ALI and ULC Continue Work on Revisions to UCC Articles 1, 3, and 9

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Since the national mortgage crisis began, there has been substantial interest in creating a more efficient system for tracking residential mortgage notes. A more efficient and effective system would serve the interests of both obligors and lenders. One of the difficulties that courts, and others, had in dealing with the mortgage crisis was understanding the relationship between a mortgage and the underlying note. This became especially important in situations of default when it was necessary to identify the holder with rights to enforce the mortgage.

Mortgage Electronic Registration Systems, or MERS, had been intended to simplify the process of tracking mortgages as they were sold to various new holders throughout their lifetime. When mortgage loans are registered in the MERS system, MERS acts as the nominee for the lender and servicer in county land records and becomes the mortgagee of record and nominee for the mortgage loan’s beneficial owner. While MERS provided a good mechanism for tracking the holder of the mortgage, it did not do the same for the underlying note.

A second major issue with tracking paper notes garnered national attention in 2005 with Hurricane Katrina and again in 2012 with Superstorm Sandy. The fact that these two storms were responsible for the destruction of so many promissory notes contributed to the desire to provide a mechanism that allowed for immobilization and dematerialization of residential mortgage notes. The goal was to make it possible for residential mortgage notes either to be originated in electronic form or to be converted from paper to electronic form. Thus began the project that became the National Mortgage Repository Act of 2017.

The Federal Reserve Bank of New York has taken the lead in drafting the Act. The Act is intended to provide

DID YOU KNOW: THE FIRST UCC WAS PUBLISHED IN 1952, 65 YEARS AGO.

More information about the project, including drafts of both the Act and the proposed revisions to Articles 1, 3, and 9, is available on the ALI website at www.ali.org/ucc.

A recent article by Professors Max M. Schanzenbach and Robert H. Sitkoff (a member of the ALI Council), “The Prudent Investor Rule and Market Risk: An Empirical Analysis,” which was published earlier this year in the Journal of Empirical Legal Studies, provides an excellent legal and financial analysis of how the ALI reshaped the modern law of fiduciary investment.

THE DIRECTOR’S LETTER BY RICHARD L. REVESZ

How the ALI Empowered Fiduciaries to Have Better Investment Strategies

Today, it is considered axiomatic that a well-designed investment portfolio should balance risk and return in a manner that is consistent with the investor’s financial objectives, and that stocks, typically offering higher expected returns and higher risks, should constitute a significant portion of portfolios that have long-term objectives. Likewise, there is a consensus among financial professionals that over the long run, investment in stocks has a significant positive impact on a portfolio’s long-term financial return (financial economists call it the “equity premium”). But until about 25 years ago, there were significant legal barriers to constructing optimal portfolios in fiduciary accounts.

The ALI played a key role in bringing down these barriers, by adopting a Restatement rule on prudence and risk that was flatly inconsistent with the majority rule prevailing at the time. Instead, the Restatement followed the strong consensus of economic theorists, and, in particular, the teachings of modern portfolio theory, which was embraced by investment professionals but was contrary to court applications of fiduciary investment law. A recent article by Professors Max M. Schanzenbach and Robert H. Sitkoff (a member of the ALI Council), “The Prudent Investor Rule and Market Risk: An Empirical Analysis,” which was published earlier this year in the Journal of Empirical Legal Studies, provides an excellent legal and financial analysis of how the ALI reshaped the modern law of fiduciary investment.

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In 1992, ALI completed the Restatement (Third) of Trusts: Prudent Investor Rule, which made several key changes to the law of trusts contained in the Restatement (Second), each under the rubric of a new “prudent investor rule.” First, contrary to the prevailing view in the case law, the Restatement (Third) directed that the prudent investor rule was to be “applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.” Second, the Restatement (Third) folded the “duty to diversify the investments of the trust” into the prudent investor rule itself. Third, the Restatement (Third) imposed on trustees an “ongoing duty to monitor investments and to make portfolio adjustments if and as appropriate, with attention to all relevant considerations.”

In contrast, the Restatement (Second), completed in 1959, used the “prudent man rule,” which had been adopted by a majority of states by the mid-1900s. That rule traced back to an 1830 Massachusetts Supreme Judicial Court decision requiring trustees 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.” Courts applying this rule, however, presumed that certain kinds of investments were imprudent, in effect creating judicially determined legal lists of proper and improper investments. Consistent with these common law rules, the Restatement (Second) establishes that federal, state, municipal, and corporate bonds and first mortgages are considered prudent investments, but that “purchase of shares of stock on margin or purchase of bonds selling at a great discount because of uncertainty whether they will be paid on maturity” and “purchase of securities in new and untried enterprises” are presumed improper. The Restatement (Second) recognized as proper the purchase of stock with “regular earnings and paying regular dividends which may reasonably be expected to continue,” but noted that some states limited the purchase of stock to a certain percentage of trust holdings.

During the late 1980s, many scholars working in the law-and-economics tradition began to call for reforming the law. Drawing on modern portfolio theory, they argued that market risk must be accepted in exchange for higher possible returns and that idiosyncratic risk could be balanced by diversified portfolios. At the time the 1992 Restatement was drafted, some legislation—such as the Uniform Management of Institutional Funds Act (promulgated in 1972 and adopted by more than half the states by 1992) and the Employee Retirement Income Security Act of 1974—already absorbed principles of portfolio theory into prudent investment standards. Only a minority of states, however, had adopted a prudent investor rule rooted in modern portfolio theory for trusts prior to 1992, and none had done so through the common law.

Following the adoption of the Restatement (Third), several states—Illinois, Virginia, Florida, and New York—swiftly adopted the “prudent investor rule” by legislation, relying significantly on the Restatement. In particular, Illinois, the first state to do so, modelled its law on draft versions of the Restatement.

The drafters of the 1996 Uniform Prudent Investor Act (UPIA) were also influenced by the Restatement, writing that “[t]his Act draws upon the revised standards for prudent trust investment promulgated by the American Law Institute in its Restatement (Third) of Trusts: Prudent Investor Rule (1992).” The UPIA drafters also in some sections drew from the 1992 Illinois law which they said was “closely modeled on the new Restatement.” By the end of the 1990s, all but five states had adopted prudent investor legislation to align the law of those states with the position of the Third Restatement, and by 2006, all states had done so. In turn, the UPIA has been adopted by forty-five U.S. states or territories (including some that had previously enacted non-UPIA prudent investor legislation).

Schanzenbach and Sitkoff’s article analyzes reports of bank trust holdings and fiduciary income tax returns to show the effect the prudent investor rule has had on asset allocation and management of market risk. Since the adoption of the prudent investor rule, they find an increase in stockholdings by trusts with relatively greater risk tolerance. The increase in percentage of stockholdings occurred in banks with larger average trust account sizes, those in and above the 25th percentile, but not for those below the 25th percentile. Schanzenbach and Sitkoff also find a pattern of portfolio rebalancing, consistent with the prudent investor rule’s requirement that the portfolio’s risk be managed in accordance with the purposes of the trust. These two findings, that increased stockholdings correlated with risk tolerance, and that portfolio risk was managed through rebalancing, serve to rebut criticisms, made in the wake of the 2008 financial crisis, that the prudent investor rule led to overly-risky investments by trustees.

Three features concerning the adoption of the “prudent investor rule” are particularly noteworthy. First, while the ALI is explicit that its black letter need not follow majority rules and that departures are appropriate in light of “the relative desirability of competing rules,” which can be determined by “social-science evidence,” it is unusual for a Restatement to adopt a black letter rule contrary to the case law and without support in a minority line of cases. Second, while we think (and hope) that over time the ALI’s work will be influential, it is unusual to see such a quick and universal response. In fewer than 15 years, every single state had enacted a statute that adopted the position of the Restatement (Third). Third, while it is reasonable to believe that the ALI positively affects the strength of the U.S. economy through its mission “to promote the clarification and simplification of the law,” we do not generally think that a single black letter rule could have a large impact on long-term wealth creation. The “prudent investor rule” stands as one of the ALI’s greatest successes!

Editor’s Note: A version of this Director’s Letter that includes a bibliography of related material with links to relevant documents is posted on the News page of the ALI website: www.ali.org/news.