

## When Trustees Have a *Duty* to Delegate Investment Management

By: Marc R. Lieberman, Mark E. Lasee, and Andrew L. McNichol

Most public retirement systems are governed by boards of trustees from diverse backgrounds. Despite the fact that many trustees have little to no investment acumen, legislation governing public retirement systems invariably vests these trustees with the ultimate responsibility for investing system assets. Historically, trustees were prohibited from delegating to third parties any of their authority to make investments, unless the terms of the trust specifically authorized such delegation.<sup>1</sup> The rationale for such a rule was that trustees were usually chosen for specific qualities, so it would be contrary to the legislative intent to allow others to exercise a trustee's fiduciary responsibilities.<sup>2</sup> Thus, in one famous case, a state supreme court held that a named trustee's delegation of investment authority to an alternate trustee was a breach of the named trustee's fiduciary duty, and remanded the case for a determination whether the trustee was personally liable for all losses incurred by the trust by the alternate trustee.<sup>3</sup> The court expressly rejected the trustee's argument that her lack of investment experience made it prudent for her to delegate her investment power to the alternate trustee, who had vastly more investment expertise; instead, the court reasoned that a trustee's delegation of investment authority for *any* reason, including an ostensibly good one, constituted a breach of trust.<sup>4</sup>

The rule that a trustee cannot delegate away his or her investment authority to make investment decisions may have made sense up to the middle of the 20<sup>th</sup> Century, when the range of investment choices was rather limited and within the understanding of most people appointed or elected to serve as trustees. Today, however, the complexity and multitude of investment options beg the question whether even the most knowledgeable and experienced trustee can competently make an informed decision to invest in many of these products. As a result, most states have adopted rules dramatically changing the law governing the delegation of a fiduciary's investment authority to allow delegation in appropriate circumstances.

This article will explain these changes, and make clear that there are few impediments with a trustee's prudent delegation of investment authority to more knowledgeable persons, *so long as* certain controls are in place. Indeed, as described more specifically below, a board's failure to delegate investment authority may constitute a breach of fiduciary duty, given the complexity and risks of today's highly-sophisticated securities markets.

### The Origin of The New Delegation Rules

In May 1990, the American Law Institute, one of the bodies responsible for codifying the common law into a uniform set of principles, published its Third Restatement of the Law of Trusts ("**Third Restatement**"). This Third Restatement expressly rejected the historical prohibition against the delegation of investment authority. Instead, the Third Restatement specifically authorizes such delegation so long as certain precautions were taken and controls were in place, and importantly, so long as the trust instrument allowed such delegation.<sup>5</sup>

It has taken many years for the Third Restatement's new delegation rules to be adopted by most jurisdictions, but by and large, the new delegation rules promulgated by the Third Restatement are now the law of the land.<sup>6</sup> As a result, it is critical for public pension lawyers, and the boards they represent, to be familiar with the rules governing a trustee's power to delegate investment authority, for today, a trustee's failure to delegate investment authority may constitute a breach of trust, as further noted below.

## THIRD RESTATEMENT

### The Third Restatement's New Delegation Rules

Section 80 of the Third Restatement sets forth the "new" rules governing a trustee's delegation of his/her authority:

"A trustee has a duty personally to perform the responsibilities of the trusteeship *except as a prudent person of comparable skill might delegate those responsibilities to others*. In deciding whether, to whom and in what manner to delegate fiduciary authority in the administration of a trust, and thereafter, in supervising or monitoring agents, the trustee has a duty to exercise fiduciary discretion and to act as a prudent person of comparable skill would act in similar circumstances." (Emphasis added).

Although the administration of a trust may not be delegated in full, the Third Restatement makes clear that a trustee may for many purposes delegate fiduciary authority to properly selected and supervised agents:



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“[D]elegation is not limited to the performance of ministerial acts. In appropriate circumstances *delegation may extend, for example, to the selection of trust investments or the management of specialized investment programs*, and to other activities of administration involving significant judgment.”<sup>7</sup> (Emphasis added).

Under the Third Restatement, there is no precise definition of acts that a trustee can properly delegate of the circumstances and conditions of proper delegation. A delegation of fiduciary authority is proper when it “is reasonably intended to further sound administration of the trust.”<sup>8</sup> Conversely, according to the Third Restatement, it is proper to delegate performance of acts that it would be unreasonable to require the trustee personally to perform.<sup>9</sup> More than that is permitted, however, for the trustee has fiduciary discretion to delegate such functions as a prudent person would delegate under the circumstances.

The Third Restatement suggests that, in considering the circumstances and conditions a particular delegation of fiduciary authority is proper, the following factors, among others, might be of importance:

- (i) The nature and degree of discretion involved;
- (ii) The amount of funds or value and character of the property involved;
- (iii) Efficiency, convenience, and cost considerations in light of the situs of the property or activities involved;
- (iv) The relationship of the act involved to the professional skills or facilities possessed by the trustee; and
- (v) The fairness and appropriateness of the responsibilities in question to the burdens and compensation of the trustee.<sup>10</sup>

The bottom line is that consideration should be given to “all factors that are relevant to analyzing whether the fact and manner of delegation can reasonably be expected to contribute to the sound, efficient administration of the trust.”<sup>11</sup>

### Factors Governing a Trustee’s Delegation of Investment Authority

The Third Restatement makes clear that a “trustee is not required to perform all aspects of the trust’s investment activities.”<sup>12</sup>

The Third Restatement also provides, however, that “a trustee cannot properly transfer the trust property to another as trustee and thereby abdicate responsibility.”<sup>13</sup> The Third Restatement’s overarching guidance with respect to delegating such authority is that “in deciding whether, to whom, and in what manner to delegate fiduciary authority in the administration of a trust, and thereafter in supervising or monitoring agents, the trustee has a duty to exercise fiduciary discretion and to act as a prudent person of comparable skill would act in similar circumstances.”<sup>14</sup> The Third Restatement intentionally provides little guidance on what types of investment authority can be delegated, reasoning that any specific guidance on the matter would be misleading and unhelpful:

“The qualities and qualifications for which trustees are properly selected for fiduciary roles, and the scope and complexity of the investment programs of some trusts, are so diverse that prescriptions for prudent behavior in the delegations of investment functions cannot be expressed in simple and precise legal rules.”<sup>15</sup>

Nevertheless, the Third Restatement does set forth some “bright line,” general rules for the prudent delegation of investment authority:

“With professional advice as needed, the trustee personally must at least define the trust’s investment objectives. In addition, the trustee must personally either formulate or approve the trust’s investment strategies and programs . . . [and] the trustee must exercise care, skill, and caution in determining what investment responsibilities to delegate. Then, fiduciary prudence must then be exercised as well in selecting an agent and establishing the terms of the delegation, all in a manner appropriate to the circumstances and conditions of the delegation and the competence of both agent and trustee.”<sup>16</sup>





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These rules are explained in more detail in Comment j of § 90 of the Third Restatement as follows:

Many factors affect the nature and extent of prudent and therefore permissible delegation. These factors include the almost infinite variety that exists in trustees and trusteeships, as well



as in investment objectives and techniques and in the types, circumstances, and goals of trusts. For example, it would be impractical for delegation decisions not to take account of the scale of a trust's operations and the nature of the trustee's operating structure. Corporate trustees necessarily act through their employees; between that situation and the individual who acts as a trustee or co-trustee, however, there are many variations of trusteeship, encompassing, for example, institutional governing bodies, law firms, and panels of individuals operating with the support of full-time staff.

The trustee's authority to delegate is not confined to acts that might be described as "ministerial." Nor is delegation precluded because the act in question calls for the exercise of considerable judgment or discretion. The trustee's decisions with regard to delegation are themselves matters of fiduciary judgment and responsibility falling within the sound discretion of the trustee.

Thus, a trustee's delegation of investment authority will not be set aside unless found to be an abuse of discretion.<sup>17</sup> A trustee will not be found to have abused his/her discretion in delegating investment authority so long as the delegation was reasonable and adequately monitored.<sup>18</sup> The size of the trust estate and the burdens and complexity of both the assets to be managed and the strategies to be implemented are important considerations. Consequently, "[a]ctive investment strategies, especially in low efficiency and privately traded markets such as real estate and venture capital, are likely to **require** the hiring of agents with special skills not possessed by many trustees, often not even by professionals or corporate fiduciaries."<sup>19</sup>

### Alternative Strategies *Require* Trustees to Delegate Investment Authority

One example of a circumstance where delegation of investment authority might be especially appropriate is in the venture capital realm. Illustration 23 of § 90 of the Third Restatement suggests that such investments might require delegation of investment authority to more expert professionals:

#### Illustration 23:

The trustees of a large trust, after consultation and study, have reasonably concluded that it would be desirable as part of an overall portfolio strategy to have a portion of the trust estate committed to a venture-capital investment program. They also have reasonable grounds for preferring to do this directly by holding company shares in the trust estate, rather than by purchasing shares of some suitable stock mutual funds or other venture-capital pools.... The trustees therefore wish to hire agents with specialized skills to manage the program. In this situation, substantial but prudent delegation is justifiable.

The Third Restatement notes that if a venture capital program of the type contemplated in Illustration 23 is to be pursued, "the trustees would have not only authority but a *duty* to delegate management activities in some reasonable fashion unless the trustees personally possess both the necessary expertise and the necessary time (even with the use of advisers) to manage the program themselves with the requisite degree of care, skill and caution."<sup>20</sup>

In sum, whereas historically, trustees were prohibited from delegating to others the right to make investment decisions for their trusts, the rule is quite the opposite today. When a trust's investments cannot be optimally managed by its trustees due to their complexity, the trustees have *duty* to retain competent professionals to manage the trust's investments to enable those investments to be successful.

### Delegation Requires Prudent Manager Selection and Monitoring

While trustees wishing to implement an investment program involving complex strategies like derivatives, private equity, real estate or hedge funds may now be obligated to delegate authority to qualified professionals to facilitate the program,



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there are certain guidelines as to how such delegation is to be accomplished. Trustees are to “make a competent, careful evaluation of potential managers... and... monitor their performance of their duties.”<sup>21</sup>

### Conclusion

Trustees no longer have to go it alone in making investment decisions. If they reasonably believe they are not competent to select and manage an investment, they are obligated to delegate responsibility to a competent professional to manage the investment. Trustees must exercise due care in selecting investment management, and must also regularly monitor their manager's activities. But the days of trustees calling balls and strikes on the suitability of particular investments, especially “alternative investments,” is largely over.

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### ENDNOTES

<sup>1</sup>See Comment c, § 18 Restatement (Second) of Agency (“trustees cannot delegate to others the use of discretion in exercising their powers, unless the terms of the trust so provide”); Comment h, Restatement (Second) of Trusts § 171 (“A trustee cannot properly delegate to another power to select investments”).

<sup>2</sup>Cf. § 171, Restatement (Second) of Trusts (“trustee, being in a fiduciary relation to the beneficiary, is under a duty *personally* to perform his duties as a fiduciary”).

<sup>3</sup>See *Shriners Hospitals for Crippled Children v. Gerdiner*, 152 Ariz. 527, 529, 733 P.2d 1110, 1112 (1987).

<sup>4</sup>See *id.* at 529, 733 P.2d at 1112 (“A delegation of investment authority is unreasonable and therefore, May Jane’s delegation is a breach of trust”).

<sup>5</sup>See §§ 80, 90, 91 Restatement (Third) of Trusts.

<sup>6</sup>The Uniform Prudent Investor Act, which was promulgated by the Uniform Law Commission and is substantially similar to the Third Restatement, has been adopted in forty-one states and the District of Columbia. Seven additional states have adopted some form of the Uniform Prudent Investor Act. *Only two states*, Mississippi and Louisiana, have not adopted some form of the Uniform Prudent Investor Act, and boards in those states should tread more carefully when considering whether to delegate investment authority to third party managers. See [https://www.fdic.gov/regulations/examinations/trustmanual/appendix\\_c/appendix\\_c.html#\\_toc497113667](https://www.fdic.gov/regulations/examinations/trustmanual/appendix_c/appendix_c.html#_toc497113667).

<sup>7</sup>See § 80, Comment e, Restatement (Third) of Trusts (emphasis added).

<sup>8</sup>*Id.*

<sup>9</sup>*Id.*

<sup>10</sup>See § 80, Comment e, Restatement (Third) of Trusts.

<sup>11</sup>*Id.*

<sup>12</sup>See § 80, Comment f, Restatement (Third) of Trusts.

<sup>13</sup>See § 80, Comment c, Restatement (Third) of Trusts.

<sup>14</sup>See § 80(2), Restatement (Third) of Trusts.

<sup>15</sup>See § 80, Comment f, Restatement (Third) of Trusts.

<sup>16</sup>*Id.*

<sup>17</sup>See § 80, Comment j, Restatement (Third) of Trusts.

<sup>18</sup>*Id.* (trustee must keep reasonably informed of investment advisor’s activities).

<sup>19</sup>*Id.* (emphasis added).

<sup>20</sup>See *id.*

<sup>21</sup>See Restatement (Third) of Trusts, § 90, Comment j.



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