

## **Risk Management for Trustees**

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## Risk Management for Trustees

### Introduction

Trustees and their legal counsel should be thoroughly educated in all aspects of fiduciary responsibility and be willing to implement policies and procedures to minimize fiduciary liability. This is not the case in all too many instances. I have become increasingly concerned that many individual trustees have not been given the tools to do even a passable job. Even more alarming is the lack of knowledge and training among many practitioners; especially those who do not practice extensively in the trusts and estates field. The purpose of this article is to outline the risks inherent in serving as trustee and to present some “best practices” for managing that risk.

When I was beginning my research for this paper I discovered an excellent outline on Risk Management for Trustees presented at the University of Miami School of Law 39<sup>th</sup> Heckerling Institute on Estate Planning by William C. Weinsheimer and John T. Brooks of Foley and Lardner in Chicago. My thanks to Bill Weinsheimer for graciously allowing me to adapt that paper for this presentation.

### I. The Need for Effective Risk Management

The increased risk environment mandates that Trustees and their counsel take a proactive approach to risk management. Fiduciary litigation is on the rise. Each year, the reported cases in the trusts and estates area continue to grow and become more complex. Many large law firms have attorneys who specialize in fiduciary litigation and even smaller boutique firms usually have an estate and trust litigator. The baby boomer generation is now coming into their inheritances. This generation is more litigious than previous generations and with the reduction in transfer tax, more of their inheritance is left for them to fight over. Attitudes toward trustees are changing. Beneficiaries used to be hesitant to question or sue an experienced individual or a corporate fiduciary serving as Trustee. Today, however, that is no longer the case,

as the litigious baby boomers are not afraid to sue trustees.

Effective risk management requires a trustee to focus on carrying out his, her or its fiduciary duties with great diligence and integrity and to adopt a “best practices” approach to serving as trustee. The result of these efforts will be that the trustee will more effectively serve the beneficiaries. The bottom line: Proper risk management should make for happier beneficiaries and, as a result minimize fiduciary litigation. Although this discussion focuses on trustees, many of the ideas and principles discussed herein can be applied to other fiduciaries, such as executors and guardians.

### II. Pre-acceptance Screening Process

#### A. Risk Profile and Profitability Standards.

Perhaps the greatest risk management tool is to avoid trusts with high risk profiles, and those which, regardless of risk, do not meet with the trustee’s profitability standards. If possible, a potential trustee should be given the opportunity to evaluate the trusteeship at the drafting stage or prior to the initial funding of the trust.

#### B. Analyze the Trust Instrument.

Look for ambiguities, inconsistencies, potential tax problems and potential conflicts of interest. Carefully analyze the trustee provision, including exculpatory clauses, if any.<sup>1</sup>

#### C. Nature of Trust Assets.

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<sup>1</sup> See Michael J. Cenatiempo, *Dealing with Exculpatory Clauses*, State Bar of Texas Fiduciary Litigation 2004; Charles A. Redd, *Modification of Duties and Liabilities of Trustees*, 29 ACTEC JOURNAL 118-20 (2003). See also, *Texas Commerce Bank v. Grizzle*, 96 S.W. 3d 240 (Tex. 2002) (exculpatory clause valid which relieved the trustee of negligence). But see, Texas Trust Code Sec. 113.059 (passed in 2003 in response to Grizzle, which prohibits a grantor from relieving a trustee from liability for breaches of trust committed in bad faith, intentionally or with reckless indifference).

The potential trustee must be sure that he, she or it is capable of handling the specific trust assets. For example, being trustee of a trust which controls a closely held business or operates oil and gas working interests is very different from a trust which is made up solely of marketable securities. The Uniform Trust Code (“UTC”) provides that a person designated as trustee, without accepting the trusteeship, may “inspect or investigate trust property to determine the potential liability under environmental or other law or for any other purpose.” See UTC Sec. 701(c)(2)<sup>2</sup>. There is no similar provision in the Texas Trust Code although proposed amendments to Tex. Trust Code Sec. 112.009 would allow investigation and inspection prior to acceptance.

#### **D. Successor Trustees.**

Several issues impact the selection of a successor trustee and the succession process. Unless there is a co-trustee still serving, the existing trustee will still have a trustee’s duties and the powers necessary to protect the trust property until the property is delivered to a successor trustee or other person entitled to possession of the property.<sup>3</sup> Whether the predecessor trustee resigns or is removed, the trustee remains liable for any breaches of duty committed during the trustee’s

<sup>2</sup> The UTC, which was approved in August 2000 by the National Conference on Uniform State Laws, has been enacted in nine states (Kansas, Maine, Missouri, New Mexico, Nebraska, New Hampshire, Tennessee, Utah, and Wyoming) and the District of Columbia. The UTC was enacted and subsequently repealed in Arizona. The UTC was amended in 2001 and 2003. See “State of the Law” Appendix attached hereto. HB 1190 if passed by the Texas Legislature would incorporate many UTC provisions.

<sup>3</sup> Julie K. Kwon, *Trustee Succession: Steering the Successor Tide*, ALI-ABA Course of Study: Representing Estate and Trust Beneficiaries and Fiduciaries, July 17-18 2003 at 27. See also UTC Sec. 707(a), which provides that unless a co-trustee remains in office or the court otherwise orders, and until the trust property is delivered to a successor trustee or other person entitled to it, a trustee who has resigned or been removed has the duties of a trustee and the powers necessary to protect the trust property.

administration of the trust. The existing trustee should seek discharge immediately as of the termination of the trusteeship so that the scope of any liability is limited and the period during which a party may bring suit is clearly defined.

Under common law, a successor trustee is not liable for a predecessor trustee’s breaches of trust and is only liable for his, her or its own breaches of fiduciary duties. However, both the successor trustee and the predecessor are liable where the successor knows of the predecessor’s breach and allows it to continue or does not try to compel his predecessor to remedy the breach.<sup>4</sup> This means that the successor trustee effectively may have a duty to review the predecessor’s administration of the trust to avoid liability for continuation of breaches committed by the predecessor. Without exception, the successor trustee should review all prior activity and asset information, and, if possible, obtain indemnification from the predecessor for any actions taken prior to the assumption of the fiduciary relationship. In any case, the successor trustee should review the trust instrument and state law for protection of successor trustees from acts of the predecessor, although exculpatory provisions in the trust instrument may not provide adequate protection to the successor (or predecessor) trustee. The successor trustee should also establish a clear date from which to successor’s own liability as trustee begins to run. The successor trustee should also determine why the trusteeship is being changed, and attempt to assess the litigious nature of the beneficiaries, and, if applicable, co-trustees.

#### **E. Assess the Risk.**

Both the predecessor and successor trustees must determine the potential for liability arising from the trust’s administration before the transition to the successor. The successor trustee should consider several factors in identifying possible risks arising from the previous trust administration:

- Qualifications and experience of the predecessor trustee;

<sup>4</sup> See, Texas Trust Code Sec. 114.002.

- Changes in value of the assets during prior administration;
- Condition and completeness of the records of administration;
- Frequency and amounts of distributions to beneficiaries;
- Regularity and completeness of accountings to beneficiaries;
- Regularity and nature of communications between the predecessor trustee and the beneficiaries;
- Preparation of tax returns, including timeliness and resolution of tax liabilities;
- Terms of the trust instrument governing powers of the trustee and dispositive terms that may create conflicts among beneficiaries;
- History of litigation or dispute relating to administration of the trust; and
- Reasons for resignation or removal of prior trustee.

#### **F. When in Doubt Decline.**

### **III. Understanding the Duties of the Trustee<sup>5</sup>**

Trustees get sued because they have failed to understand their duties as a trustee. These duties are both of a general nature (found in the common law of trusts, such as avoidance of conflicts of interest) and of a more specific nature (such as duties imposed by the trust instrument and state law which governs the trust). Texas Trust Code Sec. 113.051 incorporates all of the common law duties of trustees unless otherwise modified by the trust agreement or the Texas Trust Code. Article 8 of the UTC in effect codifies the fundamental duties of a trustee, in addition to listing the trustee's powers.<sup>6</sup>

<sup>5</sup> See Robert J. Rosepink, *Punctillio of an Honor—A Trustee's Duties*, ACTEC JOURNAL 101 (2002), for a discussion of a trustee's duties under the UTC and the Restatement (Second) of Trusts. The article also discusses a trustee's liability for failure to perform the required duties according to the appropriate standard.

<sup>6</sup> Article 8 was drafted where possible to conform with the 1994 Uniform Prudent Investor Act. UTC, General Comment to Article 8. All of the provisions of Article 8 may be overridden by the trust document, except for certain aspects of

- Nature and extent of the assets held in trust;

Texas Trust Code Sec. 113.059 authorizes the Settlor in creating, modifying, amending or revoking the trust to relieve the trustee from a duty liability or restriction imposed by Chapter 113 except for certain exceptions. A corporate trustee may not be relieved of the duties, restrictions or liabilities imposed by Sec. 113.052 and Sec. 113.053 of the Trust Code. In addition, the trustee may not be relieved for a breach of trust committed in bad faith, intentionally or with a reckless indifference to the interest of the beneficiary or any profit derived from a breach of trust nor may the trustee be relieved from a duty to provide an accounting. Texas Trust Code Sec. 113.059 also provides that a provision in a trust instrument relieving the trustee of liability for a breach of trust is ineffective to the extent that the provision is inserted in the trust instrument as a result of an abuse by the trustee of a fiduciary duty to or confidential relationship with the Settlor. A trust may not contain a provision requiring a trustee to commit a criminal or tortious act or an act contrary to public policy. Texas Trust Code Sec. 112.031. In advising trustees, whether they be individual trustees or corporate trustees, a starting point in the risk management process is to ascertain that the trustee understands his, hers or its duties and that the beneficiaries have an understanding of the trustee's duties and the beneficiaries' rights under the trust.

#### **A. Duty to Understand the Terms of the Trust and Administer the Trust by Its Terms**

As a prelude to accepting a trusteeship, a potential trustee must study and understand the terms of the trust and the material surrounding circumstances, including the nature of the trust assets and specific familial information regarding the trust beneficiaries.

the trustee's duty to keep the beneficiaries informed of administration, and the trustee's duty to act in good faith, in accordance with the trust's purposes and for the beneficiaries benefit.

1. The trustee should read every word of the trust instrument, and trust counsel should provide the trustee with a written summary of the trust terms, which highlights any special duties and responsibilities imposed upon the trustee. Topics covered in that summary should include the following:

- a. the dispositive provisions of each trust under the instrument, including any withdrawal rights and powers of appointment;
- b. provisions for mandatory and discretionary distributions of income and principal, specific standards for discretionary distributions and ages for mandatory partial and terminating distributions;
- c. Any provisions regarding special needs or treatment of a specific beneficiary;
- d. the trustee's investment limitations, if any;
- e. accounting requirements, whether under the trust or under state law;
- f. special tax planning objectives for each trust;
- g. notice requirements, including notices of withdrawal rights, such as "Crummey" notices; and
- h. trustee resignation, succession, removal delegation and deadlock provisions.

2. In addition to carefully reading and understanding the trust instrument, the trustee must administer the trust strictly by its terms and must be guided in all acts by the trust instrument, including any amendments, and, unless there is ambiguity or a lack of direction, must be limited by the intent apparent from the face of the instrument.<sup>7</sup>

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<sup>7</sup> American College of Trust and Estate Counsel ("ACTEC"), *What it Means to Be a Trustee: A Guide for Clients* [hereinafter Client Guide]. See also Texas Trust Code Sec. 113.051 See also UTC sec. 801, which provides that upon acceptance of a trusteeship, the trustee shall administer the trust in good faith, in accordance with its terms and purposes and the

## **B. Duty to Furnish Information and to Communicate.**

1. The trustee should provide the current adult beneficiaries with a written summary of their rights under the trust. This allows the beneficiaries to understand the extent of their beneficial interests and allows the trustee to manage the beneficiaries' expectations. Some of the topics which might covered in such summary are:

- a. standards for distribution of income and principal, whether mandatory or discretionary;
- b. an explanation of any guidance or restrictions provided in the instrument as to investment policy the trustee must follow, or whether the trustee has broad discretion in making investments;
- c. the frequency of accountings and whether or not court approval will be required;
- d. special tax planning objectives of the trust;
- e. provisions for mandatory partial or terminating distributions from the trust, at specific ages, or otherwise;
- f. successor trustee provisions, including provisions for removal of the trustee, and whether beneficiaries or others have the removal power;
- g. *Inter Vivos* and testamentary powers of appointment and rights of withdrawal;
- h. trustee Compensation; and
- i. Identification of trust counsel, with an explanation that he or she represents the trustee and not the beneficiaries.

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beneficiaries' interests, and in accordance with the Code. However, see Redd supra., note 1, at 124-25, which states that the duty to administer the trust according to its terms may be modified or eliminated, except in Texas.

2. The trustee must keep the beneficiaries informed regarding the trust and its administration. The trustee should provide the beneficiaries with information about the trust assets and the trusts' investment performance, and should provide each beneficiary with other information about the trustee's acts and the administration of the trust which is relevant to such beneficiary's interest. The trustee must also provide any additional information reasonably requested by a beneficiary.<sup>8</sup>

3. The UTC, which "favors disclosure to beneficiaries as the better policy,"<sup>9</sup> contains several rules relating to the trustee's duty to inform and the beneficiaries' rights to information and reports. See UTC Sec. 813. For example, a beneficiary is entitled to demand a copy of the entire trust instrument, not just the portion the trustee deems relevant (subject to waiver by the settlor), See UTC sec. 813(b)(1), and the qualified beneficiaries are entitled to advance notice of any change in the method or rate of the trustee's compensation (also subject to waiver by the settlor), see UTC sec. 813(b)(4). These rules are among the most important and controversial provisions of the UTC. In fact, the most debated issue in the drafting of the UTC and subsequent to its approval was the extent to which a settlor may waive the informational requirements contained in Sec. 813.<sup>10</sup>

4. The trustee must obtain and maintain basic information about the beneficiaries, such as their

identities, ages, locations, financial needs and other circumstances relevant to their status of beneficiaries. The trustee must regularly review such information and check it for accuracy so that the trustee can make informed decisions regarding the administration of the trust.<sup>11</sup>

5. Periodic written communications should be sent to the beneficiaries informing them of the status of the trust, important developments, investment performance and other relevant information.<sup>12</sup>

6. The frequency and type of communications between the trustee and beneficiaries should depend on the size and complexity of the trust and on the personalities, experience and desires of the beneficiaries.<sup>13</sup>

### C. Duty of Skill and Care.

Under the laws of most states, a trustee must administer the trust using the care, skill, prudence and diligence that a person familiar with the job of serving as a trustee would use to carry out the trust's purposes.<sup>14</sup> The UTC includes a section addressing the trustee's use of special skills or expertise: "A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, shall use those special skills or expertise."

### D. Duty of Loyalty and to Avoid Conflicts of Interest.

<sup>8</sup> *Client Guide*, supra., note 11. See also, UTC Sec. 813(a), which states that a trustee shall keep the qualified beneficiaries reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests, and that unless unreasonable under the circumstances, a trustee shall promptly respond to a beneficiary's request for information related to the administration of the trust.

<sup>9</sup> Rosepink, supra., note 5, at 106.

<sup>10</sup> Id.

<sup>11</sup> *Guide for ACTEC Fellows Serving as Trustees*, 26 ACTEC NOTES 322 (2001) [hereinafter *Fellows Guide*].

<sup>12</sup> Id. at 323.

<sup>13</sup> Id.

<sup>14</sup> *Client Guide*, supra., note 11. See also UTC Sec. 804 (stating that "[a] trustee shall administer the trust as a prudent person would, by considering the purposes, terms, requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.")

The trustee must not engage in any act which puts the trustee's personal interests in conflict with those of any of the beneficiaries.<sup>15</sup> Furthermore, the trustee must not use trust property for the trustee's own personal gain or for any other purpose unrelated to the trust. Note however, that the trust instrument may authorize certain conflicts,<sup>16</sup> for example: (a). The trustee may be authorized to buy designated assets from the trust; (b) The trustee may be authorized to vote for himself, herself or itself as a director or officer of a closely held business owned by the trust, and to be compensated for services as trustee from the trust and as a director or officer from the business; and (c) A trustee who is an attorney or investment advisor may be authorized to retain his or her firm as a separately compensated advisor to the trust without having to forego trustee fees. Such conflicts should be clearly disclosed to beneficiaries in order to avoid future controversies.<sup>17</sup>

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<sup>15</sup> Section 802(a) of the UTC provides that a "trustee shall administer the trust solely in the interests of the beneficiaries." Section 802 goes on the list transactions involving trust property that are affected by a conflict of interest.

<sup>16</sup> Language in trust instruments authorizing self-dealing by a trustee is "generally construed with strict scrutiny." Redd, *supra* note 1, at 120. Furthermore, "regardless of how broad the trust instrument's provisions are, the Trustee will remain liable for a breach of trust committed in bad faith or with reckless indifference to the beneficiaries." Id at 121.

<sup>17</sup> The beneficiaries themselves may consent to disloyal conduct by the trustee, as long as the beneficiaries are of age and competent, act independently and are fully informed of all relevant facts. See, Redd, *supra* note 1 at 121.

**E. Duty to Take Control of Trust Property.**

The trustee must take reasonable steps to take control of and protect the trust property.<sup>18</sup>

**F. Duty to Segregate Trust Property.**

The trustee must not commingle personal funds or other non-trust assets with trust assets.<sup>19</sup> Although not usually a problem for corporate trustees, failure to segregate trust assets from their own funds has been a significant source of liability for individual trustees.<sup>20</sup>

**G. Duty of Impartiality.**

Unless otherwise specifically provided in the trust instrument, the trustee must show impartiality in balancing the interests of life beneficiaries and remaindermen and in balancing the interests of members of the same class.<sup>21</sup> The duty of impartiality must be kept in mind when making investment decisions and discretionary distribution decisions. Any action which could conceivably be construed as partial to one beneficiary over another must be carefully documented and, perhaps explained to all of the beneficiaries at the time the action is being taken.

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<sup>18</sup> UTC Sec 809

<sup>19</sup> See UTC Sec. 810(b) (providing that a trustee must keep property separate from the trustee's own property.

<sup>20</sup> See 2A Austin W. Scott & William F. Fletcher, SCOTT ON TRUSTS, Sec. 179.1 9 (4<sup>th</sup> ed. 1987).

<sup>21</sup> See Redd, *supra* note 1, at 124, for a discussion regarding modification of the duty of impartiality.

UTC Section 803 addresses the duty of impartiality. The comment to Sec. 803 provides that the “duty to act impartially does not mean that the trustee must treat the beneficiaries equally. Rather, the trustee must treat the beneficiaries equitable in light of the purposes and terms of the trust.” If a settlor wants the trustee to favor the interests of one beneficiary over those of others when making decisions, the settlor should provide appropriate guidance in the trust document. UTC, Comment to Sec. 803.

When the terms of the trust favor one beneficiary over another, the trustee’s alteration of the trust’s investment policy in favor of the favored beneficiaries does not violate his or her duty of impartiality.

#### **H. Duty of Confidentiality.**

The trustee should not disclose the terms of the trust, the identity of interests of the beneficiaries or the nature of the trust assets to anyone who is not a beneficiary of the trust or who does not need this information to assist in the administration of the trust. Furthermore, the trustee should keep confidential any personal information the trustee has learned about the beneficiaries through serving as trustee.

#### **I. Duty to Keep Records.**

The trustee has a duty to keep accounts showing in detail the assets, liabilities, receipts and disbursements of the trust.<sup>22</sup> If the trustee fails to keep proper accounts, the trustee is liable for any loss or expense resulting from the failure. The burden of proof is on the trustee to show that he, she, or it is entitled to the credits claimed, and the trustee’s failure to keep proper accounts and vouchers may result in the trustee’s failure to establish the credits claimed.<sup>23</sup>

When a trustee’s accounts are not clear and

<sup>22</sup> Restatement (Second) of Trusts Sec. 172 cmt. a. See also Sec. 810(a) (requiring that a trustee keep adequate records of the administration of the trust).

<sup>23</sup> Restatement (Second) of Trusts Sec. 172 cmt. b.

accurate, all presumptions are against the trustee and the obscurities and doubts are to be taken adversely against the trustee.<sup>24</sup>

The Comptroller’s Handbook: Personal Fiduciary Services<sup>25</sup> contains guidelines regarding record keeping and document security for bank trustees. A national bank must:

1. Adequately document the establishment and termination of each fiduciary account and maintain adequate records.
2. Retain fiduciary account records for a period of three years from the later of the termination of the account or the termination of litigation relating to the account; and
3. Ensure that fiduciary account records are separate and distinct from other records of the bank.

The fiduciary is expected to have sound controls over the governing instrument and other original documents. The controls should ensure that original documents that are filed with court authorities are properly authenticated and preserved for future accountings. Copies may be retained in account files, but original documentation should be maintained in centrally controlled location. Original board and committee minutes, with attachments noting approvals and actions taken, should receive the same level of safeguarding.

Documenting the process may prevent liability for a poor result and helps alleviate the problems of turnover of personnel and fading memories.

Examples:

**Investments:** The test is prudence and process, not performance. Does the file exhibit prudence? Why did the trustee ride that stock all the way down?

<sup>24</sup> See *In re Martin’s Trust Estate*, 39 Wis. 2d 437, 159 N.W. 2d 660 (1968)

<sup>25</sup> The Office of the Comptroller of the Currency (“OCC”), *Comptroller’s Handbook: Personal Fiduciary Services*, at 31-32 (August 2002).

Does the file show frequent reassessment.

**Distributions:** Depending on the distribution standard, does the file reflect adequate inquiry into

**J. The Duty to Disclose.**

The duty to disclose is closely related to the duty to keep records.

The duty to disclose may be modified by the terms of the trust with respect to “how frequently information must be disclosed, to which beneficiaries information must be disclosed and what information must be disclosed.”<sup>26</sup>

If requested, a fiduciary also is obliged to provide the beneficiary “complete and accurate information as to the nature and amounts of trust property, and permit him . . . to inspect the . . . “accounts and vouchers and other documents relating to the trust.”<sup>27</sup>

“Even if the trustee is not dealing with the beneficiary on the trustee’s own account, he is under a duty to communicate to the beneficiary material facts affecting the interest of the beneficiary which he knows the beneficiary does not know and which the beneficiary needs to know for his protection in dealing with a third person with respect to his interest.”<sup>28</sup>

Perhaps nowhere in the recent past has the duty to disclose received more attention than in the various class action lawsuits related to proprietary mutual funds. The stumbling block in many cases was not self-dealing in the form of corporate profits from mutual funds, but adequate disclosure.

Fraud.

The duty to disclose includes the duty not to commit fraud. Actual fraud is an intentional misrepresentation or intentional concealment by one party of a material fact which another party relies upon to his or her detriment. The inaccurate or

the beneficiaries’ financial conditions and other relevant factors?

concealed information must be such that if the party had been aware of it he or she would have acted differently. Whether a party has reasonably relied upon the information is a question for the trier of fact. Constructive fraud does not require actual dishonesty or an intent to deceive. In a fiduciary relationship, where there is a breach of a legal or equitable duty, a presumption of fraud arises.

Punitive damages are appropriate to punish and deter conduct where the defendant is guilty of fraud, or an intentional breach of fiduciary duty. Whether to award punitive damages is an issue for the sound discretion of the trial court, and its decision will not be set aside absent an abuse of that discretion.

**K. Duty to Account.**

1. Who is entitled to an accounting?
  - a. What does the trust instrument require?
  - b. What does the relevant statute require?
  - c. Can the instrument override the statute?
  - d. See also UTC Sec. 813c which provides that a trustee must send to the distributees or permissible distributees of trust income or principal, and to other qualified or non qualified beneficiaries who request it, at least annually and at the termination of the trust, a report of the trust property, liabilities, receipts, and disbursements, including the source and amount of the trustee’s compensation, a listing of the trust assets and, if feasible, their respective market values. See Texas Trust Code Sec. 113.152 for the required contents of the accounting under Texas law. Texas Trust Code Sec. 113.151 does not require accountings to be provided on any set periodic basis but requires that accountings be produced on demand of a beneficiary. The trustee is of course required to keep and maintain adequate records. Under Texas case law, a Grantor may not restrict the ability of a beneficiary to obtain an accounting. Hollenbeck v. Hanna, 802 S.W. 2d 412 (Tex. App–San Antonio 1991, no writ). The Settlor can not oust a court of its inherent equitable jurisdiction over the trust.

<sup>26</sup> Redd, supra., note 1, at 22.

<sup>27</sup> Restatement (Second) of Trusts Sec. 173 (1959)

<sup>28</sup> Restatement (Second) of Trusts Sec. 173 cmt. d (1959)

## 2. Statute of Limitations.

a. Statutes vary. For example, in Illinois, the statute of limitations is 3 years from the date the account is furnished; in Florida, the statute of limitations is 6 months from such date. 760 ILCS Sec. 5/11(a) and Fla. Stat. Sec. 737.307. There is no specific statute of limitation under the Texas Trust Code.

An action against a trustee must be brought within four years after the date the cause of action accrues. TEX .CIV. PRAC. & REM. CODE ANN. Sec. 16.051. (Vernon 1986). The statute may not be running until all of the facts are discovered.

## b. Accelerating and expanding on the statute:

(i) The trustee should consider providing each beneficiary with an annual form for the beneficiary to sign and return to the trustee which evidences the beneficiary's approval of the trustee's accountings and receipting for distributions made during the year. The annual form will give the beneficiaries the chance to inform the trustee of any concerns or objections they may have on a reasonably timely basis, instead of having to wait until a much later time, such as when the trustee ceases to serve or the trust terminates. Issues can thus be dealt with in a timely manner, to the benefit of both the beneficiaries and the trustee.<sup>29</sup> At the same time, the trustee may also want to get releases from the beneficiaries.

(ii). In appropriate circumstances and with the necessary consent, the trustee should consider providing accountings to non-beneficiaries (or those who are not technically required to receive accountings) who have or in the future may have some kind of interest in the assets currently held in the trust. For example, if the trust beneficiaries are an elderly couple with grown children who will eventually inherit their parents' wealth, the trustee should consider sending accountings to the children as well as to the couple. If the children receive the accountings while their parents are still alive, they

will then have a better understanding of the value of the assets remaining at the parents' deaths. Furthermore, the children will be better able to plan financially for their own futures because they will have some idea of the amount of property they will inherit from their parents.

## 3. Approval of Accounts is not a release:

a. While it is clear that once a representative of an estate is discharged all of the representative's actions are deemed approved and the representative is insulated from future lawsuits related to his or her conduct in administering the estate (subject to usual fraud and mistake exceptions), it is less clear how a trustee can be so "discharged." In an estate, the representative in a dependent administration receives an order of discharge not just an approval of accounts. Different rules of course apply in independent administrations where the executor must file an action in order to obtain a court approved discharge. Texas Probate Code Sec. 149E. In a trust accounting, the trustee may be entitled only to an approval of accounts that may or may not cover the trustee's other actions, such as the operation of a business owned by the trust. Thus, the receipts from the business as reflected in the account may be approved, but not the actions of the trustee in running the business that resulted in the number reflected on the accounts. One way to solve this difficulty is to state specifically in an account approval document approved by the beneficiaries that it covers "all actions by the trustee" during the accounting period and that, upon final account, the "trustee is discharged." When the trustee has brought an accounting action, the trustee should also seek a declaratory judgment "approving all actions of the trustee and discharging the trustee" for the relevant period (in the form of a counterclaim when responding to an accounting action).

b. Releases by beneficiaries: If a trustee demands a release by a beneficiary as a precondition to making a distribution to which the beneficiary is otherwise entitled, the release will not bar future claims by the beneficiary.

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<sup>29</sup> *Fellows Guide*, supra., note 16 at 323.

(i) If a beneficiary refuses to sign a release, the trustee may present its accounts for court approval, and the trustee may abstain from making a final trust distribution until the court approves its accounts. *First Midwest Bank v. Dempsey*, 157 Ill. App 3d. 307, 509 N.E. 2d 791 (3d Dist. 1987).

Under the Texas Trust Code the trustee has a reasonable time to wind up the affairs of the trust. This would include time to present its account and obtain a judicial discharge. See Texas Trust Code Section 112.052 and *Kimble v. Baker*, 285 S.W. 2d 425 (Tex. Civ. App.– Eastland, no writ).

(ii) Practice Pointer: By presenting its accounts for court approval prior to making the final trust distribution (as occurred in *Dempsey*), the trustee has the opportunity to charge its fees and costs directly to the trust rather than trying to seek reimbursement from a beneficiary after having already made the final distribution.

#### **L. Duty to Give Notices.**

1. The trustee must examine the trust provisions to determine when the trustee is required to give notice to the beneficiaries, co-trustees and successor trustees. For example, some trusts give beneficiaries rights of withdrawal, and the trustee must give notices to the beneficiaries of such rights. If the trust authorizes the trustee to appoint an investment advisor, there may be a requirement that the trustee give the beneficiaries written notice of the appointment.<sup>30</sup>

#### **M. Duty to Enforce and Defend Claims**

The trustee must take reasonable steps to enforce claims on behalf of the trust and to defend the trust against adverse claims.<sup>31</sup>

#### **N. Duty to Invest.**

<sup>30</sup> *Client Guide, supra.*, note 11.

<sup>31</sup> *Id.* at 6. See also UTC Sec. 811 (stating that a trustee shall take reasonable steps to enforce claims of the trust and to defend claims against the trust).

c. The recalcitrant beneficiary:

The trustee must invest trust assets in a manner that is appropriate for the trust. Unless the trust document provides otherwise, the trustee generally will have a duty to diversify investments and construct an appropriate asset allocation plan. The trustee should understand the investment directions provided in the trust instrument and also the investment requirements under applicable state law.<sup>32</sup>

### **IV. Handling Trust Investments.**

#### **A. State Law and Governing Instrument.**

1. State law provides the general framework within which trust assets must be invested. However, the trust instrument can expand or restrict state law investment provisions.

2. To minimize risks, the trustee must understand applicable state law and the terms of the trust.

3. Historically, state laws were very restrictive and created lists of legal investments for trustees.<sup>33</sup> Although the legal list approach may not have been particularly remunerative for the trust, for the trustee who followed the list, it provided a safe harbor from liability for handling trust investments.

<sup>32</sup> *Client Guide, supra.*, note 11.

<sup>33</sup> See Georgiana J. Slade, *Trustee Investing in the New Millennium— Issues with Alternative Investments and Strategies*, 1-2 (2002); Stephen M. Dickson, Note, *Trust Administration in Georgia and the Prudent Investor Rule: May Trustees Delegate Their Investment Powers?*, 14 GA. ST. U. L. REV. 633, 638-39 (1998); W. Brantley Phillips, Jr., Note, *Chasing Down the Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts*, 54 WASH. & LEE L. REV. 225, 341 (1997); C. Boone Schwartzel, *Drafting for the Twin UPIAs—A Practical Guide of New Acts and Regulations*, State Bar of Texas 2004 Advanced Drafting: Estate Planning and Probate Course.

4. The prudent person rule, which replaced legal list statutes in many states, provided that a fiduciary should invest assets in the manner that persons of prudence, discretion and intelligence use in managing their own affairs seeking “reasonable income and preservation of their capital.” Sec. 11-22 of the New York Estates, Powers and Trusts Law “EPTL” (1970). See also, Ill. Rev. Stat. 1988, ch 17, par. 1675. With this expanded investment authority came additional exposure for trustees.

a. For example, it was not clear whether this rule created an absolute duty to diversify in all circumstances. However, under a facts and circumstances test, the failure to diversify could constitute imprudence, and accordingly result in liability.

5. Two recent statutory developments have dramatically changed investment rules for trustees and have modified risk management issues for the fiduciary in handling trust investments. Those developments are:

a. The Prudent Investor Rule; and

b. Total return trust legislation, including the unitrust conversion approach and statutory powers to adjust between income and principal.

### **B. Investing Under the Prudent Investor Rule.**<sup>34</sup>

1. During the past two or three decades, it became evident that the old trust investment rules were not adequate to deal with changing financial markets, including a wide range of new investment products and opportunities. This resulted in adoption of Section 227 of the Restatement (Third) of Trust by the American Law Institute in 1990 and the enactment of the Uniform Prudent Investor Act in the District of Columbia and 42 states.<sup>35</sup>

<sup>34</sup> See, Slade, supra., note 37, for a more thorough discussion of this topic.

<sup>35</sup> See “State of the Law Appendix” for a listing of the states that have adopted the Uniform Prudent Investor Act. Also, Maryland has adopted a prudent investor rule which is

2. The Prudent Investor Rule retains the traditional prudent person standard for trust investments, but does it for the entire portfolio: a trustee must “exercise reasonable care, skill and caution to make and implement investment and management decisions as a prudent investor would for the entire portfolio.” See Texas Trust Code Chapter 117.

Rather than judging propriety on an investment by investment basis, the Rule requires a trustee to pursue an overall investment strategy which will enable the trustee to make appropriate present and future distributions to beneficiaries under the governing instrument and in accordance with risk and return objectives suited to the entire portfolio.

3. Under the Prudent Investor Rule, trustee liability should not be determined by hindsight (that is, by actual investment performance), but rather by the reasonableness of the processes and procedures which form the basis upon which the investment decision was made and the investment retained and the facts reasonably known about the investment to the trustee at that time. See Texas Trust Code Sec. 117.104.

4. The Prudent Investor Rule requires a trustee to diversify assets “unless the trustee reasonably determines that it is in the best interests of the beneficiaries not to diversify, taking into account the purposes and terms and provisions of the governing instrument.” Texas Trust Code Sec. 117.005.

5. The commentary in the Restatement (Third) of Trusts provides the following helpful guidance regarding the meaning of diversification:

There is no defined set of asset categories to be considered by fiduciary investors. Nor does a trustee’s general duty to diversify investments assume that all basic categories are to be represented in a trust’s portfolio. In fact, given the variety of defensible investment strategies and the wide variations in trust purposes, terms obligations, and

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substantially similar to the Uniform Prudent Investor Act.

other circumstances, diversification concerns do not necessarily preclude an asset allocation plan that emphasizes a single category of investments as long as the requirements of both caution and impartiality are accommodated in a manner suitable to the objectives of the particular trust.<sup>36</sup>

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<sup>36</sup> Restatement (Third) of Trusts Sec. 227 cmt. g. (1992)

6. Consistent with diversification, concentrations should be avoided.

a. If permitted by the trust instrument and desired by the beneficiaries, request indemnification and hold harmless agreements from the beneficiaries, and watch the investment carefully.

b. If required by the trust instrument, consider a suit for trust modification, or modification under a virtual representation statute, if applicable.<sup>37</sup>

c. Set rules for defining and dealing with a concentration. For example:

(i) If a stock exceeds 5% of the equity portfolio, watch it and consider trimming position.

(ii) If a position approaches 10% to 15%, absent a compelling reason to retain, start trimming the position.

(iii) If the position cannot be reduced immediately:

(1). Develop a sale and investment strategy;

(2). Utilize options based strategies, including covered calls or zero-premium collars, if appropriate; and

(3). Utilize exchange funds, if appropriate.

7. To minimize risk in handling investments under the Prudent Investor Rule, prepare a list of key factors to be used in formulating an investment program for the trust,<sup>38</sup> including:

a. The size and makeup of the portfolio;

b. The relative needs of the life beneficiaries and remaindermen, including the needs of the beneficiaries for present and future distributions;

c. Liquidity and distribution requirements;

d. The purposes and duration of the trust;

e. The outside assets of the beneficiaries, the beneficiaries' asset allocation plans and their respective risk tolerances;

f. General economic conditions and the possible effect of inflation and deflation on the trustee's asset allocation plan;

g. Anticipated total return of the trust portfolio;

h. Tax consequences of various investment and distribution decisions; and

i. Alternative investment strategies.

### **C. Delegation of Investment Functions.**

1. If the trustee is not a qualified investment advisor or an experienced and successful investor, the trustee should delegate investment functions to one or more qualified professionals pursuant to the mechanism provided in most prudent investor rule states.

2. If the trustee is a qualified investment advisor, but deems it prudent to allocate to an asset class which is outside of the trustee's investment expertise, the trustee should delegate investment functions to a specialized investment advisor.

3. Most prudent investor rules allow the trustee to delegate "investment functions" to a professional "investment agent" and, if the trustee complies with the rules of delegation set forth in the statute, the trustee can shift responsibility for the investment decisions or actions to the investment agent. See, Texas Trust Code, Sec. 117.011.

<sup>37</sup> See also Redd, *supra.*, note 1, at 116 for an explanation of a Virtual Representation statute. See also, Texas Trust Code Sec. 115.013 and Davenport, Erwin, *Drafting Pleadings and Judgments in Trust Termination Construction and Modifications Suits*, State Bar of Texas Advanced Drafting: Estate Planning and Probate Course (1999)

<sup>38</sup> See similar list at Texas Trust Code Sec. 117.004

4. To be relieved from liability for the performance of the investment agent, the trustee must carefully comply with all requirements of the applicable statute. Under the Texas Trust Code, the trustee must:

- a. Exercise reasonable care, skill and caution in selecting the agent and establishing the scope and specific terms of any delegation; and
- b. Use due diligence in periodically reviewing the agent's action in order to monitor the agent's performance and compliance with the terms of the delegation.

**D. Total Return Trusts (the Unitrust Conversion Approach).**

1. Total Return Trust Legislation permits trustees to take advantage of the new Prudent Investor Rule, which focuses on modern portfolio theory and total return concepts. By allowing an income beneficiary to receive an annual unitrust distribution, rather than a strict distribution of income (typically dividends and interest), the new law enables the trustee to invest prudently and impartially for a total return, rather than having to invest for income (to make income beneficiaries happy) or growth (to make remaindermen happy). This should minimize disputes which can arise when income beneficiaries or remaindermen challenge the trustee's investment strategy.

2. Total return statutes embodying the unitrust conversion approach have been enacted in approximately 17 states. Texas has not adopted such legislation.

3. Criterion for conversion. Not every trust qualifies for conversion. For example, most statutes set forth some version of the following criteria:

- a. The trust must describe the amount that may or must be distributed to a beneficiary by referring to the trust's income.
- b. The trustee (or the court) must determine that

conversion to a total return trust will enable the trustee to better carry out the purposes of the trust; and

- c. The conversion is in the best interest of the beneficiaries.

**E. Statutory Power to Adjust Between Income and Principal.**

1. As an alternative to total return legislation utilizing the unitrust conversion approach, approximately 35 states, including Texas, have enacted statutes based on Section 104 of the 1997 Uniform Principal and Income Act ("UPAIA"), which allows the trustee to reallocate receipts between income and principal.<sup>39</sup> The purpose of this legislation is to enable the trustee to meet the requirements of the Prudent Investor Rule, which requires the trustee to invest for total return and at the same time satisfy the needs of the income and remainder beneficiaries. Texas' version of the UPAIA is contained in Chapter 116 of the Texas Trust Code.

2. Under Section 116.005 of the Texas Trust Code, the trustee must consider the following factors (to the extent they are relevant) in deciding whether and to what extent to exercise the power to adjust:

- a. The nature, purpose, and expected duration of the trust;
- b. The intent of the settlor;
- c. The identity and circumstances of the beneficiaries;
- d. The needs for liquidity, regularity of income, and preservation and appreciation of capital;

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<sup>39</sup> See "State of the Law" Appendix for a complete listing of states which have adopted the Uniform Principal and Income Act, or some form of it.

e. The assets held in the trust, the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor;

f. The net amount allocated to income under the other sections of this chapter and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available;

g. Whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;

h. The actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and

i. The anticipated tax consequences of an adjustment.

3. Under the Trust Code there are three primary requirements which must be satisfied for a trustee to exercise the power to adjust (See Texas Trust Code Sec. 116.005(a))

a. The trustee must invest and manage the trust assets as a prudent investor;

b. The terms of the trust must describe the amount that may or shall be distributed to a beneficiary as referring to the trust income; and

c. The trustee determines that he, she or it is unable to impartially administer a trust for all beneficiaries without making an adjustment.

4. The applicable state statute authorizing the In a state which has total return trust legislation with protection of the trustee from liability for

trustee to adjust between principal and income must be carefully analyzed to determine the extent of the trustee's obligations and protection from liability.

a. Texas Trust Code provides trustee significant protection from liability:

(i) Section 116.004(b) states that “[a] determination in accordance with this chapter is presumed to be fair and reasonable to all of the beneficiaries.”

(ii) Section 116.006 provides that a court may not change a trustee's decision to exercise or not exercise a discretionary power unless the court finds that the trustee abused its discretion.

(iii) The primary remedy in the case of an abuse of discretion by the trustee is to restore the income and remainder beneficiaries to the positions they would have occupied if the trustee had not abused his, her, or its discretion by distributing an additional amount to the income beneficiary or withholding future distributions from the income beneficiary. The court may surcharge the trustee if restoring the income and remainder beneficiaries to their original positions is not possible. Texas Trust Code Sec. 116.006.

#### **F. States with Both Approaches.**

Twelve states have adopted both the unitrust conversion approach and the power to adjust approach.

#### **G. How Should the Trustee Deal with This Legislation.**

1. Review the applicable state statute to determine the degree of liability protection afforded to the trustee by the statute.

2. How proactive should a trustee be?

inaction, unless it is evident to a trustee that a particular trust is a candidate for a conversion, or a

beneficiary has requested conversion, the trustee should take no action. In a state without such protection, the trustee should begin a painstaking review of the trust portfolio to determine whether conversion is appropriate.

3. In keeping with the concept that trustees should adopt best practices, a trustee should consider converting (if the unitrust approach is the law) or making an equitable adjustment (if that law applies) in the following situations:

a. When the trust was established, common stocks were paying high enough dividends that a trustee could invest in a balanced portfolio of common stocks and fixed income investments and provide the income beneficiaries with a steady income stream. Due to reduced dividends on common stocks, the trustee might be forced to invest entirely in fixed income securities in order to meet the income beneficiaries' needs, which could be detrimental to the needs of the remaindermen. This is particularly problematic where the trustee does not have authority to distribute principal to the income beneficiaries.

b. Conversion or adjustment might be a means to avoiding litigation between the income beneficiaries and remaindermen over asset allocation issues.

c. Now that the IRS has finalized its regulations under Section 643(b) of the Code, conversion or adjustment might enable the trustee to achieve income tax savings by distributing capital gains to the income beneficiaries.

d. The unitrust approach or equitable adjustment approach may well make it easier for the beneficiary, such as a surviving spouse, to manage a budget where the distributions will be steady and predictable, rather than fluctuating every month with dividend and interest payments.

e. Effective for tax years ending on or after January 2, 2004, the final regulations under Section 643(b) eliminate the tax risks changing the definition of

trust income as long as "applicable state law" provides for "a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year." (Treas. Reg. Sec. 1.643(b)-1).

(i) "Applicable state law" means either a state statute or a decision by the highest court of a state announcing a general principle or rule of law that applies to all trusts administered under the laws of the state. The tax risks are not eliminated for a trustee that changes the definition of trust income pursuant to a court order applicable only to the trust before the court or a binding non-judicial judgment.

(ii) Treas. Reg. Section 1.643(b)-1 does not define what is a "reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for a year." However, an example of a unitrust percentage not less than three percent and not more than five percent was given.

f. Private Letter Ruling 2002231011 ("Cottage Savings" case) raised the specter that the IRS could rule that a conversion would result in a variety of adverse tax consequences. However, provided that a change in the definition of trust income is made pursuant to a method approved by "applicable state law," Treas. Reg. Section 1.643(b)-1 provides the following:

(i) The definition change will not be a gift from one class of beneficiaries to another.

(ii) The definition change will not be considered a sale or exchange for income tax purposes.

(iii) The tax-favored status of a variety of trusts (generation skipping, marital, and qualified domestic trusts) will not be affected by a change in the definition of trust income.

(iv) However, "income" cannot be defined as a unitrust amount for purposes of net income charitable remainder trusts.

4. Situations in which conversion or equitable adjustment is not warranted.

Where the trustee is able to invest in a manner consistent with the requirements of the Prudent Investor Rule and meet the needs of the beneficiaries without modification of the terms of the trust, neither conversion nor adjustment may be warranted.

#### **V. Delegation to Advisors (Other Than under the Prudent Investor Rule)**

##### **A. General Overview of Delegation Law.**

1. Historically, a trustee could not delegate the functions of trust administration without explicit authorization in the trust instrument, and such authorization was rarely given. Today, however, delegation law is very different and the modern trend is to give fiduciaries greater power to delegate. Many trust documents now include language empowering the trustee to delegate certain tasks. In addition, some states have enacted statutes authorizing such delegation.<sup>40</sup> See for example Texas Trust Code Sec. 113.018 which authorizes trustees to employ attorneys, accountants, agents, including investment agents, and brokers reasonably necessary in the administration of the trust estate.<sup>41</sup>

2. The Restatement (Third) of Trusts specifically authorizes delegation:

“Although the administration of a trust may not be delegated in full, a trustee may for many purposes delegate fiduciary authority to properly selected and supervised agents. Delegation is not limited to the performance of ministerial acts. In

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<sup>40</sup> Even if the Prudent Investor Rule is not in effect in a state, it may be possible for a trustee to delegate investment functions to an investment advisor, although the trustee would not have the protection from liability afforded by the Prudent Investor Rule.

<sup>41</sup> See also UTC Sec. 807, which states that a “trustee may delegate and powers that a prudent trustee of comparable skills could properly delegate under the circumstances.” According to the Comment to Sec. 807, this Section applies only to delegation to agents, not to delegation to co-trustees.

appropriate circumstances delegation may extend, for example, to discretionary acts, to the selection of trust investments or the management of specialized investment programs, and to other activities of administration involving significant judgment. There is no precise definition of acts that a trustee can properly delegate or 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>42</sup>

3. It is important for the trustee to review both the trust instrument and state law to determine whether the trustee has authority to delegate. If the trust document does not specifically authorize persons other than the trustee to act, the trustee may be able to delegate functions under a statutory provision. If the statutory provisions is subject to the express terms of the trust instrument and the instrument specifically prohibits delegation, then the trustee may not delegate even if the statute allows the trustee to do so.

##### **B. Elements to Consider in Every Delegation.**

1. Although delegation may be allowed under the trust instrument and/or state law, the trustee is ultimately responsible for the proper administration of the trust. Therefore, the delegation of functions to an advisor requires that the trustee make sure that the advisor is fully capable of performing the delegated functions and has sufficient information to do so on a continuing basis. The trustee must also take care to clearly define the terms and scope of the delegation. The following basic elements should be considered and established for every delegation.<sup>43</sup>

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<sup>42</sup> Restatement (Third) of Trusts Sec. 171 cmt. f (1992)

<sup>43</sup> See John P. Cole, Debra Smietanski & John A. Sanders, *Delegation by Fiduciaries*, presented to Florida Bankers Association— Trust Division (June 2000) [hereinafter *Delegation by Fiduciaries*], for an in-depth discussion of delegation of investment functions under the Florida Prudent Investor Rule and the Florida Power to Adjust Statute, and other delegation by fiduciaries.

- a. The basis for the trustee's determination of whether, when, how often and what functions to delegate, based upon the circumstances of the trust, the beneficiaries and the trustee's own abilities and limitations;
- b. The actual terms and scope of the agent's duties;
- c. The agent's compensation and any corresponding reduction in the trustee's compensation;
- d. The trustee's expectations for the agent's performance of the delegated functions, and the trustee's and agent's rights and responsibilities with respect to one another; and
- e. The agent's responsibility for timely reporting and/or accounting to the trustee for the agent's activities.

### **C. Instances in Which the Trustee Should Delegate.**

1. There is no set rule regarding what functions the trustee can and cannot delegate. The general rule, however, is that the trustee must not delegate acts that he can reasonably be required to personally perform.<sup>44</sup> The trustee should, and in some cases must, delegate functions in areas in which the trustee does not have expertise. This includes delegating responsibility for management of unique assets of the trust. Such assets may require special expertise so that the income potential and value of the assets are properly exploited. Examples of unique assets include:

- a. Real estate. This may include rental real estate, operating agricultural or timber interests, vacant land or other developed or under developed property. In managing such an asset, the trustee may need:
  - (i) Help with property management;

- (ii) Advice on whether to hold or dispose of the asset; and

- (iii) The help of a developer if the trustee decides to develop the property.

- b. Closely held business interests. If a closely held business is a substantial part of the trust, the trustee's duty to diversify may require a sale of the business. However, sale may not be necessary if the trust instrument authorizes retention of the interests. In managing closely held business interests, the trustee may need to help with:

- (i) Valuing the interests;

- (ii) Determining whether to keep or sell the business; and

- (iii) Selling the business or restructuring it to maximize its value to the trust and beneficiaries.

- c. Oil and gas interests and interests in other mineral properties. The management concerns present with real estate and closely held business interests are similar to those present with oil and gas interests.

- d. Collections of art work, antiques or other collectibles. The trustee may need qualified experts to help with:

- (i) Making an inventory of, valuing and safeguarding the collection;

- (ii) Creating and implementing a plan for the disposition of the collection; and

- (iii) Determining the extent of the legal rights in the items in the collection, including the right to make copies, the right to display or perform publicly, the right to distribute copies to the public and /or the right to make derivative works.

<sup>44</sup> 2A Austin W. Scott & William F. Fratcher, SCOTT ON TRUSTS Sec. 171.2 (4<sup>th</sup> ed. 1987).

c. Intellectual Property. Intellectual property (“IP”) includes copyrights, patents, rights or publicity, trademarks, and trade secrets. The complexity of these assets may require the trustee to delegate management of the assets to an agent with expertise in dealing with IP. These assets can be very valuable, and a trust holding IP may suffer substantial loss if the property is not properly administered. In managing IP held by the trust, the trustee may need special IP counsel or other experts to help with:

(i) Determining the nature and status of the IP in the trust (for example, a copyright is separate from the work itself and does not ordinarily pass with the work unless specifically stated in the transfer);

(ii) Valuing the IP, which involves analysis of anticipated future income streams derived from exploitation of the IP, generally through licensing its use and reproduction;

(iii) Cataloging the IP and establishing a tickler system for renewals, infringement audits and royalty accountings for authorized users;

(iv) Entering into contracts with publishers;

(v) Collecting royalties;

(vi) Maintaining the copyrights, patents or trademarks;

(vii) Enforcing and policing the IP rights to protect against infringement; and

(viii) Determining whether copyrights granted by the settlor during lifetime could be terminated by the trustee.

f. Trust Owned Life Insurance (TOLI) TOLI is central to many estate plans. It enables grantors to provide for survivors, cover estate tax liability, balance inheritances among heirs and meet charitable objectives. However, in many cases, trustees may not be managing the TOLI as actively

as they manage other assets. This lack of active management could be due to the view that TOLI is a long term trust asset whose true purpose will not be needed for decades. Alternatively, trustees may be intimidated by the complexity of life insurance policies or lulled into a false sense of security due to the risk-shifting nature of life insurance. A trustee may need an insurance agent to assist with:

(i) Underperforming policies;

(ii) Policies that are insufficient for current client needs— a different amount of death benefit may be needed due to changed circumstances;

(iii) Newer policies that are more cost efficient;

(iv) New products and riders that may offer better options; and

(v) Policies scheduled for an increase in premium.<sup>45</sup>

#### **D. Liability of Trustee for Advisor’s Acts.**

1. The trustee may not be liable for actions taken pursuant to the advice of the agent or for acts of the agent if certain requirements are met. In states which allow delegation, and where the trust instrument allows delegation, the trustee should carefully examine applicable state law and the trust instrument to determine whether the trustee is protected from liability for acts or omissions of an agent, and, if so, the scope of that protection.

2. Regardless of whether there is statutory protection for the trustee from liability for acts based on an agent’s advice or for the acts of the agent, there are some steps that the trustee should take to protect himself, herself or itself<sup>46</sup> including:

<sup>45</sup> Mark A. Tietelbaum, *Trust Owned Life Insurance: Is It An Accident Waiting to Happen*, NATIONAL UNDERWRITER, May 17, 2004, at 38.

<sup>46</sup> See *Delegation by Fiduciaries*, supra., note 51, at 4.

- a. Do not act blindly on the agent's advice;
- b. Exercise good faith and reasonable care in selecting an appropriate agent and in establishing the scope of the agent's authority;
- c. Supervise and monitor the agent;
- d. Act promptly upon discovery of any wrongdoing on the part of the agent; and
- e. Require periodic accounting or reports from the agent on the agent's conduct and performance.

### **E. Compensation of Advisors.**

Generally, the trustee will use trust funds to compensate advisors for the services they perform for the trust. The trustee should review the costs of administering the trust, including the trustee's own compensation, to assure that the total cost is reasonable and not in excess of the amount allowable under the trust document or state law.

### **F. Delegation to Co-trustee.**

1. When co-trustees are serving, each may have his, her or its own talents and areas of expertise. If one trustee has expertise in a certain area, the non-expert trustee should delegate powers related to that area to the expert co-trustee, if delegation is permitted by the trust instrument or applicable state law.<sup>47</sup>

2. Liability of trustee for delegated acts of co-trustee:

a. Restatement (Second) of Trusts Sec. 224, dealing with liability for breach of trust by a co-trustee provides that:

1. Except as stated in Subsection (2), a trustee is not liable to the beneficiary for a breach of trust committed by a co-trustee.

2. A trustee is liable to the beneficiary if he

a. participates in a breach of trust committed by his co-trustee; or

b. improperly delegates the administration of the trust to his co-trustee; or

c. approves or acquiesces in or conceals a breach of trust committed by his co-trustee; or

d. by his failure to exercise reasonable care in the administration of the trust has enabled his co-trustee to commit a breach of trust; or

e. neglects to take proper steps to compel his co-trustee to redress a breach of trust.

b. Section 224 implies that as long as the delegation is proper (and the delegating trustee does not in some other way breach a duty) the delegating trustee will not be liable for the wrongful acts of the co-trustee.

c. "Even if one trustee does not affirmatively delegate the administration of the trust to his co-trustee, he is liable if by his failure to exercise reasonable care in supervising the conduct of his co-trustee he allows him to commit a breach of trust."<sup>48</sup>

This implies that if the trustee does affirmatively delegate to a co-trustee, the delegating trustee will also be liable if he, she or it fails to exercise reasonable care in supervising the conduct of the co-trustee.

## **VI. Discretionary Distributions**

### **A. Trust Provisions.**

1. Review with the beneficiaries the scope of the trustee's discretion to make distributions under the trust instrument.

2. Explain the scope of a restrictive standard, such as "health, education, support and maintenance."

<sup>47</sup> *Client Guide*, *supra.*, note 11.

<sup>48</sup> Austin W. Scott & William F. Fratcher, *SCOTT ON TRUSTS*, Sec. 224.3 (4<sup>th</sup> ed. 1987).

3. Explain the scope of a broader standard such as “general welfare and best interests” and attempt to bring the beneficiaries expectations down to a manageable level.

4. Determine whether the trust language required the trustee to consider the beneficiaries’ other resources before making discretionary distributions. If so, obtain the necessary financial information from all beneficiaries.

### **B. Procedure.**

1. Establish a set format for gathering financial and family data from the beneficiaries, which will be used to evaluate a request for a discretionary distribution, and give the beneficiaries advance warning that this data will be required before the trustee can exercise discretion. Also, ask the beneficiaries to update this information on a periodic basis.

2. If the trustee requires review by a discretionary distribution committee, forewarn the beneficiaries and explain the rules of engagement.

3. Consider making distributions on a monthly or other periodic basis in accordance with the beneficiary’s needs.

4. Communication is critical in this aspect of trust administration.

5. To the extent possible, involve the beneficiaries in the process.

6. Be responsive to requests for extraordinary or special distributions.

7. Always be aware of the tax aspects of distributions.

## **VII. Attorney Serving As Trustee<sup>49</sup>**

### **A. Ethical Considerations.**

1. Overall issue to consider: Under the circumstances, is the attorney the best person to act as trustee?

2. ABA Formal Opinion 02-426: “Lawyer Serving as Fiduciary for an Estate or Trust.” The ABA Standing Committee on Ethics and Professional Responsibility has issued Formal Opinion 02-426 (“Opinion”), dealing with the subject of lawyers serving as a fiduciary for an estate or trust. The opinion provides the following guidance:

a. A lawyer representing a client in estate planning matters should discuss with the client the selection of a fiduciary and should point out the various options available to the client. In doing so the lawyer may “disclose his own availability to serve as a fiduciary.”

b. The lawyer must not, however, “allow his potential self-interest to interfere with his exercise of independent professional judgment in recommending to the client the best choices for fiduciaries.”

c. If circumstances are such that there is a “significant risk” that the lawyer’s advice will be “materially limited”, e.g., by the economic benefits of serving as a fiduciary, then the lawyer must obtain the client’s informed consent and confirm that consent in writing.

3. Selection of counsel. A lawyer acting as a fiduciary may normally appoint himself or herself or his or her law firm as counsel to the fiduciary to perform legal work that arises in administering the trust, assuming that the lawyer chosen to do the work is competent to do so.

a. Case law may prohibit this as self-dealing unless the trust instrument authorizes it.

<sup>49</sup> See *Fellows Guide*, *supra*, note 15.

b. The ACTEC Commentaries on the Model Rules of Professional Conduct<sup>50</sup> makes the following statement of this issue:

*Lawyer Serving as Fiduciary and Counsel to Fiduciary.* Some states permit a lawyer who serves as a fiduciary to serve also as lawyer for the fiduciary. Such dual service may be appropriate where the lawyer previously represented the decedent or is a primary beneficiary of the fiduciary estate. It may also be appropriate where there has been a long standing relationship between the lawyer and the client. Generally, a lawyer should serve in both capacities only if the client insists and is aware of the alternatives, and the lawyer is competent to do so. A lawyer who is asked to serve in both capacities should inform the client regarding the costs of such dual service and the alternatives to it. A lawyer undertaking to serve in both capacities should attempt to ameliorate any disadvantages that may come from dual service, including the potential loss of the benefits that are obtained by having a separate fiduciary and lawyer, such as the checks and balances that a separate fiduciary might provide upon the amount of fees sought by the lawyer and vice versa.

4. Compensation Issues. Model Rules of Professional Conduct (“Model Rules”), Rule 1.5(a), which governs lawyer compensation, does not control trustee compensation. However, the amount of trustee compensation must be taken into account in determining what amount of legal fees is reasonable under Rule 1.5(a). The ABA Opinion notes (at page 7) that there are decisions that require reduction of legal fees as a result of the amount of fiduciary fees received in a matter.<sup>51</sup>

a. Some states have always permitted fiduciaries to

<sup>50</sup> ACTEC Commentaries on the Model Rules of Professional Conduct, at 59 (3d ed. 1999) [hereinafter *ACTEC Commentaries*]

<sup>51</sup> See *Fellows Guide, supra.*, at 324, for a discussion entitled, “Compensating the Trustee.”

receive extra compensation for performing other services for a trust, particularly legal services. See *Lembo v. Casaly*, 5 Mass App. Ct. 240 (1977). Other states have statutory provisions allowing such compensation. See Cal. Prob. Code Sec. 1080 (b).<sup>52</sup>

b. If an attorney is seeking compensation for serving in more than one role, it may be necessary to consider the time spent in each role and the results obtained.<sup>53</sup> The attorney /trustee should keep detailed records of the time spent and tasks performed in each role.

c. The Comment to UTC Sec. 708, which addresses compensation of the trustee, states that the UTC “does not take a specific position on whether dual fees may be charged when a trustee hires its own law firm to represent the trust. The trend is to authorize dual compensation as long as the overall fees are reasonable.

5. Conflicts where lawyer acts as fiduciary and also represents one or more of the beneficiaries. Rule 1.7(a) of the Model Rules would normally prevent a lawyer from representing a beneficiary on matters relating to the trust (the ABA Opinion suggests that conflict would normally be non contestable). Where the representation of the beneficiary involves matters unrelated to the trust, the representation would be permissible, with the client’s informed consent, if the lawyer reasonably believes the representation would not be adversely affected. The Opinion notes that even if the conflict arising out of representation of the beneficiaries is permissible under Rule 1.7, there may be situations where the lawyer should forego the representation.

<sup>52</sup> Stephen Ziobrowski, *Fighting Over Fees: Attacking, Defending, and Resolving*, ALI-ABA Course of Study: Representing Estate and Trust Beneficiaries and Fiduciaries, July 17-18, 2003 at 101.

<sup>53</sup> *Id.*

a. For example, a sole trustee having discretionary power to distribute income or principal in unequal amounts to the beneficiaries.

### **B. Actions to Reduce Risk**

1. Require approval of a firm committee (such as the management committee or ethics committee) before a lawyer is permitted to serve as a fiduciary.

2. Employ a screening process, such as that described above (see Section II of this Outline), so that no such position is accepted without first carefully evaluating the appointment.

3. Make sure that the lawyer has the skill set needed to act as a trustee. This requires that he or she not only have the technical competence to act as a trustee (or be willing to seek expert advice from his or her colleagues to the extent that the lawyer is not an expert in trust law), but also the temperament to deal with beneficiaries.

4. The lawyer and his or her firm need a business plan to provide (internally or through out-sourcing) the following fiduciary services<sup>54</sup> :

a. Arrangement for custody and safekeeping trust assets;

b. Trust accounting system, including a system for report to the beneficiaries;

c. Competent trust counsel who can advise regarding obligations to the courts having jurisdiction over the trust and other trust law issues;

d. Tax return preparation and competent tax counsel;

e. Competent counsel on securities laws and all other applicable compliance issues;

f. Competent investment advice, including advice

regarding asset allocation issues;

g. Appropriate professional liability insurance and bonding; and

h. Experienced paralegals/staff to administer the trust and monitor compliance with tax and other applicable laws.

5. Make sure the lawyer has the time to act as trustee. This requires that the lawyer have the time to fulfill his or her duties as trustee without interfering with the provision of legal services to his or her other clients.

6. Use an engagement letter which outlines the client's options regarding appointment of fiduciaries and gives the client alternatives to naming the lawyer as trustee, such as a family member or friend of the client or the client's accountant or other trusted advisor. The engagement letter should also explain that if appointed as trustee, the attorney and his or her firm may be entitled to both trustee fees and legal fees authorized by statute and/or the trust instrument.<sup>55</sup>

### **VIII. Trustee's Operating Manuals and Policy Statements.**

Professional fiduciaries with operating manuals, written policy statements or other guidelines are well advised to review all such materials on a regular, periodic basis to ensure compliance and update such materials as necessary to reflect changed practices.

#### **A. Likely Subject of Production.**

Copies of such materials are often at the top of the plaintiff's request for production of documents during the discovery phase of any fiduciary duty

<sup>54</sup> See, *Fellows Guide*, *supra*.

<sup>55</sup> See ACTEC, *Engagement Letters: A Guide for Practitioners* (June 1999), for suggested engagement letters, including a sample letter accepting nomination for a lawyer as trustee, which lists the responsibilities of a trustee, suggests alternatives to naming the lawyer as trustee, discusses potential conflicts of interest and compensation issues, and suggests that the client consult independent counsel.

case.

**B. Importance of Compliance.**

Noncompliance with written policies, even if not material to the main allegations of the particular case, can result in the fiduciary having to adopt a more defensive posture and can cause the trier of fact to view the fiduciary with heightened scrutiny because of its failure to follow its own policies.

**IX. Maintaining Good Beneficiary Relations<sup>56</sup>**

The fiduciary should strive to maintain excellent personal relationships with the beneficiaries of the trust. While not a substitute for technical compliance and competent trust administration, being on friendly terms with beneficiaries, to the extent possible, is a major factor in avoiding fiduciary litigation. The following are some personal observations on maintaining the human side of the fiduciary relationship.

- A. Be available.
- B. Be Responsive
- C. Listen
- D. Educate
- E. Explain
- F. Know the Beneficiary
- G. Make Accountings Understandable.

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<sup>56</sup> For helpful guidance on issues involving trust administration see, H. Kate Hopkins, *Trust Administration: A Handbook for the Trustee*, Fourth Annual Building Blocks of Wills, Estates and Probate Course, State Bar of Texas, January 2003.

## APPENDIX A - STATE OF THE LAW

State	Power to Adjust	Unitrust	Neither Power to Adjust or Unitrust	Uniform Trust Code	Prudent Investor Act
Alabama	.				
Alaska	.	.			.
Arizona	.				.
Arkansas	.				.
California	.				.
Colorado	.	.			.
Delaware		.			
Dist. of Columbia	.			.	.
Florida	.	.			.
Georgia			.		
Hawaii	.				.
Idaho	.				.
Illinois		.			.
Indiana	.	.			.
Iowa		.			.
Kansas	.			.	.
Kentucky			.		
Louisiana	.				
Maine	.	.		.	.
Maryland	.	.			.(**)
Massachusetts			.		.
Michigan			.		.
Minnesota	.				.
Mississippi			.		
Missouri	.	.		.	.
Montana	.				.
Nebraska	.			.	.
Nevada	.				.
New Hampshire		.		.	.
New Jersey	.				.
New Mexico	.			.	.
New York	.	.			.
North Carolina	.	.			.
North Dakota			.		.
Ohio	.				.
Oklahoma	.				.
Oregon	.	.			.
Pennsylvania	.	.			.
Rhode Island			.		.
South Carolina	.				.
South Dakota		.			
Tennessee	.			.	.
Texas	.				.
Utah			.	.	.
Vermont			.		.
Virginia	.				.
Washington	.	.			.
West Virginia	.				.
Wisconsin			.		.
Wyoming	.			.	.

\*\* Maryland's Prudent Investor Rule is substantially similar to the Uniform Prudent Investor Act.