the Treatise had such a profound and persistent influence on the law of investment management? Certainly the first *Restatement of Contracts*[92] and Williston's treatise,[93] for example, while influential, have not been treated with comparable judicial deference.[94]

At least two distinct factors seem significant in accounting for the influence of Scott and, thus, the persistence of the constrained Prudent Man Rule: first, the position of those subject to the rule, and second, the process of judicial reception of a complex social science model whose acceptance appears to entail sweeping doctrinal change.

Feb. 1965, at 63; Treynor, Priest, Fisher & Higgins, Using Portfolio Composition to Estimate Risk, Fin. Analysts J., Sept.-Oct. 1968, at 93; Block, Elements of Portfolio Construction, Fin. Analysts J., May-June 1969, at 123; Welles, The Beta Revolution: Learning to Live with Risk, Institutional Investor, Sept. 1971, at 21; Lorie, Four Cornerstones of a New Investment Policy, Institutional Investor, Nov. 1971, at 48. The theory was quickly funneled into the work of legal academics. See, e.g., Cohen, The Suitability Rule and Economic Theory, 80 Yale L.J. 1604 (1971); Note, The Regulation of Risky Investments, 83 Harv. L. Rev. 603 (1970).

91 For example, courts have recently employed one key element of the modern finance paradigm, the efficient market hypothesis (EMH), in finding the reliance element in a securities fraud action satisfied by reliance on the market price—which on an EMH view impounds all relevant information—even if the plaintiff had not read the documents containing the misleading statement. See, e.g., In re Ramada Inns Sec. Litig., 550 F. Supp. 1127, 1330-31 (D. Del. 1982); In re LTV Sec. Litig., 88 F.R.D. 134, 142-45 (N.D. Tex. 1980); Black, Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions, 62 N.C.L. Rev. 435 (1984); Fischel, Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities, 38 Bus. Law. 1 (1982).

92 Restatement of Contracts (1932).

93 S. Williston, A Treatise on the Law of Contracts (1920).

94 For example, the first *Restatement of Contracts* stated that an assignee's acceptance of a contract ordinarily carries the assignee's promise to perform the assignor's duties under the contract. Restatement of Contracts § 164(2) (1932). No distinction was drawn between contracts for the sale of goods or services and those for the sale of land. Nevertheless, courts drew such a distinction and rejected the rule in land contracts. See, e.g., Langel v. Betz, 250 N.Y. 159, 164 N.E. 890 (1928). This is recognized in the *Restatement (Second) of Contracts*, which retreats to a "no opinion" on the land contracts distinction. Restatement (Second) of Contracts § 328 & comment c (1979). See 3 S. Williston, A Treatise on the Law of Contracts § 418A (3d ed. 1959 & Supp. 1979); 4 A. Corbin, Corbin on Contracts § 906 (1951 & Supps. 1971 & 1980).

The first *Restatement of Contracts* stated that a promisor's duty to a donee beneficiary could not be altered by any contrary agreement with the promisee, unless such a power were reserved in the initial agreement. Restatement of Contracts § 142 (1932). Thus, a party taking out a life insurance policy could not change the beneficiary unless the policy reserved such a right. Courts rejected such irrevocability, as is recognized and accepted by the *Restatement (Second)*. Restatement (Second) of Contracts § 311 (1979); see 2 S. Williston, supra, §§ 396-397; 4 A. Corbin, supra, §§ 813-815.

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II

THE POSITION OF THOSE SUBJECT TO THE RULE

The persistence of the constrained Prudent Man Rule, as evidenced by recent judicial interpretation of the Rule, derives in part from the position of those who are affected by the Rule: trustees and beneficiaries. A significant factor in the development of the common law is the decision of particular litigants to contest rules adverse to their interests. Through litigation, parties seek to educate and lobby courts; out of litigation, new rules may emerge.[95] What is surprising, even stunning, is the paucity of recently decided cases that take up the question of investment prudence.[96]

It was argued above that the authority of the Restatement and the Treatise diminished the likelihood of litigation challenging the constrained Prudent Man Rule.[97] It seems unlikely, however, that this authority alone could discourage almost all such litigation. But if we assume that trust investment litigation is based on an economic calculus, then we find that certain peculiar characteristics of trust law further reduce the likelihood of litigation. In particular, one set of potential litigants, the beneficiaries, is stymied by a series of collective action problems, each reducing the probability of litigation. Another set of potential actors, trustees, confront a compensation structure that discourages them from challenging the constrained Rule, whether by litigation or legislative action.

A. Beneficiaries

1. Contracting Around

Settlors (including testators) are permitted to contract around investment limitations otherwise set by law.[98] A well-advised party can include trust provisions to permit investments that might otherwise be

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[95] The claim is not that litigation will necessarily lead to a superior rule, but that without litigation a superior rule cannot emerge. See Cooter & Kornhauser, supra note 37, at 145-50.

[96] See note 50 supra.

[97] See text accompanying notes 47-49 supra.

[98] See Restatement (Second) of Trusts § 227(a) & comments u-v (1959); 3 Treatise (3d ed.), supra note 17, § 227.14, at 1848-54. See also H. Bines, The Law of Investment Management ¶ 5.02[2] n.16 (1978) (giving examples of clauses expanding investment powers). A similar principle obtained even in the legal list states, such as New York. See, e.g., In re Will of Clark, 257 N.Y. 132, 177 N.E. 397 (1931); see also Temporary State Comm'n on the Modernization, Revision and Simplification of the Law of Estates, The Prudent Man Rule for Fiduciary Investments, 2 N.Y. Legis. Docs. Rep. No. 6.12A, 188th Sess. 536 (1965) [hereinafter N.Y. State Comm'n Report] ("Where, however, a testator has granted full investment discretion to his fiduciary under the terms of his will or trust deed, the New York courts have unhesitatingly sustained acts of the trustee done in good faith and of the sort that might be imputed to a prudent man."). See generally Annotation, Authorization by Trust Instrument of Investment

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questionable under the Prudent Man Rule. Over time, settlors have employed such provisions with increasing frequency.[99] Because large trusts are likely to receive sophisticated legal advice and thus will often contract out of the Rule,[100] the class of beneficiaries with the most substantial economic stake will tend to be excluded from the pool of potential litigants; they have no need for such litigation.[101]

2. *Beneficiary Free Riding*

A beneficiary of a trust subject to the constrained Prudent Man Rule could bring a surcharge action based on the trustee's failure to invest in accordance with an unconstrained Rule, or, less aggressively, a declaratory judgment action seeking application of the unconstrained Rule.[102] In either event, the litigating beneficiary faces a structural barrier to litigation known as the free rider problem. A successful beneficiary litigant can capture the gain from the new Rule only in proportion to his interest in the trust—even if he bears the full cost of litigation.[103]

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of Trust Funds in Nonlegal Investments, 78 A.L.R.2d 7 (1961) (discussing construction of such authorization clauses).

It is important to distinguish clauses that expand investment power from exculpatory, or exoneration, clauses, which excuse trustee negligence. The latter, if enforced at all, are strictly construed. See H. Bines, supra, ¶ 5.02[2].

99 A study done before the 1950 revision of New York law that permitted partial investment in "non-legals" indicated that the proportion of trusts subject to the statutory limitation was approximately 20% by assets and 30% by number. Trust Investment Study Comm., New York State Bankers Ass'n, Report 21 (1949). A subsequent New York study, in 1963, indicated that the proportion of trusts subject to the statutory limitation was approximately 9% by assets and 20% by number. N.Y. State Comm'n Report, supra note 98, at 542-43. See generally Strand, New York's Partial Prudent-Man-Rule, 25 N.Y.U. L. Rev. 583 (1950) (commenting on 1950 revision).

100 Small trusts eventually receive some benefit when the expanded powers clauses appear in form books.

101 The ability of settlors to contract around investment restrictions is not unlimited, however. Courts may strictly construe purported authority to invest beyond the scope of the constrained Rule. See 3 Treatise (3d ed.), supra note 17, § 227.14, at 1848-52; see also Restatement (Second) of Trusts § 227 comments u-w (1959) (suggesting limits on trustee's discretion in using expanded investment authority). Thus, expanded powers clauses of previously drafted trust instruments may not provide sufficient comfort for a trustee contemplating investments or investment techniques not specifically approved. Moreover, there may be a significant lag time between the invention of new instruments or techniques and their inclusion in expanded powers clauses.

102 Technically, such a declaratory action would probably be characterized as a petition for instructions or a will construction.

103 Whether a beneficiary could recover such litigation costs out of the trust fund is uncertain. Many courts allow recovery for *successful* litigation where the entire trust has benefited, for example, where a beneficiary's action against the trustee resulted in a surcharge. But for litigation that succeeded in expanding the trustee's investment powers, a court might refuse litigation costs on the grounds that the benefit is speculative. Recovery for *unsuccessful* litigation costs is still more problematic. A court upholding the constrained Prudent Man Rule is likely to regard recovery of litigation costs as an encouragement of pointless litigation wasting

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Other beneficiaries will "free ride" on his success. Even if the expected return to the beneficiaries collectively is positive, rarely will any particular beneficiary acting individually encounter a positive expected return. The result is to reduce the probability of a litigation challenge.[104]

A simplified example will illustrate this point. Assume a generation-skipping trust of $100,000 with five beneficiaries (and their heirs) equally sharing in income. The trust earns a ten percent annual return under the constrained Prudent Man Rule but would earn fifteen percent under an unconstrained Rule. Assuming a constant discount rate of ten percent, the net present value of the trust would increase from $100,000 to $150,000 because of the change in Rule. Assume that the costs of litigation are $10,000 and that there is a thirty percent chance of success. If the beneficiaries act collectively, the expected return is positive, $1000 for each beneficiary [.30 × (150,000 − 100,000) = 15,000, which is $5000 more than litigation costs]. But each beneficiary would much prefer to free ride—to let someone else bring the litigation (i.e., bear the litigation costs)—improving the expected payoff for a nonlitigating beneficiary to $3000 [15,000/5]. The problem is that none of the beneficiaries has a large enough interest in the trust to warrant bringing the litigation individually. The expected return to any single beneficiary is less than the litigation costs.[105] In the absence of a device to force the parties to act

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trust fund assets. See 3 Treatise (3d ed.), supra note 17, §§ 188.4, 245, 245.1; Annotation, Allowance of Attorneys' Fees in, or Other Costs of, Litigation by Beneficiary Respecting Trust, 9 A.L.R.2d 1132, 1144-45, 1150-56, 1162-68, 1192-1202, 1205-11 (1950).

[104] On occasion, beneficiaries may bring suit to obtain deviation from restrictive terms in the trust instrument, typically to permit investment in common stocks and bonds. Deviation has been granted in some instances. See In re Mayo, 259 Minn. 91, 105 N.W.2d 900 (1960); see also Davison v. Duke Univ., 282 N.C. 676, 194 S.E.2d 761 (1973) (institutional beneficiary bringing suit). It has been denied in others. See Toledo Trust Co. v. Toledo Hosp., 174 Ohio St. 124, 187 N.E.2d 36 (1962); see also Troost Ave. Cemetery v. First Nat'l Bank, 409 S.W.2d 632 (Mo. 1966) (institutional beneficiary). Such deviation suits also have free rider problems, but since the object is only to gain permission for the trustee to follow the constrained Prudent Man Rule, the likelihood of success may be greater.

The free rider problem goes beyond the question of capturing all the gains to a particular trust. Presumably litigation that successfully unconstrained the Prudent Man Rule would benefit all other trusts. No beneficiary, and no single trust, could capture any of those gains. See text accompanying notes 114-16 infra.

[105] For the sake of simplicity, this example is presented on risk neutral assumptions. If the parties are risk averse, the payoff from success must be correspondingly larger, both for the beneficiaries acting collectively and for any single beneficiary whose stake in the trust might be sufficiently large to warrant individual action.

The expected return to a risk neutral individual beneficiary is negative even if litigation costs in a successful suit are reimbursed by the trust fund. The payoff structure is as follows: the beneficiary has a 30% chance of an $8,000 gain [.30 (150,000 − 100,000 − 10,000)/5] but a 70% chance of a $10,000 loss. The expected return is negative [.30 (8,000) + .70 (−10,000) = −4,600]. In this not atypical example, the expected return to the individual beneficiary is positive only on a rule of trust fund reimbursement of litigation costs in all beneficiary suits brought to benefit the fund, even unsuccessful ones [.30 (8,000) + .70 (−10,000/5) = 2,400

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collectively (or share costs), the litigation will not be brought, and the rule is less likely to be changed.[106]

The free rider problem is exacerbated by the effect of the authoritative commentary supporting the constrained Rule.[107] Such commentary further reduces the likelihood that a particular beneficiary will find positive expected return in a litigation challenge.

3. *Reduced Settlement Opportunities*

The expected payoffs of beneficiary litigation are also diminished by the collective action problems associated with trust litigation settlement. Were the litigation a typical, bipolar private law dispute, the two parties (here, beneficiary and trustee) would face the choice of whether to settle the dispute or litigate it to judgment and appeal. Current models of the litigation process suggest that settlement should generally occur where the plaintiff expects to gain less than the defendant expects to lose.[108] It

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– 1,400 = 1,000]. These examples make the simplifying assumption that litigation costs are fixed. This is not so in most actual litigation, in which parties are continuously making judgments as to whether further litigation expenditures are warranted. For a detailed analysis of the effect of litigation costs on the development of the common law, see Denzau, Litigation Expenditures as Private Determinants of Judicial Decisions: A Comment, 8 J. Legal Stud. 295 (1979).

[106] In some contexts, state law addresses the problem of collective action by beneficiaries, for example, New York's guardianship procedure for common trust funds. N.Y. Banking Law § 100-c(6) (McKinney Supp. 1987) (guardian compensated out of fund whether or not he prevails). The predecessor of this statute was the basis for the suit in In re Bank of N.Y. (Spitzer), 35 N.Y.2d 512, 323 N.E.2d 700, 364 N.Y.S.2d 164 (1974).

Another means of attempting to avoid the free rider problem is the class action. A recent Alabama common trust fund case was brought as a class action, with the beneficiaries' attorneys evidently contemplating fees out of a successful class recovery. See First Ala. Bank v. Martin, 425 So. 2d 415 (Ala.), cert. denied, 461 U.S. 938 (1983).

The theory of attorney compensation in class actions is that the party creating a fund for the benefit of the class is entitled to compensation from the fund. But since it would be difficult to persuade a court that a trustee's adherence to the constrained Rule constituted imprudence, see, e.g., In re Will of Kilmer, 18 Misc. 2d 60, 69-70, 186 N.Y.S.2d 120, 130-31 (Sur. Ct. 1959) (conservative investment plan not a basis for imposition of liability), litigation seeking to revise the Prudent Man Rule would likely produce no fund. And a court would be reluctant to award attorney fees out of future incremental gains.

Moreover, *First Ala. Bank* notwithstanding, the availability of class actions for beneficiary trust litigation is controversial. See 3 Treatise (3d ed.), supra note 17, § 214, at 1726 (1967 & Supp. 1984) ("Ordinarily a beneficiary . . . is not permitted to bring a class suit . . . . But where there are numerous beneficiaries, such a suit may be permitted."). In Ferrell v. Mercantile Trust Co., 490 S.W.2d 397 (Mo. Ct. App. 1973), for example, the court dismissed a class action brought by a beneficiary of one of the trusts administered by a bank trust department to challenge increased fees announced by the trustee bank. Id. at 399. The class included the beneficiaries of that particular trust and of all other trusts administered by the bank. The alternative proposed by the court, objection by the beneficiaries of each trust at the time of the bank's accounting, id. at 400, is a much more expensive mechanism.

[107] See text accompanying notes 44-47 supra.

[108] See, e.g., Landes & Posner, supra note 45, at 260.

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could well be that the trustee would offer to settle by adopting an unconstrained Rule for a particular trust. The possibility of such a settlement, a low-cost option for the resolution of a two party dispute, would undoubtedly influence the initial decision to litigate.[109] Settlement of a trust dispute will not be so simple, however. Trust litigation, because it is generally not bipolar, is much harder, and more costly, to settle. A settlement cannot bind absent beneficiaries,[110] so negotiation costs among beneficiaries must be incurred and apportioned. Moreoever, to bind beneficiaries of a common trust fund, or beneficiaries lacking legal capacity, or not yet in existence, would require special, costly representation by a guardian accountable to the court.[111] Thus, adoption of the unconstrained Rule through settlement of trust litigation would in many cases require judicial intervention[112] and judicial agreement with the proposed standard—in effect, a litigation of the unconstrained Rule. In short, a cheap settlement option, in which the trustee agrees to invest per the unconstrained Rule, may not exist, thereby reducing the willingness of beneficiaries to initiate litigation.[113]

4. *Public Goods*

Many of the problems associated with litigation against the constrained Prudent Man Rule stem from the public goods problem of an improved rule of law. An improved rule may be like a bridge: everyone benefits, but no one person benefits enough to warrant his building the bridge.[114] An unconstrained Rule would benefit all trusts, but the particular beneficiary litigant cannot capture these benefits and thus may have insufficient incentive to bring the litigation. In some areas of law the private goods (the litigation payoff) may be large enough that a substantial amount of public goods (an improved rule) gets produced. In other

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[109] See the discussion of litigation costs, which bear crucially on the question of settlement, in note 103 supra.

[110] See 3 Treatise (3d ed.), supra note 17, §§ 216, 216.2 to .3.

[111] See 1 id. § 7, at 71-73; G. Bogert & G. Bogert, supra note 12, § 871, at 144-45. However, under the doctrine of "virtual representation" a guardian ad litem will generally not be appointed for underage or nonextant beneficiaries whose interests derive directly from beneficiaries who can appear. Id. at 141-45.

[112] This result also occurs in class actions, see, e.g., Kornhauser, Control of Conflicts of Interest in Class-Action Suits, 41 Pub. Choice 145 (1983), and in child custody disputes, see, e.g., Wexler, Rethinking the Modification of Child Custody Decrees, 94 Yale L.J. 757 (1985).

[113] Put somewhat differently, litigation ordinarily gives an aggrieved party two opportunites for law reform: reform of the public rule, through adjudication and appeal (high cost), and reform of the private rule that governs the relationships between the particular parties to the dispute, through settlement (low cost). In trust law, the two opportunities may merge into one.

[114] See generally Landes & Posner, supra note 45 (finding that public courts do not automatically generate efficient rules).

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areas, such as trust investment management law, it is likely that not enough of this public good is produced. In the example above,[115] adopting more realistic assumptions about the gain in investment performance from an unconstrained Rule will illustrate the public goods problem. Assume an annual return improvement from ten percent to only twelve percent (rather than fifteen percent). The expected return from litigation, \$6000 [.30 × (120,000 − 100,000)], is less than the costs, even if all the beneficiaries of the particular trust act collectively. Yet there will undoubtedly be other trusts similarly situated. All would benefit from an unconstrained Rule; but because each is unable to capture the benefit conferred on other trusts, each is unwilling to litigate. The problem is especially serious because many financial fiduciary relationships draw on trust law for guidance and analogy on investment management issues. No private trust litigant could capture the benefit all such fiduciary institutions would derive from an unconstrained Rule.[116]

One factor exacerbating the extent to which private trust litigation fails to produce enough of this public good is the contracting-around option discussed above.[117] Large, recently established trusts are likely to have received advice enabling them to adopt an unconstrained Rule by settlor contract. But these are precisely the trusts for which the payoff of an unconstrained Rule might well justify litigation (or legislative action) for an improved rule that would benefit all. This leads to a heretical question: Should we therefore deny the enforceability of trust provisions enlarging trustee investment management powers?

The question is heretical because it suggests a wealth transfer from large trusts—deprived of the presumably lower-cost contracting-around option—to all other trusts and to those other financial fiduciaries that look to trust law for guidance. Of course, the mere fact that a transfer of wealth would occur is not dispositive. This particular proposal, for example, would satisfy both Posnerian and Rawlsian conceptions of justice

[115] See notes 105-06 and accompanying text supra.

[116] For a general discussion of the problems of individuals creating a collective benefit, see M. Olson, The Logic of Collective Action (1971).

One question raised by this analysis is why, in light of their considerable assets, endowments and foundations have not challenged the constrained Rule. The answer may lie in the risk that such litigation could end their ambiguous status vis-a-vis the Prudent Man Rule and other trust law investment management doctrines. See W. Cary & C. Bright, The Law and the Lore of Endowment Funds 19-27 (1969) (arguing that corporate standard, rather than trust standard, governs investment management by charitable corporations). Endowments apparently regard themselves as somewhat less confined by the constrained Rule than bank trust departments, see B. Longstreth, supra note 1, at 22-29, perhaps because of the absence of a plaintiff (except a state attorney general) to challenge their investment decisions. They also frequently employ total return concepts that let them freely spend from capital gains. See note 202 infra. A definitive adjudication could end this separate status.

[117] See text accompanying notes 98-101 supra.

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if it simultaneously increased wealth generally (if more trust money was subject to an unconstrained Rule)[118] and increased the wealth of the least well off.[119]

Moreover, it might be that preserving the contracting-around option is a decidedly second best policy in comparison with a regime that facilitates regular updating of the standards for prudence. Trusts frequently endure for long periods during which investment models change; today's expansive clause may be insufficiently broad to permit next year's new investment. Litigation (or perhaps legislative action) may be necessary in a continuous process of unconstraining; thus, a greater number of potential litigants (or legislative activists) seeking improved rules benefits all trusts. Whether the end of the contracting-around option would result in a transfer of wealth depends on whether large trusts are better off with individually tailored investment provisions that may become obsolete or with general investment management rules that are more likely to be modern.

If, on libertarian grounds, one is ill-disposed toward eliminating the contracting-around option, there is a way in which the option could be employed to ameliorate the public goods problem of improved trust investment rules. A public disclosure mechanism for clauses modifying trustee investment powers could be instituted. Such a mechanism would make it relatively easy to argue, to a court or a legislature, that the content of prudence is best defined by the contemporary consensus of contracted-for trust provisions, because these will reflect the views of sophisticated, well-advised settlors as to appropriate investment. Put another way, prudence, as the standard form investment provision for trusts should reflect the investment policy that settlors would contract for in the absence of transaction costs. These transactions costs include the lack of perfect foresight as to optimum investment strategy. At a given point in time, the best evidence of what silent settlors would have contracted for is the explicit provisions that other settlors at that time generally include. Private activity in the trust area could thereby be used to help provide the public good of a continuously modernized trust investment rule.[120]

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[118] See R. Posner, The Economics of Justice 60-65 (1981).

[119] See J. Rawls, A Theory of Justice 14-15 (1971).

[120] Arguments about implicit contractual terms of silent parties must be made with caution. It may be the case that silent parties are not similarly situated in relevant respects to explicitly contracting parties, or that making certain terms explicit would have indeterminate spillover effects on other terms. For example, it may be contended that the risk preferences of settlors creating large trusts (with state-of-the-art investment clauses) will differ from those of other settlors. One reponse is that most settlors, irrespective of wealth, share the common goal of assuring the financial security of immediate beneficiaries, and that this goal will lead to similar attitudes toward risk. This hypothesis could be tested through empirical study of actual in-

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5. *Beneficiary Calculation*

A separate factor, unrelated to payoffs, that inhibits litigation by beneficiaries subject to a constrained Rule is the lack of sophistication among beneficiaries, particularly those of smaller trusts. The analysis developed above[121] assumes that beneficiaries know of the potential payoff from a change to an unconstrained Rule. But this assumption may be unrealistic for most beneficiaries. Indeed, one reason for the establishment of a trust is the settlor's belief that the beneficiaries are not competent to manage money. Even a relatively sophisticated beneficiary may be unaware of the modern portfolio theory paradigm that identifies the costs of a constrained Rule. So long as the trust earns a positive rate of return, such a beneficiary will be content and thus unmotivated to challenge the constrained Rule.[122]

B. Trustees

Ordinarily we think of trustees as solving many of the collective action problems for trust beneficiaries. Trustees are charged to act for the beneficiaries as a group and to provide the financial sophistication that the beneficiaries may lack. But the incentive structure that trustees face reduces the likelihood of both litigation challenges to the constrained Prudent Man Rule and efforts at legislative reform. First, professional trustees are generally compensated by reference to assets under management rather than performance.[123] Performance-based fee structures for superior trustee performance are viewed as antithetical to the traditional aversion to speculation by trustees.[124] Second, the difficulties in shifting trust funds from one trustee to another limit the competitive effect of

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vestment clauses. As for the possibility of spillover, it seems unlikely that the adoption of a broadened investment clause would have an effect on other substantive provisions of the trust instrument.

[121] See text accompanying notes 105-06 supra.

[122] A beneficiary plaintiffs' bar would address the problem of lack of sophistication; however, there may be problems in compensating such a group of specialist attorneys. See note 106 supra.

[123] See 3 Treatise (3d ed.), supra note 17, § 242, at 2108-11. The general principle is that the trustee is entitled to "reasonable compensation" for his services. Id. at 2109. Many state statutes set fees as a percentage of income and principal received and paid out, ordinarily on a downward sliding scale. Id. Often these are maximum fees, leaving the court with discretion to award smaller fees. States without fee-setting statutes generally set fees by custom as a percentage of income and principal received and paid out. Id. at 2111. Such fee structures may reward superior performance slightly (if income and principal increase) but are hardly incentive driven. There are no bonuses such as a higher percentage for superior performance or penalities for weaker performance. See G. Bogert & G. Bogert, supra note 12, § 975, at 24-28.

[124] For a discussion of the recently adopted SEC rule permitting investment advisors to charge performance-based fees to sophisticated clients, and the significant problems in adopting such fee structures for most trusts, see note 140 infra.

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superior investment performance, for trustees can ordinarily compete only to attract the funds of newly established trusts.[125] A trustee with only average investment performance risks losing future business only, not current accounts.[126] The trustee compensation structure and the limited competitive impact of superior investment performance operate to weaken trustee incentives to seek an unconstrained Rule.[127]

1. Trustee Investment Policy

A trustee has two possible courses of action in opposition to the constrained Rule. First, the trustee might make trust investments consistent with its own conception of prudence, even if at variance with the constrained Rule. The trustee would hope that its expectations of better performance will prove correct, or if not, that the beneficiaries will not sue or will not prevail in litigation. This entails significant risks for the trustee and is an improbable course. A beneficiary might well sue the trustee if an investment goes sour; a guardian might be obligated to sue on such facts.[128] The costs of failing to convince the court of the virtues of an unconstrained Rule may be steep for the trustee.[129]

Nevertheless, there is evidence that some trustees, particularly some bank trust departments in connection with their common trust funds, do take on at least some of these risks.[130] Although bank trustees are ordinarily compensated by assets under management rather than by perform-

[125] Unless the trust provides otherwise, beneficiaries cannot themselves compel removal of the trustee, even if they all agree and all are sui juris. 3 Treatise (3d ed.), supra note 17, § 107.3, at 854. Ordinarily the trustee may be removed by a court only for cause, id. § 107, at 840, or possibly on account of friction or hostility between beneficiaries and trustee that seriously impedes the performance of the trust, id. at 844-46. Whether substandard investment performance would be regarded as sufficient cause for removal is questionable. Moreover, if the trustee has full control over investments, it is hard to see how beneficiary dissatisfaction would impede the performance of the trust. Finally, in selecting a new trustee, the court will ordinarily give great weight to the unanimous wish of the beneficiaries, but is not bound to follow their choice. Id. § 108.4, at 865-67.

[126] Over time the amounts in such current accounts may dwindle as trusts expire. But this is not comparable to the competitive pressure of potentially losing a significant percentage of assets under management through redemptions.

[127] The question of incentive structures is relevant only for the professional trustee, such as a bank trust department. Thus, the rest of this discussion is directed toward professional trustees, which exercise investment authority over the vast bulk of trusteed funds.

[128] See In re Bank of N.Y. (Spitzer), 35 N.Y.2d 512, 517, 323 N.E.2d 700, 702, 364 N.Y.S.2d 164, 167 (1974) (guardian's role is to assure trust beneficiaries that the "trustee's accounts will receive careful and thorough review").

[129] See, e.g., First Ala. Bank v. Martin, 425 So. 2d 415 (Ala.), cert. denied, 461 U.S. 938 (1983) ($2.65 million judgment upheld against trustee bank for imprudent investments in common funds).

[130] Bank trust departments seem more aggressive with arguably risky securities than with sophisticated financial instruments, such as options or financial futures, which, under the constrained Prudent Man Rule, may be deemed speculative per se. See B. Longstreth, supra note 1, at 89-91. In effect, they may employ a semiconstrained Prudent Man Rule.

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ance, demonstrably superior performance of a common trust fund helps attract new assets to manage.[131] The new assets come from sophisticated settlors and pension fund managers, and the competition for their business is fierce. The risk of surcharge thus becomes a promotional cost that some banks are willing to incur to attract new business. On the other hand, the fact that most of the funds of previously established private trusts are virtually immobile will reduce the trustee's potential gain from superior investment management performance, in turn reducing the incentive to compete.[132]

It seems unlikely that unilateral trustee investment activity is sufficient to address the problems of the constrained Rule. Although such action clearly serves the interests of particular beneficiaries, it does nothing to change the constrained Rule directly.[133] Nor does it aid beneficiaries whose trusts are separately managed, or trusteed by a party not engaged in this particular competition or otherwise risk averse.[134]

2. *Trustee Litigation*

An alternative response for the trustee is to bring a declaratory judgment action seeking to unconstrain the Rule. Such litigation will face many of the same economic payoff problems and free rider problems as beneficiary litigation.[135] Because of the linkage of trustee compensation

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131 Although regulations of the Comptroller of the Currency appear to limit advertisement of common trust fund performance, see Fiduciary Powers of National Banks and Collective Investment Funds, 12 C.F.R. § 9.18(b)(5)(v) (1986), such information is gathered by private firms and made available to the investment management community. Some banks also advertise performance results of their pooled investment funds in periodicals aimed at this community.

132 Compare the situation of the bank trustee to that of the mutual fund. The easy redeemability of mutual fund shares means that a fund producing consistently mediocre performance will face a declining pool of assets to manage (and thus lower fees). Because of the immobility of trust funds, trustees generally do not have this exposure to competition, even vis-a-vis other trustees subject to the same legal constraints on investment management.

133 Investments outside the constrained Prudent Man Rule do set the stage for subsequent surcharge litigation concerning investment prudence. But the trustee's litigation posture in such cases is hardly propitious for persuading a court to adopt an unconstrained Rule; the trust has already suffered losses, the victimized beneficiaries are more sympathetic parties than a trustee bank, and the bank would prefer to justify its conduct within the parameters of the familiar standard rather than employ what a judge may regard as a post hoc rationalization for poor performance. In some cases, however, if a sufficient number of financial fiduciaries acquire a particular security, a court may be persuaded that the investment must be prudent. See, e.g., Chase v. Pevear, 383 Mass. 350, 365-70, 419 N.E.2d 1358, 1368-69 (1981) (relying on the stock holdings of other financial institutions and common trust funds to establish prudence of investments).

134 It seems probable that most trustees will not take the risk of following their own best judgment of prudence. But see Carlick v. Keiler, 375 S.W.2d 397 (Ky. 1964) (approving trustee's investments in common and preferred stocks despite trust limitation to debt securities where estate increased four-fold in value).

135 See text accompanying notes 102-06 supra.

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to assets rather than performance, the trustee's principal incentive for bringing the litigation is the opportunity to demonstrate superior investment performance under an unconstrained Rule, thereby generating more trust business. But the potential payoff for a trustee will be modest, at best. The litigating trustee gains no long-term competitive advantage over free riding trustees. Once a court authoritatively unconstrains the Rule, all trustees will be able to offer similar investment services (although some trustees may demonstrate a greater level of skill). Some trustees may even regard the payoff of such litigation as negative. Greater investment latitude requires greater skill and may raise the specter of greater exposure to surcharge from hindsight adjudication.[136]

It is not surprising that such litigation is rare. At best, the trustees will have an incentive to bring a litigation challenge only if the costs are always borne by the beneficiaries. But a court may not permit the costs of such litigation, if unsuccessful, to be charged to the costs of administration. It may be difficult to charge the costs even of successful litigation.[137] The court may find it unfair to allocate the costs to a single trust, but unworkable to divide the costs among all the trusts under the trustee's management.[138]

The result is that the positions of beneficiaries and trustees work against litigation challenges to the constrained Prudent Man Rule. When combined with an authoritative commentary, which reduces the likelihood of success,[139] the effect is to cushion the Rule against the usual common law processes of change. This is not to say that challenges will never occur, but only to help explain the persistence of the constrained Prudent Man Rule in the face of strong evidence that it leads to suboptimal investment performance.[140]

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[136] Indeed, in explaining the legal list movement, the desire to protect trustees from subsequent complaints about investment decisions may have been as important as the desire to protect beneficiaries. See, e.g., Delafield v. Barret, 270 N.Y. 43, 48, 200 N.E. 67, 68-69 (1936) (describing the effect of the legal list as "afford[ing] a measure of protection to fiduciaries").

[137] See 3 Treatise (3d ed.), supra note 17, § 188.4, at 1533-34 (trust should bear expenses of "necessary" litigation and judicial proceedings brought for benefit of trust). The question of actual benefit to the trust will be at issue.

[138] If the action could be brought in the name of a common trust fund, the allocation problem among different accounts would be less serious. Here the problem would be whether such litigation costs would run afoul of state statutes that purport to bar double billing by the trustee employing a common trust fund. See, e.g., N.Y. Banking Law § 100-c(3) (McKinney Supp. 1987) ("A common trust fund shall not be deemed a separate trust fund on which commissions or other compensation is allowable and no trust company maintaining such a fund shall make any charge against such fund for the management thereof.").

[139] See text accompanying notes 46-47 supra.

[140] One possible response to the problems addressed in the text is the adoption of performance based fees for trustee investment management. This would add to trustee incentives to optimize investment performance and could cover the possibility of greater surcharge exposure. There are many difficulties with such an approach. First are the obvious performance

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3. *Trustee Legislative Activity*

There is a third possible trustee response to the problem of the constrained Prudent Man Rule: law reform through legislative lobbying. Although a full exploration of reform efforts is beyond the scope of this Article, some of the factors inhibiting a trustee litigation challenge also operate in the legislative arena. In particular, the economic payoff of legislative action to trustees may be minimal, or even negative.

Legislative action does have the advantage over litigation that it could be funneled through a trustee trade association, making the lobbying costs for any particular trustee insignificant even if costs could not be shifted to beneficiaries. What, then, is holding back such legislative initiatives? One possibility is that belief in the superiority of an unconstrained Rule is not shared widely enough in the trustee community for concerted legislative action. This would move the legislative burden to individual trustees, for which the costs might be too great, particularly in light of the free rider problem. The hypothesis of lack of widespread belief, however, is generally inconsistent with the results of the Longstreth survey,[141] which demonstrate that many bank trust departments regard themselves as significantly constrained in their investment practices by current legal standards of prudence.[142]

Another, and more plausible, possibility is that the trustee fee structure makes the economic payoff from legislative reform minimal or negative. First, assuming all trustees apply the unconstrained Rule equally well, then no trustee gains a competitive advantage, while all must incur the expense of implementing a new investment technology. Moreover, the shift between regimes will engender an uncertainty about the scope of

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monitoring problems in determining whether allegedly superior investment results derive instead from greater risk taking. Performance monitoring in general is problematic, see Gordon & Kornhauser, supra note 6, at 800-01 & 800 n.94, particularly for unsophisticated investors. The SEC has recently adopted a rule permitting performance based fees for registered investment advisors, but only for clients deemed to be sophisticated: wealthy individuals (having at least $500,000 under the advisor's management or net worth of more than $1 million) and institutions. Rule 205-3, Investment Advisors Act of 1940, 17 C.F.R. § 275.205-3 (1986); see SEC Investment Advisors Act Release No. 996, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,939, at 87,902 (Nov. 14, 1985). In addition to general performance evaluation questions, performance based fees may test the ingenuity even of sophisticated investors in devising compensation agreements that limit strategic behavior by advisors, such as unusual risk taking at the end of a marking period, early profit taking, or distorting the benchmark. See Another "May Day" Worries the Market, N.Y. Times, Dec. 22, 1985, § 5, at 10.

The second set of problems relates to the difficulty of negotiating (and renegotiating) such a performance contract with trust beneficiaries. If the settlor (or a sophisticated cotrustee) were no longer available, how could the trustee fairly conduct such a negotiation? One alternative might be a performance based fee provision written as an administrative regulation and subject to administrative monitoring.

[141] B. Longstreth, supra note 1, app. C.

[142] See note 1 supra.

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prudence under the unconstrained Rule that is likely to lead to surcharge litigation.[143] There will be litigation, settlement, and probably some adverse judgment costs. Why should a trustee be eager to bear these costs if it sees no rewards? Second, even assuming that some trustees will apply the unconstrained Rule in a superior manner, the potential rewards to a trustee are limited by the immobility of current trust funds. Moreover, trustees that regard themselves as likely to be inferior performers under an unconstrained Rule will see only the costs of the change. Concerted legislative action in favor of reform then becomes less likely. For these reasons it is not surprising that most state legislatures have not been subject to the kind of pressure that would lead to a legislative unconstraining of the Prudent Man Rule.

The few instances of widespread enactment of changes in trust investment management law illustrate some of the factors at work when legislative reform does occur. The most significant legislative change has been the shift from legal list to Prudent Man Rule standards, which occurred in the late 1930s and 1940s. Whatever the lessons of the Depression about the fallacy of the "safe investment," the competition for trust business seems to have been the animating factor for the shift. Professional trustees observed that portfolios managed in Massachusetts, and therefore subject to the Prudent Man Rule, were earning four percent on average, whereas comparable portfolios in legal list states, confined principally to low-yield debt issues, earned only two percent.[144] Such a swing (100%) was large enough to affect future trust business. In 1942, the Trust Division of the American Bankers Association prepared a model statute closely following the language of *Harvard College v. Amory*.[145] Many states quickly switched from legal lists to the model statute approach.[146]

Another significant legislative change has been the sanction of common trust funds.[147] Such funds permit more economical management of trustee accounts. Given a fee structure principally based on assets under management rather than costs, the savings from such an innovation accrue directly to the trustees.

The point is not that legislative law reform will never respond to the

143 For a discussion of judicial management of the greater latitude of an unconstrained Rule, see notes 166-69 and accompanying text infra. For consideration of the general problem of legal uncertainty, see Calfee & Craswell, Some Effects of Uncertainty on Compliance with Legal Standards, 70 Va. L. Rev. 965 (1984).

144 See Shattuck, supra note 27, at 501.

145 Trust Div., American Bankers Ass'n, The Prudent Man Rule for Trust Investment (1942), reprinted in Shattuck, supra note 27, app. A.

146 See Shattuck, supra note 27, at 501-04; H. Bines, supra note 98, ¶ 6.02[1].

147 3 Treatise (3d ed.), supra note 17, § 227.9, at 1829-32.

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problems of the constrained Prudent Man Rule.[148] The response to economic incentives by potential legislative actors does not fully account for the legislative process. Professional trustees, even in corporate form, may respond to the other-directed claims of fiduciary duty that sometimes exert a powerful influence on trustee behavior. Nevertheless, there are inherent and logical reasons that account for the slow pace of change.

III

THE SHIFT TO A PORTFOLIO THEORY MODEL

The previous Parts have tried to account for the rigidity of judicial interpretations of the Prudent Man Rule in terms of first, a historical anomaly—the happenstance career of Professor Scott—and second, the peculiar litigation posture of most potential objectors to the constraints. But there is another set of factors that helps explain the past and continuing rigidity. These factors relate to the complexity of the portfolio theory model that underlies the claim for an unconstrained Rule; the problems of monitoring conduct under such a rule; and the changes in trust law institutions that acceptance of the model would require.

A. Receiving a New Model

The claim of proponents of an unconstrained Rule is that it is more "efficient"—that an unconstrained but prudent trustee can produce superior results for the beneficiaries, either higher returns for a particular level of risk or lower risk for a particular level of returns. The gain derives both from the portfolio theory approach to investment management and from transaction cost savings through use of financial instruments such as financial futures and options. The claim of efficiency frequently finds a receptive hearing in the courts—why not in this particular case? One answer may lie in a kind of vicious circle: the most significant efficiencies of the unconstrained Rule become evident only after one understands the portfolio theory model, but until courts understand the

148 For example, the California Bankers Association, in cooperation with the California Bar Association, spearheaded recent legislation that effectively enacts an unconstrained Rule. See Wade, The New California Prudent Investor Rule: A Statutory Interpretive Analysis, 20 Real Prop. Prob. & Tr. J. 1 (1985) (discussing amended version of Cal. Civ. Code § 2261 (Deering Supp. 1986)). It will be interesting to see if the California innovation spreads because of competitive pressures and/or a demonstration that the unconstrained Rule does not entail significant additional costs for trustees.

Additionally, endowments and foundations have undertaken legislative action, as opposed to litigation, in the investment management area. One product of their work is the Uniform Management of Institutional Funds Act, approved by the National Conference of Commissioners on Uniform State Laws in 1972 and adopted in 29 states, see 7A U.L.A. 95 (Supp. 1987), which liberalizes the rules pertaining to investment management by nonprofit organizations.

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efficiency claims they will have little motivation to assimilate such a relatively complicated financial model. This problem may be illustrated by a comparison with the judicial response to an efficiency claim in another situation laden with fidiciary duties—interested director contracts.

As Professor Marsh tells us, there was in 1880 a clear rule regarding the enforceability of contracts between a corporation and one of its directors (or between corporations with interlocking directors); such contracts were "voidable at the instance of the corporation or its shareholders, without regard to the fairness or unfairness of the transaction."[149] The rule "appeared to be impregnable. . . . It was stated in ringing terms by virtually every decided case, with arguments which seemed irrefutable, and it was sanctioned by age."[150] Nevertheless, Marsh continues, "Thirty years later this principle was dead."[151] The new judicial rule held such contracts enforceable, if fair, upon full disclosure and ratification by disinterested directors.[152] The change appears to have occurred without clear judicial articulation of its basis. Yet such contracts became increasingly prevalent, and it seems that the advantages of the change in rule had become apparent to all.[153] In a contemporary analytic framework, we would say that the courts realized that the relaxed rule permitted the parties to save on transaction costs. Buyer and seller could use their corporate connection to find one another and to gain quick access to reliable information regarding reputation, capacity, and credit-worthiness.[154] Given the opportunities for litigation and other shareholder action in response to abuses, such contracts would provide a net benefit to the corporation. In short, the relaxed rule appeared to be more efficient.[155] But herein lies a puzzle. The relationship between a corpora-

[149] Marsh, Are Directors Trustees? Conflict of Interest and Corporate Morality, 22 Bus. Law. 35, 36 (1966).

[150] Id. at 39.

[151] Id.

[152] Id. at 40.

[153] Id. at 41; see also Rhoads, Personal Liability of Directors for Corporate Mismanagement, 65 U. Pa. L. Rev. 128 (1916).

[154] For example, take the case of an automobile manufacturer that needs to purchase tires. If the owner (or director) of a tire manufacturer sits on the automobile manufacturer's board, the two companies can very easily discover one another's needs, capacities, reputation, and credit-worthiness. Assuming some assurance that the tires will be delivered at the market price and quality, a contract between these two firms would realize an efficiency.

[155] The claim that common law courts (consciously or intuitively) adopt more efficient rules is controversial. See, e.g., Note, The Inefficient Common Law, 92 Yale L.J. 862, 862 nn.1-2 (1983) (citing literature making efficiency claims, but proposing model of inefficiency). Some might claim that judges favor certain groups or interests. See generally M. Horwitz, The Transformation of American Law, 1780-1860 (1977). In the case of the change in rule on director contracts, for example, one could hypothesize a judicial disposition to favor directors at the expense of shareholders. Given the original rule, however, this explanation seems a less plausible account of the change than the cost-savings explanation.

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tion and its directors has been described in judicial opinions in terms of fiduciary duties and trustee obligations drawn from the law of private trusts. Why, then, have potential efficiencies led to a new rule in the case of director contracts (in the face of palpable conflicts of interest), but not in the case of the Prudent Man Rule?

1. Understanding the Gains

First, and most important, the potential gains from a relaxed director contracts rule are easier to understand than the gains from an unconstrained Prudent Man Rule. In the director contracts context, a court can readily perceive the transaction costs avoided by a mutually advantageous bargain between a connected buyer and seller. This perception would come naturally to the persons of affairs typically appointed to the bench.[156]

By contrast, the efficiencies of the Prudent Man Rule are less obvious. Appreciation of the gains from an unconstrained Rule requires acceptance of a new financial model, in which the risk of an investment is measured as part of a portfolio, not in isolation. The very definition of "efficiency"—maximum expected return for a given level of risk—is a model-related concept. In a sense, the gains exist only if you believe in the model.[157] To be sure, courts inevitably employ some economic model in deciding investment prudence cases.[158] But given the complexity of the modern portfolio model, it is not surprising that judicial acceptance should be slow.[159]

This judicial torpor is partly explained by the inability or unwilling-

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[156] See A. Watson, The Evolution of Law 118-19 (1985) (legal development is determined by the culture of lawyers and lawmakers; "social, economic, and political factors impinge on legal development only through their consciousness").

[157] This is not entirely true, for example, in the case of certain uses of options and financial futures. Even without a full portfolio theory approach, a court might understand the gains from covered call writing or use of a financial futures contract to hedge a long-term Treasury bond. Options and futures exchanges argue strenuously that particular uses of these vehicles are consistent with the traditional understanding of prudence under the constrained Rule. See note 89 supra.

[158] For example, the model employed by Scott analyzes "risk" in terms of the variance (or risk) of a particular security in isolation. See text accompanying notes 26-29 supra.

[159] In re Morgan Guar. Trust Co., 89 Misc. 2d 1088, 396 N.Y.S.2d 781 (Sur. Ct. 1977), and Stark v. United States Trust Co., 445 F. Supp. 670 (S.D.N.Y. 1978), which validated transactions in particular equity securities on the grounds of the formal decision-making process of professional trustees, illustrate a typical judicial response to uncertainty about a substantive theory—reliance on process. See notes 84-88 and accompanying text supra. But without a substantive theory as a guide, a court's reliance on process may encourage costly formal procedures and paper trails that do not contribute to beneficiary welfare. Moreover, the court's process standard may create difficulties for the fiduciary who believes that stock markets are highly efficient and undertakes to buy and hold a diversified portfolio that is a reasonable proxy for the market portfolio. He will not engage in extensive fundamental research about

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ness of counsel to argue the gains from an unconstrained Rule to the courts in surcharge cases.[160] The education of courts is frequently accomplished through litigation. But while the tenets of portfolio theory have become a staple of finance theory[161] and have been argued successfully to courts and administrative bodies in other contexts,[162] not one of the reported surcharge cases in the 1970s or 1980s seems to have been argued on portfolio theory grounds, even where such an argument might have been decisive.[163] Under these circumstances, it is hardly astonishing that courts have not adopted a portfolio theory approach sua sponte.[164]

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each portfolio security or constant review of portfolio holdings. A process standard uninformed by theory could conceivably find his approach imprudent.

The process approach of *Morgan Guaranty* and *Stark* may provide comfort for the trustee willing to live within the confines of the constrained Rule and follow a documented process of securities selection and retention. Such an approach provides little comfort, however, to the trustee who uses new financial products and techniques, for which a demonstration of prudence depends upon an understanding of the theory behind an unconstrained Rule.

[160] Counsel may be influenced in their case presentation by the prior tailoring of trustee conduct to fit into the conception of prudence set forth in the Restatement and the Treatise. See text accompanying note 48 supra. If the trustee's decision-making process is not geared toward a portfolio theory approach, it may be difficult to present such a case, even in the alternative.

[161] See note 90 supra.

[162] See D. Harrington, Modern Portfolio Theory and the Capital Asset Pricing Model 129 (1983) (public utility rate regulation); Gordon & Kornhauser, supra note 6, at 810-23 (discussing use by SEC in integrated disclosure scheme and shelf registration).

[163] See text accompanying notes 70-91 supra.

[164] But see Hamilton v. Nielson, 678 F.2d 709 (7th Cir. 1982) (Posner, J.) (suggesting that plaintiffs had missed a potential basis for surcharge by failing to argue portfolio theory).

The general unresponsiveness to portfolio theory, by both judges and lawyers, is in part a reflection on the law school curriculum. See generally A. Watson, supra note 156, at 118-19 (legal development is determined by the culture of lawyers and lawmakers). In this connection, an examination of the presentation of the Prudent Man Rule in trusts casebooks over the past 30 years is instructive. The dominant casebooks in the 1950s and 1960s emphasize the trustee's duty not only to earn a reasonable return, but to insure the safety of principal. The casebooks promote the Prudent Man Rule over the legal list approach to the extent of encouraging investments in seasoned securities, but not speculation. See A. Scott, Selected Cases and Other Authorities on the Law of Trusts 418-48 (4th ed. 1951); A. Scott & A. Scott, Selected Cases and Other Authorities on the Law of Trusts 472-505 (5th ed. 1966); G. Bogert, Cases on the Law of Trusts 498-541 (2d ed. 1950); G. Bogert, Cases on the Law of Trusts 480-511 (3d ed. 1958); E. Scoles, Problems and Materials on Decedents' Estates and Trusts 924-58 (1st ed. 1965).

The casebooks of the 1970s signal a shift. The selected cases seem to stress the procedures followed by the trustee, rather than the type of security or outcome. In particular, the textbooks emphasize the appropriateness of trustee reliance on qualified investment advisors. See J. Ritchie, N. Alford & R. Effland, Cases and Materials on Decedents' Estates and Trusts 1173-92 (4th ed. 1971); J. Ritchie, N. Alford & R. Effland, Cases and Materials on Decedents' Estates and Trusts 1179-1211 (5th ed. 1977); E. Scoles & E. Halbach, Problems and Materials on Decedents' Estates and Trusts 596-611 (2d ed. 1973).

The casebooks of the 1980s generally quote from recent literature on portfolio theory and the efficient market hypothesis. See J. Dukeminier & S. Johanson, Wills, Trusts, and Estates

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2. *Confining the Costs of Unconstraining the Rule*

Apart from the difficulty in understanding the potential gains, there is a second obstacle to judicial acceptance of the unconstrained Rule: the costs of its flexibility. Even if the unconstrained Rule yields the potential gains, will its costs make the rule inefficient? More formally, can the grant of discretion conferred by the unconstrained Rule be monitored, so that incompetent or faithless performance will be adequately deterred?

Once again, comparison to the relaxed director contracts rule is useful. In the director contracts context, certain private parties, such as disinterested directors and shareholders, have an interest in monitoring against unfair dealings. A prior approval process for such contracts curtails some abuses. In addition, a substantive (albeit vague) fairness standard sets parameters for ex post settling up through shareholder derivative suits. While the monitoring of interested director contracts is imperfect, shareholder losses are unlikely to be catastrophic. In short, the assertion that the gains of a relaxed rule will outweigh the costs of flexibility is persuasive.[165]

The monitoring of performance under an unconstrained Prudent Man Rule is more problematic. There are difficult questions about the

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917-47 (3d ed. 1984); W. McGovern, Cases and Materials on Wills, Trusts, and Future Interests 574-89 (1983); J. Ritchie, N. Alford & R. Effland, Cases and Materials on Decedents' Estates and Trusts 1230-61 (6th ed. 1982); R. Wellman, L. Waggoner & O. Browder, Palmer's Cases and Materials on Trusts and Succession 739-44 (4th ed. 1983). It is impossible to determine what material is actually covered in classes, what glosses professors may add, and how students respond. Nevertheless, one can predict that the portfolio theory paradigm will become increasingly accepted as lawyers gain skill at its argument, and as judges (aided perhaps by law clerk discussion) become more familiar with this relatively novel theory.

165 Another example, drawn from the law of trusts, illustrates judicial receptivity to efficiency claims where assessment of potential gains and costs requires only an incremental advance in understanding. Courts have in several instances permitted trustees to invest in common stocks despite restrictions in the trust instrument limiting investment to fixed income instruments, on the grounds that inflation was rapidly eroding the real value of the trust estate. See Carlick v. Keiler, 375 S.W.2d 397 (Ky. 1964); In re Mayo, 259 Minn. 91, 105 N.W.2d 900 (1960); Davison v. Duke Univ., 282 N.C. 676, 194 S.E.2d 761 (1973). But see Stanton v. Wells Fargo Bank & Union Trust Co., 150 Cal. App. 2d 763, 310 P.2d 1010 (1957) (changed economic conditions do not permit deviation from trust provision except in grave emergency or where settlor's main purpose would otherwise fail); Troost Ave. Cemetery Co. v. First Nat'l Bank, 409 S.W.2d 632 (Mo. 1966) (changed circumstances in real estate financing insufficient to permit deviation from trust restrictions); Toledo Trust Co. v. Toledo Hosp., 174 Ohio St. 124, 187 N.E.2d 36 (1962) (inflation held not to justify deviation from strict investment provisions). The gains from such deviation from the trust instrument are easily understood. The real value of a trust corpus consisting of long-term fixed income investments deteriorates in inflationary times; the addition of common stocks will help hold values constant. As for the costs, since the deviation grants the trustee only the latitude of the constrained Prudent Man Rule, not more, a court faces no new discretion problems. The gain is readily understood, the additional discretion minimal. This judicial flexibility in the face of contrary express trust language indicates once again the ordinary response of courts to comprehensible claims of efficiency.

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capacity and adequacy of beneficiary monitoring.[166] More seriously, however, the portfolio theory model complicates the determination of prudence, both as a matter of theory among financial economists and as a matter of proof before a court. Scott's standards for determining whether an investment was prudent had the virtue of relative ease of application.[167] If the investment was a common stock, did it pay dividends, and if so, for how long? How long had the enterprise been in business? Did the security exceed the debt? A portfolio theorist, on the other hand, would argue that few, if any, investments are imprudent per se. The question would be, given the other portfolio components, did the investment make the portfolio as a whole imprudent? Courts will be called upon to evaluate complicated strategies, not simply specific investments viewed in isolation. Instead of referring to a list of imprudent investments in the Restatement,[168] courts will have to evaluate conflicting expert testimony. Courts may fear that portfolio theory will serve as a smokescreen for trustee incompetence.[169] Moreover, the cost to beneficiaries of a complicated investment strategy gone awry through mishandling is probably greater than the loss to shareholders from a contractual overreaching by a director.

3. *Understanding the New Model*

The flexibility inherent in portfolio theory—the absence of a list separating permissible from impermissible investments—is necessary for an unconstrained Rule. The mere fact that portfolio theory offers no mechanical tests for evaluating trustee conduct, however, does not justify a court's rejecting it to follow a rule based on an inferior theory of investment management. Furthermore, the unconstrained Rule allows less discretion than initial appearances would suggest. The appropriate risk parameters for a particular trust fund will significantly limit the trustee's investment behavior. Under an unconstrained Rule, a trustee will have

[166] See text accompanying notes 102-06, 121-22 supra and 175-76 infra. These problems probably account for the continuing strictness of rules pertaining to trustee self-dealing.

[167] The attractiveness of a judicially manageable standard was undoubtedly powerful inducement for courts to lean towards a legal list approach, too. See King v. Talbot, 40 N.Y. 76 (1869) (effectively adopting a legal list approach for investments in stock despite paean to prudence standard).

[168] See text accompanying notes 30-32 supra.

[169] Some commentators have argued that the restrictions on trust investment flexibility derive principally from judicial perception of the incompetence of trustees. See H. Bines, supra note 98, ¶ 1.02[2][a], [c]. Many of Scott's cases inveighing against speculative investments and new and untried enterprises seem clear examples of trustee incompetence or even self-dealing. See notes 55-66 and accompanying text supra. But most trust investment management activity today is carried out by professional trustees, such as banks, trust companies, and investment advisors registered with the SEC. Potential incompetence is more narrowly circumscribed.

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no more discretion to adopt an investment strategy that is too risky than it has to buy a security that is too risky under the present Rule.

The general point is this: courts seem amenable to efficiency claims where assessments of gains and costs require only an incremental advance in their understanding of the subject matter. Acceptance of modern portfolio theory and an unconstrained Rule requires more than an incremental change; courts must adopt a new way of understanding investments and investment strategies under a complicated model. Before one understands the new model, the gains of an unconstrained Rule seem chimerical, the costs real. After one understands the model, the gains are real, the costs manageable. But the model is sufficiently complex that the first steps toward judicial assimilation will be difficult.

B. *The Effect on Trust Law Institutions*

In addition to raising difficult issues of evaluating gains and costs, adoption of an unconstrained Prudent Man Rule on portfolio theory grounds would challenge the durability of some important institutions in trust law. A foreboding about these further implications may have discouraged courts from accepting the theory, and counsel from pressing it. Because of its intergenerational reach, courts may consider the stability of trust law more important than, say, tort or contract law. Settled rules, even if obsolete, may be deemed efficacious. This attitude may be reinforced by the settlor's ability to contract around many such rules.[170] The fear concerning the reach of portfolio theory is a red herring in some instances; in others, it is not.

1. *The Trustee's Duty of Caution*

A frequent criticism of the unconstrained Prudent Man Rule is that it would establish too permissive a standard for the evaluation of trustee behavior. The claim is that an unconstrained Rule amounts to a Business Judgment Rule for trustees, which would insulate trustees from liability for their investment decisions.[171] Properly understood, however, an unconstrained Rule would still include a duty of caution.

The claim of undue permissiveness misunderstands the contrasting premises underlying the Business Judgment Rule and the unconstrained Prudent Man Rule. The Business Judgment Rule can be understood only in light of the particular duties of a corporate director. A disinterested director who exercises reasonable care in informing himself about a

[170] See text accompanying notes 98-101 supra.

[171] See, e.g., Comm. on Trusts, Estates, & Sur. Cts., Ass'n of the Bar of the City of New York, Report No. 27 on S. 9572, A. 7114-A, at 3-4 (1985) (proposed prudent person rule drafted for professional trustees moves rule closer to business judgment rule).

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business decision, and who rationally believes the decision to be in the corporation's best interests, cannot be held liable if the decision turns out badly.[172] The trustee's duties, however, are different from the director's. In addition to the duties of reasonable care and loyalty, the trustee owes a duty of caution.[173] This duty requires the trustee to assure an appropriate risk level in light of the needs of the trust. Nothing in portfolio theory negates the trustee's obligation to invest with due caution; indeed, the theory puts that obligation on firmer ground.

A comparison of the parties to be protected—shareholders and trust beneficiaries—shows that the two are situated quite differently. Since well-chosen risks frequently yield greater returns, most shareholders would not want a director liability rule that discouraged risk taking. Shareholders can select firms on the basis of risk and the skill of management in risk taking. Shareholders can also hold diversified portfolios of securities to reduce the risk to which they are exposed.[174] Finally, shareholders can monitor the performance of managers and dispose of those whose performance is substandard by casting their votes for an insurgent in a proxy battle, selling in a hostile takeover, or simply selling off their investment.[175] Thus, from a shareholder's perspective, it makes sense to protect the corporate director from liability for a disinterested business decision that rationally—but wrongly—assesses the risks and rewards.

On the other hand, a rule that encouraged a high degree of trustee risk taking would not serve trust beneficiaries, for at least two reasons. First is the monitoring problem. Beneficiaries do not generally select the trustee (and the settlor who did is likely dead), and even if they have sufficient financial sophistication to identify poor risk taking, they may find it burdensome to remove the trustee. Restrictions in trust instruments and the problems of collective action by beneficiaries make removal onerous. In contrast to the corporate context, an outsider is unlikely to mount a campaign to persuade beneficiaries to substitute it as trustee.

The second and more serious objection is the limited ability of beneficiaries to diversify their trust holdings. The typical beneficiary may have a large portion of his wealth tied up in the trust. If so, he will be unable to diversify against a trust portfolio that is exposed to a high de-

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[172] See, e.g., Principles of Corporate Governance § 4.01(c) (Tent. Draft No. 4, 1985).

[173] Restatement (Second) of Trusts § 227 comment e (1959); 3 Treatise (3d ed.), supra note 17, § 227, at 1805-07.

[174] See Joy v. North, 692 F.2d 880, 885-86 (2d Cir. 1982), cert. denied sub nom. Citytrust v. Joy, 460 U.S. 1051 (1983).

[175] The limits on shareholder monitoring of management performance in selling the company may account for the heightened judicial scrutiny of directors in Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

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gree of risk. No matter how wisely the trustee has selected the risks, such a beneficiary will regard the portfolio as too risky for his interests.

Thus, under a portfolio theory analysis, trust law appropriately imposes a duty of caution on the trustee. Since the Business Judgment Rule takes no account of risk taking (except in the limited sense that the risk must be rational in light of the expected return),[176] it is not an appropriate trust law standard. An unconstrained Prudent Man Rule would recognize that the trustee must construct and maintain a portfolio of appropriate risk for the trust.[177] The trustee must use reasonable care (including the appropriate level of skill),[178] but he should be able to use any investment vehicle or technique reasonably calculated to maximize expected returns for the permitted risk and minimize the transaction costs. Assuming undivided loyalty, due caution in selecting a portfolio risk level, and due care in managing the portfolio consistent with the permitted risk, the trustee should be free from liability for particular investment decisions that turn out badly. The insight of portfolio theory is that the duty of caution comes into play in the selection of the appropriate portfolio risk level, not as a bar to reasonable means of investing in light of the allowed risk.

2. *Anti-netting Rule*

Another tenet of trust law that may be unsettled by a portfolio theory approach is the rule against balancing losses against gains.[179] Because portfolio theory looks at the performance of the portfolio as a whole, the concern is that the standard trust law anti-netting rule would

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[176] See, e.g., *Joy*, 692 F.2d at 885-86 (construction loans were no-win proposition); Selheimer v. Manganese Corp. of Am., 423 Pa. 563, 224 A.2d 634 (1966) (expenditures on economically unfeasible plant).

[177] The discussion assumes that the settlor has not given other instructions affecting the level of portfolio risk, such as expressing a desire that the trust remain concentrated in a particular firm or industry. See, e.g., Jackson v. Conland, 178 Conn. 52, 420 A.2d 898 (1978) (newspaper industry). Most settlors, even those who expand the array of investment vehicles beyond the constrained Rule, anticipate a background standard of prudence. The text argues that a reasonable background standard would include a duty of caution consonant with the limited ability of beneficiaries to diversify against a trust estate that is too risky. Where beneficiaries are well-situated to bear risk, the trustee may argue for a deviation from the standard.

[178] The skill required of a trustee, particularly a corporate trustee, is a matter of debate. See, e.g., Committee on Investments by Fiduciaries of the A.B.A. Section of Real Prop., Probate, & Trust Law, Fiduciary Responsibility and the Employee Retirement Income Security Act of 1974, 12 Real Prop. Prob. & Tr. J. 285, 289 (1977). It seems appropriate to hold a party that has solicited trust business on the basis of special expertise to a level of care consistent with that claim. See Restatement (Second) of Trusts § 174, § 227 comments c-d (1959). A trustee using sophisticated financial instruments should be taken as representing that it has sufficient skill to employ them correctly.

[179] Restatement (Second) of Trusts § 213 (1959); 3 Treatise (3d ed.), supra note 17, § 213.1.

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have to be discarded.[180] In fact, the anti-netting rule is not inconsistent with portfolio theory. The rule pertains to balancing losses arising from one or more *breaches of trust* against gains from any source.[181] The implication of portfolio theory is only that the determination whether a particular investment amounts to a breach of trust should be made in light of the risk the investment adds to the portfolio. Thus, the purchase of a particular security or instrument whose returns are volatile when viewed in isolation is not necessarily a breach of trust.

A misapplied anti-netting rule would make portfolio theory impossible to use, for the very essence of a portfolio strategy is diversification such that losses will be balanced out by gains in a way that makes the overall portfolio less risky and the overall returns more dependable. A riskless portfolio would be one in which two securities had a negative covariance of minus one (-1). Any loss would be balanced out by a gain. It is a rational portfolio strategy to include some securities whose expected returns are negative, if, for example, in unusually difficult economic times their returns are positive and will balance out losses on the rest of the portfolio.

A case such as *In re Bank of New York (Spitzer)*[182] illustrates how an anti-netting rule might be applied under a portfolio theory conception of prudent investment. The *Spitzer* court is surely right in saying that an overall increase in the value of a portfolio should not "insulate the trustee from responsibility for imprudence with respect to individual investments for which it would otherwise be surcharged."[183] To hold the contrary would be to immunize trustees in a rising market and perhaps to encourage unwarranted risk taking in attempt to recoup from errors. Even on a portfolio approach, a particular investment may be imprudent. The key issue is the means for determining the prudence of a particular investment. Few investments are imprudent per se if the determination of prudence is portfolio based.[184]

3. *Optional Diversification*

One area of established trust doctrine that would change upon acceptance of a portfolio theory paradigm is the optional diversification principle. The prevailing view is that the trustee ordinarily must "dis-

[180] See G. Bogert & G. Bogert, supra note 12, § 671, at 7-8; Fleming, Prudent Investments: The Varying Standards of Prudence, 12 Real Prop. Prob. & Tr. J. 243, 248-49 (1977).

[181] Restatement (Second) of Trusts § 213 (1959); 3 Treatise (3d ed.), supra note 17, § 213.1.

[182] 35 N.Y.2d 512, 323 N.E.2d 700, 364 N.Y.S.2d 164 (1974).

[183] Id. at 517, 323 N.E.2d at 703, 364 N.Y.S.2d at 168.

[184] *Spitzer* is ambiguous about the extent to which its review of particular securities is portfolio based. See id. Nevertheless, descriptions of *Spitzer* as an unfair application of the anti-netting rule, see G. Bogert & G. Bogert, supra note 12, at 7-8 (categorizing *Spitzer* as applying individual investment standard); Fleming, supra note 180, at 248-49 (same), are unpersuasive.

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tribute the risk of loss" by "reasonable diversification."[185] On the other hand, some jurisdictions, in particular New York, specifically reject the idea that prudence requires diversification.[186] The concept of diversification at issue in traditional analysis is a simple one: the advisability of putting one's eggs in several baskets. The justification for not requiring diversification is Andrew Carnegie's: "Put all your eggs in one basket and watch the basket."[187] A court that accepts portfolio theory is likely to regard diversification as mandatory except upon a showing of special insight by the trustee or some other unusual circumstances.[188] Portfolio theory's claim is not merely that diversification avoids the risk of loss, but that it increases expected return at the chosen risk level.

The diversification principle has another advantage: it would provide a solid basis for decisions that now rest tenuously on other grounds. For example, in *In re Newhoff*, the trustee of three family trusts had invested more than fifty percent of the principal of each trust in real estate investment trusts (REITs) that subsequently plummeted in value.[189] Because New York does not require diversification, the only grounds for surcharge was a finding that the particular investments were imprudent when made. The New York court thus ended up holding that a newly formed REIT investing in construction and development mortgages was virtually per se imprudent as a trust investment.[190] Despite its invocation of *Harvard College v. Amory* and the Prudent Man Rule,[191] the *Newhoff* court in effect put the REITs on a negative legal list. A portfolio approach would have led to the same result without the doctrinal embarrassment.

Acceptance of the diversification principle is not without complica-

[185] Restatement (Second) of Trusts § 228 (1959); see also 3 Treatise (3d ed.), supra note 17, § 228, at 1855.

[186] See, e.g., In re Newhoff, 107 Misc.2d 589, 595, 435 N.Y.S.2d 632, 637 (Sur. Ct. 1980) (noting New York does not require diversification but arguing it should), aff'd, 107 A.D.2d 417, 486 N.Y.S.2d 956 (1985). The New York position stems from In re Estate of Adriance, 145 Misc. 345, 260 N.Y.S. 173 (Sur. Ct. 1932), which noted conflicting views among investment experts on the wisdom of diversification and made no definite decision either way. "This divergence of sentiment among the financial authorities would render a judicial decision in favor of either school of thought an *ultra* hazardous undertaking." Id. at 352, 260 N.Y.S. at 181; see Note, Trust Fund Investment in New York: The Prudent Man Rule and Diversification of Investments, 47 N.Y.U. L. Rev. 527, 534-35 (1972).

[187] See *Adriance*, 145 Misc. at 352, 260 N.Y.S. at 181 (quoting Andrew Carnegie's adage); Strand, supra note 99, at 591 (same).

[188] For example, perhaps the settlor held a large block of stock in a particular firm and preferred, but did not require, that the trust retain the stock. Alternatively, one purpose of a trust might be for a family group to retain control over a firm, which would necessitate retaining a large block of stock. See note 177 supra.

[189] See 107 A.D.2d at 419, 486 N.Y.S.2d at 957-58.

[190] Id. at 425-28, 486 N.Y.S.2d at 961-63.

[191] See id. at 423, 486 N.Y.S.2d at 960.

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tion. Courts may have to develop more precise standards for appropriate diversification. Such standards would require courts to contemplate the differences between passively managed portfolios, which follow a pure diversification strategy at the desired risk level, and actively managed portfolios, which combine diversification with the search for undervalued securities.[192]

4. *Principal and Income*

The most important aspect of trust law cast into doubt by the acceptance of an unconstrained Rule on portfolio theory grounds is the traditional allocation of investment returns. No principle in the law of trusts seems more settled than the rule that income beneficiaries receive ordinary cash dividends from common stock ownership and remaindermen receive capital gains if the stock is sold.[193] The only skirmishing is on the edges of the rule, regarding, for example, the allocation of extraordinary cash dividends[194] or stock dividends.[195] Acceptance of portfolio theory, however, would undermine the traditional rule. The economic models on which portfolio theory relies all calculate investment returns based on the total return during a specific period—cash

[192] See note 6 supra.

[193] 3 Treatise (3d ed.), supra note 17, §§ 236-236.14; 3 Treatise (2d ed.), supra note 17, §§ 236-236.141; 2 Treatise (1st ed.), supra note 17, §§ 236-236.14. Another part of the standard rule is that interest payments on fixed income instruments count as income (including increments in value because of original issue discount) and that repayment of the face amount (and gain or loss on a sale before maturity) counts as principal. 3 Treatise (3d ed.), supra note 17, § 233.1.

Most states have adopted either the Uniform Principal and Income Act of 1931 or the Revised Uniform Principal and Income Act of 1962. See Hirsch, Inflation and the Law of Trusts, 18 Real Prop. Prob. & Tr. J. 601, 614 (1983).

[194] States are split on this issue. Under the "Massachusetts rule," all cash dividends are treated as income, even if extraordinary. See 3 Treatise (3d ed.), supra note 17, § 236.3, at 1976. The "Pennsylvania rule" (repudiated by statute in Pennsylvania) makes an allocation based on the extent to which the dividend came from earnings that accrued to the corporation during the period of the trust (income) or prior thereto (principal). See id.

[195] The "Massachusetts rule" treats all stock dividends as principal. See id. The "Pennsylvania rule" follows an allocation approach. See id.; note 194 supra. The Revised Uniform Principal and Income Act opts for the Massachusetts rule: "Corporate distributions of shares of the distributing corporation, including . . . a stock split or stock dividend, are principal." Revised Uniform Principal and Income Act § 6 (1962); see also Restatement (Second) of Trusts § 236(b)-(c) (1959) (dividends payable in shares of declaring corporation are principal unless there is option of either shares or cash); Annotation, Modern Status of Rule Governing Allocation of Stock Dividends or Splits Between Principal and Income, 81 A.L.R.3d 876 (1977) (the modern trend is toward Massachusetts rule). A few states have opted for the "six percent rule," which arbitrarily declares that any stock dividend of less than (or "up to," in some versions) six percent counts as income. E.g., N.Y. Est. Powers & Trusts Law § 11-2.1(e)(2) (McKinney 1967); see Comment, Trust Allocation Doctrine and Corporate Stock: The Law Must Respond to Economics, 50 Tex. L. Rev. 747, 766-67 (1972).

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payouts (dividends and interest) plus gain or loss.[196] The analysis of covariance or comovement among securities returns, which provides the basis for determining the amount of risk a particular security adds to a portfolio, depends upon this total return definition.

A division of a firm's return between income and capital gain is highly artificial from the perspective of financial economics. Imagine two firms, *A* and *B*. For every hundred dollars of shareholders' equity, each earns ten dollars. *A*, thinking its primary business has reached a no-growth steady state, pays out all earnings as dividends. *B*, thinking its business provides additional investment opportunities, reinvests all earnings, which leads to an increase in the price of its shares. Each firm is providing comparable economic return to its sharedholders; only the form is different.[197] But a trustee holding *A* must pay out all dividends to income beneficiaries, even if, because of inflation, the purchasing power of the remainder interest, the *A* stock in the portfolio, is meanwhile depreciating.[198] A trustee holding *B* can pay out nothing to income beneficiaries, even if the remainder interest is increasing in value because of *B*'s decision to reinvest earnings that would otherwise be available to an income beneficiary.

To assure fairness between income beneficiaries and remaindermen, the trustee may have to adopt an investment policy that mixes *A* and *B* stock. Alternatively, present law apparently allows the trustee to refuse to hold *B*.[199] The result in either case will be a portfolio that is not optimally diversified; it has not been assembled with the objective of produc-

[196] A total return approach draws no distinction between realized and unrealized gains and losses. Unless otherwise indicated, references to gains in this section include realized and unrealized gains. See W. Cary & C. Bright, supra note 116, at 28-32.

Adoption of the total return approach would require the excision of statements in the Treatise and the Restatement about "prudence" as the "preservation" of capital and "speculation" as the effort to increase it. See Restatement (Second) of Trusts § 227(a) & comment e (1959); 3 Treatise (3d ed.), supra note 17, § 227.6. The goal of the prudent fiduciary should be to maximize returns while incurring no more than the appropriate level of risk for the particular fund under management. In many instances, achieving this goal entails investment choices made with the hope of capital gains.

[197] This example much simplifies a topic that continues to puzzle financial economists: What factors determine a firm's dividend policy? The general point holds, however; firms with different dividend policies can provide shareholders with the same level of economic return, depending on the effect of reinvestment on share prices.

[198] For simplicity the text adopts a model requiring the trustee to distribute currently all income. Some trusts give the trustee power to accumulate income for subsequent payout. The principal and income allocation rules nevertheless require such a trustee to treat all dividends as income.

[199] See 3 Treatise (3d ed.), supra note 17, § 232 (trustee has duty of impartiality as to successive beneficiaries); id. § 240 (trustee sometimes under duty to sell unproductive and underproductive property). Some courts, however, have held that the trustee may not buy and sell trust assets so as to alter the allocation of returns between income and principal. See, e.g., Maryland Nat'l Bank v. Merson, 249 Md. 353, 239 A.2d 905 (1968), discussed in Note, Range

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ing the greatest expected returns for the risk. It is easy to see why systematic exclusion of companies with low dividends but high reinvestment rates will upset a diversification scheme. But there is no assurance that a portfolio that emphasizes balance between high and low dividend-paying securities will be well-diversified in other respects.[200] The allocation of total returns between income and principal compelled by settled trust law is profoundly inconsistent with the portfolio theory paradigm.[201]

Many endowment funds have adopted a solution that could be adapted to private trusts.[202] It would be possible to tally portfolio results on a total return basis but set standards for allocation of returns between income and remainder interests based on assumptions regarding normalized annual returns. While theoretically correct, such a solution presents practical problems in trust administration because of the inevitable conflicts among income beneficiaries and remaindermen over the appropriate assumptions.[203] Thus, the revision of the Uniform Principal and Income Act to work out the practical details of a total return allocation scheme would be particularly helpful in making a portfolio theory approach readily available to private trusts.[204]

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of Returns: A New Approach to the Allocation of Trust Gains and Losses, 21 Stan. L. Rev. 421, 424-33 (1969).

200 For example, assume that all utilities pay high dividends and that all technology firms pay low dividends (but reinvest earnings). A portfolio that contained stocks of such firms might be well-balanced as to dividends, but the concentration in only two market sectors would mean that the portfolio was inadequately diversified.

201 The standard allocation of principal and income fails even without regard to the claims of portfolio theory. The interest paid on a fixed income investment will include some element of compensation for expected inflation to preserve the real value of the principal upon maturity. Under standard allocation rules, all such interest belongs to the life beneficiary, irrespective of the depreciation of principal. See note 193 supra. An investment of unreproachable prudence, short term Treasury notes, can thus work to the remaindermen's severe disadvantage in inflationary times. A total return approach would address this problem.

202 See, e.g., W. Cary & C. Bright, The Developing Law of Endowment Funds: The "Law and the Lore" Revisited 7-12 (1974); see also Yale Univ., 1982 Fin. Statements and Supplemental Schedules 7 (computation of amount that can prudently be spent from endowment by "University Equation Method"). The Uniform Management of Institutional Funds Act adopts a total return approach in permitting the trustees of a nonprofit institution to count appreciation, realized and unrealized, in the value of the fund, as moneys available for appropriation. Uniform Management of Institutional Funds Act § 2 (1972).

203 The difficulties of administering a notionally correct rule may skew judicial outcomes. For example, it is possible to understand judicial hostility to common stock ownership by trusts as a defensive response to the problems courts knew would arise in the fair allocation of capital gains between income and remainder interests. Judicial circumspection may also explain why the logic of the Pennsylvania rule on the allocation of cash dividends was not extended to the allocation of capital gains as well, since the gains are the result of income earned and retained during the income beneficiary's entitlement. See 3 Treatise (3d ed.), supra note 17, § 236.3, at 1983; note 194 supra.

204 A recent article argues strenuously, but not entirely convincingly, that the present Uni-

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The starting point must be certain assumptions about the customary intent of the settlor.[205] What can we infer from the settlor's general instructions that the income from a property should go to certain people now alive and that the principal should go to others, who may or may not be alive, or which may be charitable institutions rather than individuals? The settlor's main object is most likely a continuous income stream to the life beneficiaries, but how should that stream be fashioned, and who should bear the risks of uneven returns? The focus should be on the stability in real terms of both the payouts and the corpus—payouts, because of the settlor's presumed desire to provide a constant level of support, and corpus, because stable payouts ultimately depend upon the corpus, and because of the settlor's presumed desire to transfer wealth dynastically.

On this view, there are five separate approaches to the allocation of total trust returns that bear scrutiny: prudent trustee payout; fixed nominal payout; fixed real payout; fixed portfolio percentage payout; and payout of fixed real yield.

a. Prudent trustee payout. One way to handle the allocation problem is to remit it to the discretion of the trustee under a prudence standard. Depending on portfolio performance and inflation related changes in expenses faced by the life beneficiaries, the trustee could determine the appropriate allocation of returns. This approach, however, will inevitably put the trustee in the very difficult position of balancing the interests of life beneficiaries and remaindermen.

The closest analogy in current trust law practice appears to be clauses that give the trustee discretion to allocate receipts or expenses to either principal or income. The influence of the traditional allocation rules has led some courts to construe such clauses narrowly, as limited to situations of doubt under state law.[206] A more substantive objection is that such clauses do not provide the trustee with a standard for exercising discretion.

An alternative model for prudent trustee payout is the invasion-of-principal clause, which permits the trustee to spend principal for life beneficiaries where appropriate. But invasion-of-principal clauses seem best suited for unforeseeable circumstances of beneficiary need, where special

form Act permits sufficient trustee discretion in the allocation of income to protect the principal, at least against erosion from inflation. See Hirsch, supra note 193, at 614-24.

[205] See Note, Effectuating the Settlor's Intent: A Formula for Providing More Income for the Life Beneficiary, 33 U. Chi. L. Rev. 783, 783-84 (1966).

[206] See J. Dukeminier & S. Johanson, supra note 164, at 905-06. In one leading case, the court denied the trustee discretion to use such a clause without a good faith argument under accounting or trust principles. In re Will of Clarenbach, 23 Wis. 2d 71, 126 N.W.2d 614 (1964) (trustee arbitrarily allocated to income half the capital gain realized on sale of stock).

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flexibility is necessary, rather than for the foreseeable problem of allocation. Allocation should be addressed more specifically by the settlor. Reliance on continual trustee discretion is likely to embarrass both the life beneficiary, who may be put in the position of special pleading, and the trustee, who must consider the remainder interest (and potential surcharge claims).[207] If there is to be any sort of trustee discretion in the allocation question, it should be as narrow as possible.[208]

b. Fixed nominal payout. A fixed nominal payout approach contemplates that the life beneficiary will receive a constant stream of income that neither increases to reflect inflation nor decreases to reflect portfolio losses.[209] The payout is an annuity fixed in nominal terms. One immediate question is how to fix the amount of the payout. Presumably the payout will be geared to some assumption about the long-term nominal yield of the portfolio.[210] Such an assumption could be set by statute, subject to change by the settlor, or the statute could require the settlor to provide the desired percentage or actual dollar payout.[211] The settlor could adopt one of two strategies in setting the payout. The settlor could assign a payout based on a zero (or minimal) inflation rate, on the grounds that the portfolio will almost always earn this nominal amount, so that the corpus will not be depleted to make the payout. This strategy all but guarantees the certainty of income flow to the life beneficiaries and the existence of a remainder interest. If the zero inflation assumption is incorrect, however, the life beneficiaries are faced with steadily declining real income. Elements of return that compensate for inflation, such as higher nominal interest rates, inure to the remaindermen. Irrespective of inflation, the remaindermen receive all growth in the value of the portfolio. This strategy therefore favors remaindermen.

The other possible strategy is to set a payout based on an assumption of significant inflation, assuring at least a certain real income payout for the life beneficiaries. Such a strategy will overcompensate the life

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[207] See, e.g., Carpenter, The "Fixed-Income," "Annuity," and "Modernized" Types of Trust, 5 Law & Contemp. Probs. 368, 371 (1938).

[208] Corporate trustees have vigorously opposed the adoption of a discretionary rule as a general substitute for the Uniform Act. See the panel discussion reprinted in Uniform Revised Principal and Income Act, 101 Tr. & Est. 894, 896 (1962).

[209] See Carpenter, supra note 207.

[210] Any return assumptions depend on the specific portfolio, and particularly its level of risk.

[211] For example, assume that a settlor establishes a testamentary trust. Believing that the sustainable long-term nominal yield is six percent, but uncertain how large the trust corpus will be at the time of his death, the settlor could set a payout percentage of six percent of the trust corpus rather than a fixed dollar amount. Under the fixed nominal payout approach, the payout would be fixed at the dollar amount equal to six percent of the trust corpus at the trust's effective date.

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beneficiaries in the early years, and if the inflation assumption is too high, or if the increase in nominal returns is less than the increase in inflation, the strategy will lead to significant deterioration of the corpus. Such deterioration puts the life beneficiaries' continuous income stream at risk and jeopardizes the remainder interest. Thus, although formally a solution to the problem of return allocation, the nominal fixed income approach forces the settlor to choose between two unattractive strategies.[212]

c. Fixed real payout. The fixed real payout approach contemplates that the life beneficiaries will receive a stream of income that is adjusted according to some measure of inflation.[213] The payout is an annuity fixed in real terms. Setting the payout requires an assumption about the long-term sustainable real yield on a particular portfolio. This in turn requires three other assumptions: the long-term nominal return, the extent to which increases in inflation are matched by increases in nominal returns, and the variability of real returns. The uncertainty associated with the latter two assumptions is likely to force the settlor to set the payout at a rate that favors the remaindermen. For example, if inflation depresses real returns on particular financial instruments—such as common stocks during the 1972-1981 period—the yield of a portfolio containing such instruments may be depressed in real terms. A payout set without regard to this possibility may lead to a deterioration of the corpus in real terms, jeopardizing the future payout to both the life beneficiaries and the remainder interest.

The effect of the assumption about the variability of real returns is also likely to favor remaindermen. The average real returns may be con-

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[212] The fixed payout approach contemplates invasion of the corpus if necessary to make the prescribed payout. The amount of the payout would depend partly on the settlor's concern about potential erosion of the corpus, either because of the ultimate effect on income beneficiaries (the funds might run out) or on remaindermen (not as much wealth will be passed on to them).

The interest of income beneficiaries will always be to receive the largest possible payout as soon as possible. To the extent that they are concerned about future income, income beneficiaries can fend for themselves (by reinvesting a portion of the payout, for example). But in establishing a trust, as opposed to making a direct gift or bequest, the settlor expresses an intention somewhat at odds with the desires of income beneficiaries.

[213] Calls for such an approach have been made. See, e.g., Barclay, Lot of the Income Beneficiary (pt. 3), 107 Tr. & Est. 389 (1968); Note, Common Stocks in Trust, 113 U. Pa. L. Rev. 228 (1964). Problems involving the appropriate measure of general inflation would inevitably arise: consumer versus producer prices; quarterly versus yearly adjustments; regional versus national prices. In addition, the inflation rate may vary for different expenditures faced by life beneficiaries at different stages in their lives. Housing costs may not increase significantly for the widow in a house already paid for, but her medical costs may increase significantly faster than the general inflation rate. An undifferentiated inflation assumption deals imperfectly with the changing market basket of goods and services that a life beneficiary will require over his or her life.

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stant under various economic conditions over the long run,[214] but highly variable over shorter periods. Forcing the payout of the average rate could lead to a deterioration of the corpus from a kind of "gambler's ruin": the need to make the payout in lean years will reduce the corpus, making it harder to catch up, even in good years. The inclination of the settlor will be to account for this risk by setting the payout at a rate that favors the remaindermen.

Another way to consider the problem of fixed payouts, either in nominal or real terms, is to look at the market for annuities. If the settlor's objectives could be fulfilled merely by guaranteeing a certain income stream, then the solution would be the purchase of annuity contracts for the life beneficiaries, the balance of the corpus to be held in trust for the remaindermen. Such purchases, however, are not regularly directed as part of the trust disposition. The fixed nominal annuity obviously does not solve the problem of inflation. More interesting is the fixed real annuity. Such an instrument does not appear to be a regular part of the annuity market. The likely reason is that it would be very expensive because of the risks associated with providing constant real returns. In other words, the insurance company would be in a position similar to that of the remaindermen. The insurance company would have to set a price (require a corpus) for a specific fixed real payout that would enable it to meet its payment obligation while earning a profit at the end (assuring against depletion of the corpus).[215] But the price—the ratio of guaranteed fixed real payout per dollar of premium—appears to be so high that settlors do not use such instruments, suggesting that settlors would not favor a fixed real payout approach as a solution to the total return problem. The guarantee of a specific fixed real payout carries too high a price.

Thus, the fixed payout approach, whether nominal or real, is unsatisfactory because the need to generate the fixed payout will lead the settlor to lower the payout requirement to avoid deterioration of the corpus. On average such an approach will favor the remainder interest. In other words, assuring absolute stability of payouts is undesirable because the need to maintain the stability of the corpus will then reduce the allowable payout. Settlors who prefer fixed payouts, nominal or real, for their life beneficiaries can instruct trustees to enter into private contracts for such payouts with private insurers, who will use a total return approach in computing the price to be charged. That settlors do not commonly make

[214] Such a result would be more plausible under portfolio management that shifted among investment vehicles in light of changing economic conditions—from stocks to bonds to real estate to precious metals.

[215] The analogy is not exact because the insurance company, unlike the remaindermen, also guarantees the making of the payout, even beyond exhaustion of the premium it charges.

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such arrangements suggests that their objectives are more complex; they want relatively stable real payouts, a relatively stable corpus, and a process that shares the fruits of portfolio growth with the life beneficiaries. Thus, we turn to approaches that vary payout.

d. Fixed portfolio percentage payout. A fixed portfolio percentage approach contemplates that the life beneficiaries will periodically receive a payout of a certain percentage of the current value of the portfolio.[216] Thus, the dollar amount of the payout will vary depending on the fluctuating value of the portfolio; only the payout percentage remains constant. The percentage will be based on assumptions about sustainable long-term nominal and real returns on the portfolio. This approach raises questions about the stability of the payouts and the corpus. If the payout percentage is set too high, the corpus is subject to deterioration and the payouts will become smaller. This possibility leads to strategies that favor the remainder interest, as discussed above. But the real problem is that the fixed portfolio percentage approach does not focus on the important variables—real payouts and real corpus—but on a third variable—the percentage payout—which bears only an incidental (and variable) relationship to them.

e. Payout of adjusted real yield, or payout of yield above fixed real corpus. An adjusted real yield approach contemplates that the life beneficiaries will receive payouts geared to the real yield of the portfolio. The payout is based on total portfolio returns for the period (income and capital gains) after correcting for any loss in the real value of the corpus, whether from inflation or capital loss.[217] This approach requires no assumptions about the long-term portfolio yields or the rate of inflation. Moreover, preservation of the corpus follows automatically under the adjusted real yield approach, protecting the life beneficiary's income stream and the remainder interest.

The only problem is that the stability of corpus comes at the expense

[216] See Carpenter, supra note 207; Clark, Power to Invest Without Yield, 100 Tr. & Est. 495 (1961); David, Principal and Income—Obsolete Concepts, 43 Pa. B.A.Q. 247, 251 (1972).

A twist on the proposal is offered by a student note suggesting that the current allocation rules should continue to apply, subject to a minimum and maximum portfolio percentage payout. Note, Range of Returns: A New Approach to the Allocation of Trust Gains and Losses, 21 Stan. L. Rev. 420 (1969). The problems with this proposal are that continued reliance in any manner on the current allocation rules is likely to interfere with acceptance of modern portfolio management, and that the various percentages proposed have no necessary relation to sustainable real yields.

[217] The gains and losses referred to in the text are "capital" in the economic sense, not the tax sense, and represent unrealized as well as realized gains and losses. This approach would thus require a change in the customary trust law practice of focusing on realized gains and losses. See 3 Treatise (3d ed.), supra note 17, §§ 236.11-236.12.

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of a stable income stream, in nominal or real terms, to the life beneficiaries. The requirement that the value of the corpus be held constant even taking into account capital losses makes this problem particularly acute. It is easy to imagine periods in which the total real returns on a well-managed portfolio would be minimal, if not negative. Thus, a real yield approach would not always supply steady maintenance for the life beneficiaries.

How can this income stability problem be addressed? One way is to set a tentative payout assumption based on long-term average real yields and construct a stabilization account that reflects surpluses or shortfalls. In years of higher-than-average returns, the account would accumulate funds that would cover payouts in leaner years. The account could be bounded above and below; at a certain point, the payout assumption would change to reflect accumulated higher or lower returns.[218] Thus the adjusted real yield approach suggested here is based on real portfolio yields, but it would use a stabilization fund to smooth out the variability in actual payouts.

Such an approach comes closest to effectuating the settlor's objective of a steady real income stream that nevertheless admits of some variation. It is almost certain that this approach will produce higher average sustainable real payouts for the life beneficiaries than either fixed payout approach. If the stabilization account is properly conceived, both the life beneficiaries and the remainder interest can be protected against dramatic shifts in conditions. This approach also underscores the proper emphasis of trustee investment management: producing a steady stream of real returns while managing the inevitable flux of market conditions. Nonetheless, there are many technical, financial, and legal problems with the approach.

The first set of technical financial problems relates to the establishment of the benchmark real yield expectation. Two matters are at issue: first, the identification of the appropriate benchmark trusteed portfolio (which could conceivably change over time), and second, the computation of real yields on this portfolio. One would want to know, for example, the composition of the portfolio that provided the most stable real returns over particular time periods, and the extent of the tradeoff be-

[218] A similar proposal is found in Comment, supra note 195. Another student note makes a related proposal: set an annual payout based on the sum of the current average annual dividend yield of all stocks and the long-term average annual real capital gain for such stocks. Note, supra note 205 at 793. This payout scheme in effect assumes that the benchmark trusteed portfolio consists of the market index of equity securities; debt is not considered. It is not evident why a portfolio at this level of risk should be the appropriate benchmark. Moreover, making the required annual payout could rapidly erode the corpus in a period of declining market conditions.

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tween increased real returns and additional risk. The second major set of questions relates to the stabilization account. What is the appropriate lower bound (i.e., negative surplus) to avoid the "gambler's ruin" problem of a quickly deteriorating corpus, and how sharply should the payout assumption be reduced after that point? Similarly, what is the appropriate upper bound (and point of changed payout assumption) to avoid unfair diversion of returns to the remaindermen?

All of these questions are empirical and better suited for analysis in the first instance by financial economists, not necessarily lawyers. This Article recommends that an authoritative body—for example, the National Conference of Commissioners on Uniform State Law or the American Law Institute—retain a team of financial economists to work through some of these technical financial problems. Their work could lead to specific data that might suggest statutory assumptions in the absence of contrary provision by the settlor, or to a procedure for determining the correct assumptions.

An adjusted real yield approach also raises some legal problems. What follows is a brief survey of federal tax and state law concerns. Federal tax issues arise from the question of whether the payout under the adjusted real yield approach is consistent with the various concepts of income used for the taxation of trust income and estate and gift transfers. The traditional distinction between principal and income has been used in developing the tax rules. A new approach to allocation, under state law or as a provision crafted by the settlor, raises questions about the continued fit of the tax rules.

Although a trust is a taxpaying entity, it is treated as a mere conduit for income required to be distributed.[219] Moreover, such income is taxable to the beneficiaries whether or not actually distributed.[220] Will the use of reserve funds in the adjusted real yield approach jeopardize the deductibility of distributed income for the trust? Will it result in tax liability for beneficiaries on income not yet received? The Code directs us to look to the state law of trusts for the definition of income.[221] The regulations indicate that "[t]he determination of whether trust income is required to be distributed currently depends upon the terms of the trust

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[219] Simple trusts, which under the terms of their governing instruments must distribute all income currently, are entitled to a deduction of that amount in computing taxable income. I.R.C. § 651(a) (1982). Complex trusts, whose governing instruments may have additional provisions, are entitled to a deduction for required distributions up to the "distributable net income of the . . . trust." I.R.C. § 661(a) (1982).

[220] I.R.C. § 652(a) (1982) (simple trusts); I.R.C. § 662(a) (1982) (complex trusts).

[221] "[T]he term 'income' . . . means the amount of income of the . . . trust for the taxable year determined under the terms of the governing instrument and applicable local law." I.R.C. § 643(b) (1982).

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instrument and the applicable local law."[222] This presumably should mean that a state statutory change modifying the allocation formula—thus modifying the law of trusts—would sufficiently address any potential problem. Even in the absence of such change, however, is there any problem with settlor-crafted provisions based on adjusted real yield?[223]

A second significant federal tax question is the impact of the adjusted real yield approach on the marital deduction for bequests and gifts made in trust by a spouse. To qualify for the deduction, a bequest (or gift) in trust must provide the spouse recipient with the equivalent of absolute ownership or, at the very least, the right to receive "all income" from the property during the recipient's life.[224] The question is whether the payout under the adjusted real yield approach meets the statutory "all income" requirement. The regulations state that this income requirement is satisfied if the recipient is treated substantially as a life beneficiary under the law of trusts.[225] So once again, a state statutory change

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[222] Treas. Reg. § 1.651(a)-2(a) (1956); see also Treas. Reg. § 1.661(a)-2(b) (as amended in 1973) (" '[I]ncome required to be distributed currently' includes any amount required to be distributed which may be paid out of income or corpus . . . to the extent it is paid out of income for the taxable year.").

[223] In this connection, the regulations provide that, in determining whether income is required to be distributed currently, "if the trust instrument provides that the trustee in determining the distributable income shall first retain a reserve for depreciation or otherwise make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the retention of current income for that purpose will not disqualify the trust from being a 'simple' trust." Treas. Reg. § 1.651(a)-2(a) (1956). The payout under an adjusted real yield approach involves even less trustee discretion than these regulations permit.

[224] For estates of decedents dying before Jan. 1, 1982 (or for spousal gifts made before that date), the bequest (or gift) had to confer on the spouse the equivalent of absolute ownership, or at the very least, all income from the property plus a general power of appointment; a "terminable interest," such as a life estate, did not qualify for the deduction. I.R.C. § 2056(b)(1) (1982) (bequests); I.R.C. § 2523(b) (1982) (gifts); Rev. Rul. 60-385, 1960-2 C.B. 77. For estates of decedents dying after this date (and for spousal gifts made after this date), provisions added by the Economic Recovery Tax Act of 1981 permit bequests (or gifts) of "qualified terminable interests" in property, such as a life estate, to qualify for the marital deduction. Pub. L. No. 97-34, § 403(d)(1), 95 Stat. 172, 302-03 (1981) (adding I.R.C. § 2056(b)(7) (1982) (bequests)); id. § 403(d)(2), 95 Stat. at 303 (adding I.R.C. § 2523(f) (1982) (gifts)). Under both regimes, qualification for the marital deduction (for bequests and gifts) requires that the spouse recipient receive "all income" from the property for life. This raises the question of whether the payout under the adjusted fixed yield approach satisfies the statutory standard.

[225] Treas. Reg. § 20.2056(b)-5(f)(1) (1973) provides that the trust must assure the surviving spouse

> substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust. Such degree of enjoyment is given only if it was the decedent's intention, as manifested by the terms of the trust instrument and the surrounding circumstances, that the trust should produce for the surviving spouse during her life such an income . . . as is consistent with the value of the trust corpus and with its preservation.

These regulations apply to standard marital deduction trusts, not to the "Qualified Terminable

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in allocation should avoid federal estate and gift tax problems. On the other hand, the regulations also suggest that a settlor-crafted allocation formula adopting the adjusted real yield approach would not necessarily jeopardize the marital deduction.

> Provisions granting administrative powers to the trustee will not have the effect of disqualifying an interest passing in trust unless the grant of powers evidences the intention to deprive the surviving spouse of the beneficial enjoyment required by the statute. . . . Among the powers which if subject to reasonable limitations will not disqualify the interest passing in trust are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus . . . .[226]

Clarification from the Internal Revenue Service might be necessary to provide comfort, particularly for settlor-crafted provisions.[227]

Under state law, the first problem with the adjusted real yield approach is the applicability of various common law and statutory limitations on "accumulation" of trust income. The accumulation problem arises when trust income (conventionally interest and dividends) exceeds the payout amount. This could easily happen under the adjusted real yield approach, for part of the interest on fixed income securities might be retained to hold constant the real value of the corpus.[228] The accumulation problem is twofold. First, is the accumulation permissible, even if consistent with the settlor's intent, in light of common law or statutory rules against perpetuitites?[229] Second, does the accumulation represent a

Interest Property" (QTIP) trusts permitted as of 1981. See note 224 supra. However, proposed QTIP regulations indicate that the earlier regulations will generally apply in determining if the "surviving spouse is entitled for life to all the income from the property." Prop. Treas. Reg. § 20.2056(b)-7(c)(1), 49 Fed. Reg. 21,350 (1984).

226 Treas. Reg. § 20.2056(b)-5(f)(4) (1973) (standard marital deduction trust). Note also the need to argue that the adjusted yield approach does not entail "accumulation" that would deny the surviving spouse "all income." Treas. Reg. § 20.2056(b)-5(f)(7) (1973). As to these problems, Jackson v. United States, 376 U.S. 503 (1964), indicating that the marital deduction is not to be broadly construed, sounds a cautionary note.

227 A similar problem may arise under state laws that reduce a surviving spouse's "elective share" against a decedent's will by property previously transferred to the surviving spouse as a life estate. As in the marital deduction case, a statutory change could address the problem but is arguably unnecessary since a settlor-crafted allocation formula on the adjusted fixed yield approach is not in derogation of the spouse's life estate. Both the standard marital deduction and the elective share questions are discussed in greater detail in Hirsh, supra note 193, at 643-46.

228 It could also be the case that the life beneficiaries might receive a payout greater than current income (i.e., interest and cash dividends) or total retained income, depending on economic conditions and the composition of the trust portfolio.

229 See Restatement (Second) of Property (Donative Transfers) § 2.2(1) comments and reporter's notes (1981).

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withholding of funds due the life beneficiary, in derogation of the settlor's intent?[230]

A statutory change in the allocation formula could address these accumulation limitations directly. Even without statutory changes, it could be argued, following the *Restatement (Second) of Property*, that any retention of funds under the adjusted real yield approach is not an "accumulation" because it is "merely in the course of judicious management of the trust."[231] Because the approach is a means of managing the trust so as to produce a relatively stable real income stream to the life beneficiaries, it raises none of the policy concerns that have given rise to the doctrines against accumulation.

Another legal question raised by the adjusted real yield approach is what happens to any surplus in the stabilization account upon the life beneficiary's death. It would seem that the surplus should properly go to the remaindermen. On the assumption that any deficit in the stabilization account would not have to be covered by the life beneficiary's estate—and thus would reduce the corpus—rough symmetry suggests that any surplus should inure to the remaindermen. This also seems consistent with the settlor's intention: to provide the life beneficiary with a steady income stream *during his life*, with the corpus passing to a successor designated by the settlor. The surplus account is simply a mechanism for assuring that steady real income stream, not property of the life beneficiary.

The final legal problem, a policy question as well, is whether statutory adoption of an adjusted real yield allocation formula should be retroactive. Should trusts that contain general "principal and income" language become subject to the new allocation formula? One useful comparison is to other significant statutory changes in the trustee's investment management powers, such as the change from a legal list to the Prudent Man Rule, or the authorization to invest trust funds in a common trust fund. Such changes generally apply retroactively, even without a specific legislative declaration to this effect.[232] The only exception

[230] See id. § 2.2(3) comments and reporter's notes; 2 Treatise (3d ed.), supra note 17, § 182, at 1466-68. Buried in this question is the further question about retroactive effect of any such change in the allocation formula. See text accompanying notes 232-33 infra.

[231] Restatement (Second) of Property (Donative Transfers) § 2.2(4) (1981); see id. comments j-k and reporter's notes 8-9, 12-13; see also G. Bogert & G. Bogert, supra note 12, § 217, at 284 (creation of reserve for later payout is not an accumulation). It would be entirely consistent with an investor's expectation in purchasing a high-yield fixed income instrument during inflationary times that part of the interest is compensation for erosion in the real value of the principal. In a sense, the adjusted real yield approach merely broadens that insight into a mode of "judicious trust management."

[232] 3 Treatise (3d ed.), supra note 17, § 227.13, at 1843 (general principle); id. § 227.9, at 1832 (common trust funds).

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seems to be if the trust instrument contains "specific directions . . . which unalterably prescribe the investment to be made."[233] This seems sound. Statutory change is presumably based on what is believed to be a better understanding of markets and investments; why deny the benefits to trusts already in existence and to their beneficiaries?

A similar argument could be made for retroactive application of a revised allocation statute. What motivates the change, after all, is the desire to employ a superior means of investment management: an unconstrained Prudent Man Rule. Better investment management should not lead to a conflict between beneficiaries and remaindermen; it increases the value of the trust to both sets of interests. The problem seems more ticklish, however, because the revised allocation formula will more directly reallocate between interested parties. On a total return approach, gains that traditionally have gone to remaindermen may go to income beneficiaries. On the other hand, if something like the adjusted real yield proposal is adopted, what previously had been regarded as income may go to remaindermen. The disruption of settled expectations is likely to be a short-term phenomenon, however, as it will soon become clear that no set of interests is favored. Moreover, reflection upon the trustee's current ability to manipulate allocation through adjustment of the portfolio's holdings may further undercut any objection against retroactivity. Thus, unless the trust instrument contains an allocation clause that expressly changes the customary "principal and income" division,[234] adoption of a new allocation formula should apply retroactively. Any new statute should so state.

Conclusion: A Comparison

A commentator on an earlier version of this paper noted certain striking similarities and differences in the pattern of doctrinal change in the areas of trust investment management and vertical restraints in antitrust law.[235] Despite some of the same homeostatic factors, the law of

[233] In re Estate of Stillman, 81 Misc. 2d. 747, 750, 366 N.Y.S.2d 934, 938 (Sur. Ct. 1975). The court continues, "Where the instrument is silent or contains only permissive language with respect to investments, the statutory authorization in existence at the time of any particular investment will control." Id. (citations omitted).

[234] For example, the settlor may have adopted a provision implementing a total return approach, but using a nominal fixed payout scheme. Or the settlor may not intend the usual division of current benefits of trust assets to life beneficiaries, corpus to remaindermen.

[235] See L. White, Modern Investment Management and the Prudent Man Rule: Further Puzzles and Comments (1986) (remarks prepared for the Salomon Brothers Center for the Study of Financial Institutions Conference on Modern Investment Theory and the Prudent Man Rule) (on file at New York University Law Review). "Vertical restraints" are constraints imposed by a manufacturer on resales in the chain of distribution, including constraints on price, territory, and customers.

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vertical restraints has undergone a sea change in the last fifteen years. Courts now readily accept vertical restraints that not so long ago would have been condemned as anticompetitive.[236] Yet antitrust law had its important authority, Kaysen and Turner's *Antitrust Policy*,[237] a standard guide to policy analysis in the 1960s and early 1970s, that strenuously criticized vertical relationships. Moreover, the economics involved in judicial acceptance of vertical restraints is not notably simpler than modern portfolio theory. The conclusion of such a critique is that the explanation for stasis in trust law must be found elsewhere.

Actually, the differences between the two cases reinforce the explanatory claims offered in this Article. The one volume Kaysen and Turner book is much more a monograph than a treatise-like account of antitrust law. By contrast is the Areeda and Turner antitrust treatise,[238] a descriptive and prescriptive account of the law, that is at six volumes and still expanding. In the ten-to-fifteen-year period of its greatest influence, Kaysen and Turner would not have embedded itself into the consciousness of several generations of law teachers, lawyers and judges, as did Scott's treatise.[239]

Even more important has been the continuing role of economic analysis in antitrust. Kaysen and Turner itself, for example, offers a law and economics treatment of vertical restraints. The work of the new generation of antitrust advocates has been to persuade courts of a different model of the consequences of vertical restraints, in a field in which the relevance of economic analysis had already been established.[240] By contrast, in trust law the first problem is to persuade courts that the constrained Prudent Man Rule is itself based on a particular economic model. Only then will a court be prepared to consider the claim that modern portfolio theory offers a better model. Trust investment management law has no tradition of economic analysis. It is not that modern portfolio theory is necessarily more complex than the microeconomic

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[236] See L. White, The Revolution in Antitrust Analysis of Vertical Relationships: How Did We Get from Here to There (1986) (working paper on file at New York University Law Review). Compare United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967) (manufacturer's customer and territorial restraints on ordinary wholesaler are per se unlawful) with Continental T.V., Inc. v. GTE Sylvania Co., 433 U.S. 36 (1977) (overruling *Schwinn* to hold that rule of reason ordinarily applies to vertical restraints).

[237] C. Kaysen & D. Turner, Antitrust Policy (1959).

[238] P. Areeda & D. Turner, Antitrust Law (1978).

[239] Moreover, "[a]ntitrust policy concerning vertical restraints has followed a wavering course. Over the years, Congress and the courts have vacillated between disapproval and approval, never reaching a resolution . . . satisfactory to their successors." Comanor, Vertical Price-Fixing, Vertical Market Restrictions, and the New Antitrust Policy, 98 Harv. L. Rev. 983, 983 (1985). Obviously no treatise has yet shaped a stable consensus.

[240] This is not to say that more benign views of vertical restraints are necessarily correct, only that they have at least partially prevailed. See generally Comanor, supra note 239.

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analysis of vertical restraints (though it might be), but that economic analysis has seemed so foreign to trust law doctrinal analysis.

Another pivotal distinction has been rapid pace of private litigation in the vertical restraint area. There have been literally hundreds of cases in the vertical restraint area since the landmark 1967 Supreme Court decision of *United States v. Arnold, Schwinn & Co.*[241] By contrast, over the same twenty-year period there are fewer than a dozen cases that examine trustee investment management. The pace of vertical restraints litigation provides pressure and the occasion for rapid doctrinal change. The disparity points to the obviously different situation facing private litigants in the two areas. As noted above, sophisticated trusts can contract around the constrained Prudent Man Rule. Such a contracting-around option is obviously not available in the antitrust area. Moreover, private antitrust plaintiffs are not generally beset by the collective action and other problems that reduce the incentives for beneficiary or trustee litigation. Thus, the antitrust comparison underscores the extent to which skewed litigation incentives, in conjunction with an authoritative commentary and the difficulties of a new economic model, have made the law of investment management inordinately resistant to change.

In the end, the persistence of the constrained Prudent Man Rule may not be a puzzle after all. The constrained Rule derives principally from authoritative commentary that has remained virtually unchanged for over fifty years. An alternative, unconstrained Rule rests on a sophisticated economic model whose conclusions slowly percolate through the bar. Acceptance of the model may require further change in an area of the law where innovations come slowly. This is not to justify legal standards that contradict our best understanding, only to explain why an obsolete rule has persisted, and in so explaining, hasten the process of change.

[241] 388 U.S. 365 (1967). A recent Lexis search turned up 220 citations. The search request was "vertical restraint! or (restrict! w/10 customer or territor!) and Schwinn" addressed to the trade regulation/courts library.

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