FEATURE:
FIDUCIARY PROFESSIONS

By Susan R. Schoenfeld

Should You Be Trusted?

What to consider before taking on the trustee role

There's much advice available to prospective grantors and their counsel on selecting an appropriate trustee, but guidance is scarce for would-be trustees on whether to accept an appointment and what to look out for if they do. If a client asks you to be a trustee, here are 10 tips to consider before you take on the trustee role and to help you once you do.

Keep in mind that the most effective techniques to manage fiduciary liability are for the trustee to: (1) establish a disciplined process for investments and all other exercises of its discretion; (2) document its decision making; and (3) communicate, communicate, communicate, as early and often as possible.

1. Understand Control Issues

Many families establish trusts to control the behavior of their descendants, the proverbial "dead hand from the grave." Before you take on the role of trustee, you should understand the underlying control issues in that particular family, as it will impact on your continuing relationship with the grantor and future generations of beneficiaries. (For more information about dead hand trusts, see "The Ultimate in Dead Hand Control—Incentive Trusts: Part I," by Charles A. Redd, p. 12, in our May 2015 issue.)

The control issues can cut both ways. On one hand, there's the classic scenario in which the amount of control that's imposed by a trust is overkill for a particular beneficiary, perhaps someone who's successful in her own right, fiscally responsible, yet must deal with the onerous restrictions of a trust that might not even allow for any distributions to her own children. Beneficiaries often resent that restrictions in the trust instrument may limit their access to funds and frequently blame the trustee for making unpopular and/or unwise distribution decisions.

At the other end of the spectrum, most attorneys have seen situations in which beneficiaries could have used a bit more control and would have benefitted from a more limited stream of income or limits in the types of investments that can be requested of the trustee. One of the difficulties with trusts is that you have to plan far into the future, and you don't know exactly what the family's needs will be 25, 50 or even 75 years from now.

If possible, get the family involved at the outset. When dealing with these major control issues, it's the responsibility of the professionals to counsel the grantor about the potential repercussions of his desire to control his heirs and advise the beneficiaries up front about any inherent limitations imposed on the trustee by the governing instrument itself.

2. Understand Trust Terms

Review the governing instrument and understand all your obligations, paying special attention to particular trust provisions that might cause problems down the road.

Trustees of special needs trusts must be careful to not only scrupulously follow the terms of the instrument, but also to not inadvertently endanger the beneficiary's right to receive continuing government entitlements.

An increasingly common provision is language allowing (or even requiring) a trustee to withhold distributions if a beneficiary has substance abuse issues. Before you accept a trustee appointment over such a trust, consider: (1) your comfort with imposing drug testing, and (2) the governing jurisdiction's laws on the subject. As the professional trustee, you might suggest that the grantor name a family member or friend as your

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co-trustee, and that individual will have the responsibility to determine whether the beneficiary is suffering from substance abuse.

Trust instruments occasionally have special investment clauses requiring the trustee to retain certain assets or requiring (or prohibiting) certain asset classes. Decide whether you can live with such a provision—is it unreasonable or unfeasible due to state law, prevailing investment management wisdom and your own expertise? Give careful consideration to, and be mindful of, the rules in your particular state.

Make sure you also understand any special beneficiary circumstances. If the family has a history of litigation, or if a particular beneficiary has a circumstance that will require you as trustee to behave differently from your customary approach, think about whether the situation will be more trouble to you than it's worth.

3. Analyze Investment Portfolio

The Uniform Prudent Investor Act has been adopted with some modifications in almost all states (the others have modified or stand-alone versions) and has as one of its fundamental principles that diversification is required for prudent fiduciary investing. In many states, a trustee can be held liable for failure to diversify. What's the trustee to do when the grantor created a trust and funded it with a concentrated position? This scenario might include the family-owned company or a publicly traded company where the parents worked their whole lives and accumulated significant stock.

Even if the trust instrument authorizes or directs the trustee to hold an investment forever, asset retention clauses don't always provide the protection to the fiduciary that was intended by the grantor or the drafting attorney. If the beneficiary requests (or insists) that the trustee retain a concentrated position for sentimental or other reasons, the trustee might consider requesting written approval and a release from the beneficiary. All decisions not to diversify a concentrated position should be reviewed periodically. The pattern of communication with beneficiaries to manage their expectations protects trustees from liability in many cases.

Even an exculpatory clause or indemnification clause in the governing instrument may not be enough to help a trustee who fails to diversify, regardless of the grantor's intent, depending on the facts and circumstances.

Another approach is to designate a third party to direct the trustee regarding investments, including the retention or sale of a concentrated position in a particular asset, in a state that allows the trustee to rely on such direction.

A disciplined process around documenting your exercises of discretion, as well as clear communication with the beneficiaries, are the keys to avoiding liability.

4. Document Distributions

One of the principal non-delegable duties of a trustee is the exercise of discretion with respect to distributions to beneficiaries.

Depending on the governing law of the trust, the trustee may choose to adopt a power to adjust or unitrust approach to distributions, which would more practicably allow the trustee to invest the trust assets for total return. In exercising its discretion to make distributions, a trustee must balance the current income beneficiary's need for cash flow with the remainder beneficiaries' right to receive the balance of the trust principal.

The trustee must also balance the discretionary distribution requests of multiple current beneficiaries. This responsibility applies to so-called "pot trusts"—one big trust created for many family members. There may reach a point when the trustee is asked to make larger distributions to one beneficiary over the other, for example, if the beneficiaries have drastically different financial circumstances and needs. Some trustees are loath to do this, because they're worried that the other beneficiaries will claim improper favoritism. A

disciplined process around documenting your exercises of discretion, as well as clear communication with the beneficiaries, are the keys to avoiding liability.

The trustee's discretion is either limited in the document by an ascertainable standard (the HEMS standard of health, education, maintenance and support or broad and unlimited (for example, comfort, happiness and best interests)). The trustee should also be mindful of any guidance from the grantor, whether a binding direction to consider a beneficiary's other resources or maintain his standard of living or a precatory letter of wishes.

5. Use a Team Approach

Clients appreciate when their advisory team members collaborate with each other. The client hires a lawyer, tax advisor, insurance professional, wealth management investment advisor, family stewardship consultant and trustee to best serve his family; however, these team members don't coordinate and collaborate with each other as often as the client would like or expect.

> The penalties for failing to provide the required materials can be substantial, so it's critical to understand your obligations and establish appropriate procedures to comply.

We all want to be the client's main trusted advisor, but no one person can know everything, and it's important to reach out to other professionals for specialized knowledge. Trustees should call regular team meetings and think about the client family holistically.

6. Send Required Notices

For trusts governed by the law of a state that's adopted the Uniform Trust Code (UTC), trustees have duties to inform and report to the trust beneficiaries. UTC Section 813(a) requires the trustee to "keep the qualified beneficiaries . . . reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests." This duty includes the requirements to: (1) furnish a copy of the trust instrument, (2) notify qualified beneficiaries of the trustee's acceptance, contact information and any change in compensation, and (3) provide periodic reports. The grantor or beneficiary of the trust may waive some of these duties. Others are mandatory.

Many of the states that have adopted the UTC have modified its information and reporting provisions. In addition to determining whether the governing state has adopted the UTC at all, carefully review your state's enacted modifications, paying attention to which beneficiaries must be provided with trustee's reports, what information the trustee's reports must contain and which reports are mandatory and nonwaivable.

Some non-UTC states go beyond the UTC rules and impose even stricter requirements on the trustee to provide information and reports to the beneficiaries. The penalties for failing to provide the requisite materials can be substantial, so it's critical to understand your obligations and establish appropriate procedures to comply.

7. Consider Fiduciary Income Tax

Some states tax trusts based on the residence of the trustees. If you live in such a state (for example, California), the trust may have to pay state fiduciary income tax that it might not otherwise have to pay. In that case, you might consider declining the appointment or resigning if you're already serving and there's a named successor residing in a different state.

8. Include Certain Provisions

Trustees generally accept their appointment with the intent to serve throughout the duration of the trust term, but occasionally, circumstances arise in the trustee-beneficiary relationship that cause the beneficiaries to wish to remove the trustee or the trustee to want to resign.

If you're drafting (or are being asked to serve as trustee under) a new trust instrument, consider whether to insist on a provision allowing you to resign without court intervention. Without such a provision, and depending on whether your state law authorizes it, including whether your state has adopted the UTC, you may have to go to court to be permitted to resign.

Conversely, consider adding a provision allowing the

beneficiaries to remove you as trustee. Some attorneys prefer not to include such a clause, asserting that trustees shouldn't be fired for making unpopular decisions, but the ability to terminate an unhappy relationship should be bilateral. Sometimes, the trustee can be unreasonably restrictive in investment selection or distribution decisions, or perhaps, the family and trustee simply don't get along.

Either way, it's important to add a mechanism to name a successor trustee to serve in the event of the resignation or removal of the trustee if there's a vacancy in the successors designated in the trust instrument. Common examples are authorizing the current income beneficiary to name the successor trustee, or the resigning trustee itself may name its own successor. Some boilerplate clauses even authorize the drafting law firm to name the successor trustee, but many clients object to this language as overreaching, unless there's a special client relationship.

9. Communicate With Beneficiaries

The grantor may have been your longstanding client, but as a trustee, it's incumbent on you to communicate regularly with the beneficiaries. Don't think that your monthly statements are all the contact that's needed. You should establish a pattern of regular communication, including meetings, if appropriate, with the current beneficiaries to discuss administration of the trust and to create a relationship with the entire family.

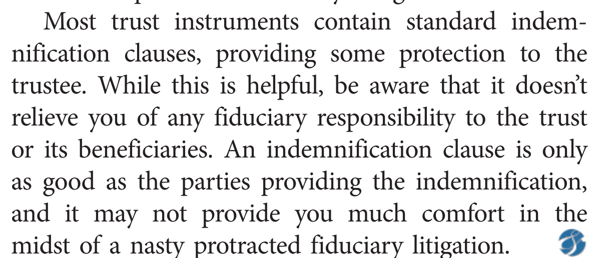
These interactions may prevent many of the pitfalls discussed in this article, avoid litigation and create bonds with the younger generations so that when the grantor dies, family members still feel that you're their trusted advisor. Don't forget what George Bernard Shaw wisely said: "The single biggest problem in communication is the illusion that it has taken place."[1]

10. Remain Mindful of Your Liability

Calendar all of your responsibilities under the trust, including distribution dates, *Crummey* notices and other events. File the trust's fiduciary income tax returns on a timely basis, including providing K-1s to the income beneficiaries. Comply with any necessary gift, estate and generation-skipping transfer tax filing responsibilities. Understand your obligations under the securities laws, including those under the Investment Advisers Act of 1940.

Avoid conflicts of interest, real or perceived. Apply your firm's conflict checking procedures to your trustee appointments, as well as other engagements, and if your firm will also be providing legal services to the trust, keep the lawyer-client relationship at arm's length and have a firm partner other than you sign off on all work.

Most trust instruments contain standard indemnification clauses, providing some protection to the trustee. While this is helpful, be aware that it doesn't relieve you of any fiduciary responsibility to the trust or its beneficiaries. An indemnification clause is only as good as the parties providing the indemnification, and it may not provide you much comfort in the midst of a nasty protracted fiduciary litigation.



Endnote

1. *http://thinkexist.com/quotation/the_single_biggest_problem_in_communication_is/155222.html.*

SPOT LIGHT

Goat Plate!

"Goat's Head in Profile" (16 1/8 in. by 15 7/8 in.) by Pablo Picasso, sold for $18,750 at Doyle's recent Prints and Multiples Sale in New York on April 28, 2015. Picasso started working with ceramics late in his life after being inspired by the works on display at the annual pottery exhibition