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Fiduciary Law Alert

An End-of-Year Refresher on Trustee Duties and Responsibilities

BY NATHAN R. OLANSEN

If you perform services for clients as a trustee, it is wise practice to periodically review the duties and responsibilities that apply to your conduct. In a society where the end often justifies the means, it is important to remember that when serving as a trustee, the opposite is generally true. The process by which you obtain a product or formulate a conclusion is often more important than the conclusion itself. Mistakes happen; judges and juries understand this, and mistakes are even excusable if the trustee engaged in some type of meaningful analysis and exercised sound judgment in making the decision that ultimately turned out poor. With this in mind, a brief discussion of the duties and responsibilities of trustees follows, including a general overview of the information that should be considered and the process that should be engaged when acting and making decisions as a fiduciary.

Understand the Trust Document

To be able to make proper, sound fiduciary decisions, the trustee must start by reading and understanding the governing trust document. An assumption can never be made about the terms or purpose of a trust, or the manner in which that purpose is to be carried out. Absent a purpose that is illegal or contrary to public policy, the trust document controls the parameters of operating the trust as well as the trustee's powers, duties and obligations. If the trust document is silent on a particular issue, the trustee should look to statutory and common law guidance to help shape the understanding of the trust.

At the most basic level, understanding the trust requires the trustee to understand the distribution provisions of the trust. Know whether the trust requires the payment of all income to the beneficiaries (i.e., a simple trust), or whether it allows for, or requires, the accumulation of income or the distribution of principal (i.e., a complex trust). The trustee should ascertain the number of beneficiaries, and whether all the beneficiaries are to be treated in the same manner. Perhaps charitable distributions are authorized or mandated, or maybe the trustee is supposed to encourage some type of behavior by making distributions only in specific circumstances. Some of the more common distribution problems encountered include: over or under distributing income; making distributions to unauthorized beneficiaries (such as charities); and making late distributions.

Trusts often contain very advanced provisions as well. Common examples are decanting provisions, the ability to merge or sever the trust, tax elections, income and principal allocation provisions, and beneficiary powers of appointment. Provisions such as these generally carry a meaning and impact that go well beyond the understanding of many trustees. Proper interpretation and application often requires an in-depth knowledge of statutory and common law, income and estate tax law, the laws of other states and sometimes foreign countries. Special care and caution must be taken when considering the application of any of these advanced provisions. The trustee should document his or her understanding of the trust with a written summary. Not only will it serve as a reference source for future questions, it may also serve as future evidence that the trustee was diligent in ascertaining the terms and obligations of the particular trust.

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Create a Process

Once the trustee has determined what the trust document requires them to do, the trustee must formulate a plan for investing and managing the trust assets. What works for one trust does not necessarily work for another; there is no one-size-fits-all formula. Too often trustees use the same or similar investment models for multiple trusts, because it is the investment model that the financial advisor normally uses and is most comfortable with. It may not necessarily be, however, a model that is tailored to the unique circumstances of a particular trust and its beneficiaries. Absent contrary provisions in the trust, trustees must invest and manage trust assets as a prudent investor would, by considering the purpose, terms, distribution requirements, and other unique circumstances of the trust. In satisfying this standard, the trustee must exercise reasonable care, skill, and caution. If the trustee holds himself out to be someone who possesses a greater level of skill than the average person, the trustee will be held to a higher level of care.

A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy, having risk and return objectives reasonably suited to the trust. It is incumbent upon the trustee to document and support investment decisions in writing. Ideally this will include an analysis of why the decision was made and what other options were available. The stronger the process for making a decision, the stronger the end result will be, and the less likely it is that the decision will be subject to attack in the event assets lose value. To highlight the importance of adhering to a process when formulating investment decisions, consider the following examples.

> **Example 1:** Warren is the trustee of the BMG Spendthrift Trust which was established on January 1, 2005 with a cash gift of $10M. Warren has been in the trustee and investment business for some time, and holds himself out as a professional trustee and investor. The beneficiary of the Trust is 15 years old when the trust is established, and is not to begin receiving distributions for another 15 years. Warren decides that a long-term investment model and asset allocation is most appropriate. He invests 70% of the Trust assets in the Vanguard Total Stock Market Index Fund and 30% of the Trust assets in the Vanguard Total Bond Market Index Fund. Warren's investment model is based on nothing more than prior personal experience, and once established, Warren undertakes no further review nor does he make any changes to the investment model or asset allocation over the next four years. By November of 2008 the value of the Trust is $5M. The now 19-year-old beneficiary brings suit against Warren for breach of fiduciary duty, asserting that Warren failed to invest the assets of the Trust prudently. The suit demands that Warren be held personally liable, and reimburse the Trust for the $5M decrease, plus interest from January 1, 2005.

> **Example 2**: The same facts as example 1 apply, except in deciding to invest the assets of the Trust in the 70/30 Vanguard portfolio, Warren creates a five-page investment report considering the following factors and how they impact the decision to invest the Trust assets: the general economic conditions; possible effects of inflation or deflation; expected tax consequences of investment decisions and strategies; the role that each investment or course of action plays within the overall trust portfolio; the expected total return from income and the appreciation of capital; the need for liquidity, regularity of income, and preservation or appreciation of capital; and the any special relationship or special value that a particular asset may have to the purpose of the trust or to one or more of the beneficiaries. Warren reviews the Trust portfolio and revises the investment report every six months. Based on his consideration of the preceding factors and his professional experience, Warren never changes the 70/30 Vanguard portfolio allocation. By November of 2008 the value of the Trust is again $5M, and the beneficiary brings the same breach of fiduciary duty suit against Warren.

Even though Warren invested the assets in the identical manner in both examples, the Warren in example 2 has a much better chance of escaping the breach of fiduciary duty suit because of the process he employed to arrive at his investment decisions. He clearly understood his fiduciary duties and did his best to comply with his obligations. He engaged in meaningful, regular analysis, and based on his knowledge, experience, and application of all the facts involved, decided on the 70/30 Vanguard portfolio. He also has several written and updated investment reports to support his decision. It is much more plausible to believe that a judge or jury would find that this Warren fulfilled his fiduciary obligation and despite his best efforts, the market unforeseeably turned down sharply. He has a reasonable chance of not being held personally liable for the $5M loss in value.

On the other hand, the Warren in example 1 is much more susceptible to attack. He gave little thought to his investment decisions, and failed to consider any of the factors that a prudent person would in deciding how to invest the $10M. This Warren left no paper trail and at trial will be unable to produce any meaningful analysis to support his decisions. There is a good chance he will be held personally liable for the $5M loss in value, plus interest. The more thorough the trustee's process is for making investment decisions, the more likely the process will aid the trustee in withstanding an attack.

Remember the Beneficiary

While we touched on the role of the beneficiary in the discussion with Warren above, it is worth focusing more specific attention on this topic. Beneficiaries come in many shapes and sizes, and are after all, why trusts exist. Part of the trustee's meaningful investment decision-making process must include consideration of the beneficiaries. A trustee's decisions must be tailored to fit the

particular beneficiaries of each trust. To ensure that the trustee's decision-making process will withstand scrutiny, he or she should be aware of the beneficiary's unique characteristics, needs, requirements and expectations. Imperative to the individual understanding is an awareness of a beneficiary's significant life changing events such as disabilities, marriages, new children and confinement or imprisonment. The trustee should also consider the income available to the beneficiary, including sudden income or asset increases (e.g., lottery winnings or inheritances), or decreases (bankruptcy or foreclosure), as well as the initial assets of the beneficiary outside of the trust (savings and investments). One could argue it is not enough to simply request the information from the beneficiary, and that some affirmative action is required of the trustee to demonstrate that he or she has actually made a good faith effort to obtain the information.

Beneficiaries change and evolve. What is considered a reasonable decision with regard to one may not be for another, and what may be a reasonable decision this year may not be for the next. The trustee owes a duty to act only in the best interests of each beneficiary, and if there are more than one, the trustee must give due regard to the respective interests of each. Only by considering each beneficiary's unique personal circumstance can the trustee satisfy this duty.

Seek Advice

Few trustees, not even the largest institutions, can perform all tasks or know all information necessary to properly administer a trust without questions arising from time to time. When a question occurs, the trustee should seek the advice of a competent professional to provide advice, whether that is an accountant or a lawyer or both. A misapplication of the trust terms or ignorance of facts and circumstances expected to be known or considered by a fiduciary can be devastating. In a worse case scenario, a trustee's misapplication or failings can result in a breach of fiduciary duty claim and the imposition of personal liability for a diminution of value in trust assets. Consulting a professional for guidance can go a long way in establishing that the trustee exercised due care in making decisions.

About the Author

Nate Olansen provides advice to individuals and businesses on estate planning, individual and entity tax planning, asset protection, and a variety of related transactional matters. He regularly represents clients before the IRS and state taxing authorities in income tax and trust fund penalty disputes, appeals and litigation. Mr. Olansen is a certified public accountant and is active in the Hampton Roads Estate Planning Council and Financial Planning Association.

About our Practice

For over 50 years, Williams Mullen has been privileged to represent bank trust departments and trust companies, as well as individual executors, administrators and trustees regarding both complex and routine issues arising in the context of fiduciary relationships. Our practice comprises leading attorneys in estate planning and fiduciary law, and ten of our attorneys are fellows in the prestigious American College of Trust and Estate Counsel. Our partners and associates alike are frequent speakers on the Uniform Trust Code and other aspects of fiduciary law. We regularly advise clients on best practices to avoid litigation in connection with fiduciary responsibilities. If litigation is unavoidable, we have decades of experience in successful representation of individual and corporate fiduciaries and beneficiaries throughout the mid-Atlantic and Southeast.

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