FEATURE:
FIDUCIARY PROFESSIONS

By **Joseph C. Mahon** & **Patricia M. Angus**

Planning Trust Administration to Avoid Conflict

Insights and best practices for individual trustees

In wealth management, the trust is the most common structure used to realize our widely recognized and accepted freedom of disposition. Within broad parameters, the law of trusts allows the grantor to set forth a private law that both permits and restricts the use of property for the benefit of two or more people, either simultaneously or in succession.

Therein lies potential for disagreements about "who gets how much and when"—disputes that may morph into conflicts and even lawsuits. Whatever benefits the trust provides—tax, asset protection or otherwise—conflict can offset those gains and impose a burden on the management of the wealth subject to the trust. As a matter of best practice, every trust should have an administration plan designed to minimize the potential burdens that may otherwise result from differences, conflicts and litigation.

The banking industry is most familiar with this concept because bank regulators have long required trust companies to adhere to compliance standards for trust administration to minimize potential liabilities.[1] Having the advantage of career professionals and administrative operations, trust companies carefully plan the administration of trusts under their purview.

Individuals, both beneficiaries and trustees, tend to be less likely to develop detailed plans, as they're often unfamiliar with the basic elements of trust administration. They also often lack administrative support to assist in accomplishing their duties. For these individuals, a trust administration plan will help ensure that they can realize the purposes set forth by the grantor in the trust document, while providing a roadmap for the trustee and beneficiaries to guide their relationship. Given the number of individuals now serving as trustees, whether as an outgrowth of their professional practices or their family and personal relationships, planning trust administration is a compelling issue.

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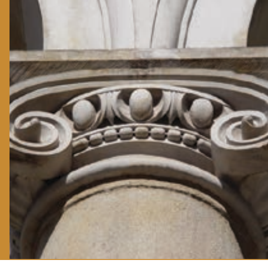
Four Basic Elements

A trustee has four basic tasks: 1) secure and protect the trust assets; 2) invest the trust assets; 3) make distributions to the beneficiaries; and 4) keep records, file tax returns and otherwise meet compliance obligations. In pursuing these tasks, the trustee is subject to the highest levels of fiduciary duties, including good faith, care and diligence in executing the trust provisions, collecting, preserving and investing trust assets, being loyal to the trust and its beneficiaries, avoiding conflicts of interest and being impartial to and communicating with the beneficiaries.[2]

These fiduciary duties often seem ephemeral and may be overlooked, until they come into focus when a dispute arises between the trustee and one or more beneficiaries. For example, the duty of loyalty is at stake when a trustee desires to invest trust assets in a vehicle in which the trustee has a financial interest. The duty of impartiality is implicated when a trustee favors one beneficiary over another in a manner inconsistent with the grantor's purposes and inconsiderate of the relationships among beneficiaries. The duty of care is violated when a trustee keeps records in a haphazard way that results in assets that are either underreported or improperly invested. Risk of breaching these duties, inadvertently or otherwise, can be mitigated through the trust administration plan.



Accomplishing the trustee's basic tasks may be more involved than one would think. Recordkeeping and tax filing become increasingly complex over extended periods of time, employing different custodians and recordkeeping systems. Multi-jurisdictional elements may also increase tax and other compliance requirements. Securing cash and marketable securities is relatively easy, particularly when they're consolidated in a single account for record-keeping purposes. But, other assets present greater challenges. Real estate and tangibles, such as fine art, antiques and jewelry, need to be physically secured, insured and monitored. Non-publicly traded assets, such as closely held businesses, hedge funds and private placements, also require enhanced audit standards.

Distribution and Investment Tasks

Distributions either required or permitted by the trust instrument may be broadly defined, allowing for a wide range of permissible actions, not all of which provide consistently wise and desirable results. Even a simple standard requiring the distribution of trust accounting income may be subject to trustee discretion created by the Uniform Principal and Income Act[3] so that income isn't limited to interest, dividends, rents or royalties, but may be adjusted either by dollar amount or as a percentage of the assets. Similarly, under the Uniform Prudent Investor Act (UPIA), trustees are permitted to invest in any kind of property or type of investment consistent with the UPIA's standards, presenting increased expenses for compensating managers and increased risks of leverage and illiquidity.[4] The UPIA's emphasis on process necessitates keeping records of how the trustee made decisions about choosing managers in light of the needs of the overall portfolio.

Considered together, the distribution and investment tasks provide the most fertile ground for differences to arise among trustees and beneficiaries. In addressing these issues, neither the distribution nor the investment function can be elevated over the other. Each has limitations to take into account when the interested parties determine what they seek to accomplish in the administration of the trust.

The trustee's task of making annual distributions to beneficiaries must start with a review of the basic purpose of the trust and its capacity for generating distributions of income and/or principal to beneficiaries in keeping with that purpose. This raises two basic questions best addressed at the start of the administration. First, how well does the beneficiary wish to live? Second, how long does the beneficiary wish to have the trust support his lifestyle? If the goal is sustainable distributions to maintain the beneficiary's lifestyle, the trustee and beneficiary both should heed the widely recognized wealth management principle: Spend less than you earn, and invest the difference!

> Inconsistent distribution patterns may also disrupt the relationships among beneficiaries, particularly in different generations, and place them at odds with each other.

Potential for Distribution Dysfunction

If a trust is intended to last for a long time, trustees and beneficiaries need to keep in mind that for a trust to grow sufficiently to keep pace with inflation, the annual distribution needs to be less than the total return (income plus appreciation less expenses) earned by the trust. If the distribution is equal to the total return each year, the trust value will remain flat and be unable to keep up with inflation. If the trust distribution exceeds the total return each year, the value of the trust will be reduced so that it returns even less in the future and is ultimately exhausted.[5]

When distributions are made aggressively, exceeding annual returns, the trust functions like an annuity, impairing principal value and leaving less for the next beneficiary or remainderman. Aggressive distributions may be as disruptive to current beneficiaries as they are to remainder beneficiaries. Trust beneficiaries, like most people, tend to make lifestyle choices, including housing and mortgages, based on their anticipated income. A trustee's decision to make distributions in amounts that

exceed income and vary from year to year may be correct, in the sense of being legally permissible. But, over time, a correct decision isn't necessary wise and doesn't necessarily produce a desirable result.

For example, if a current beneficiary becomes accustomed to receiving distributions at a specific level, say $1 million per year for several years, and distributions are then reduced to $500,000 a year when the trustee realizes that current distributions aren't sustainable as the principal value withers, the current beneficiary can suffer wrenching experiences in adjusting his lifestyle. In this case, a trustee may wish to point to the beneficiary's poor decisions, but the trustee has played a contributing role in setting expectations.

To guard against the overconcentration of risk in any one investment, the UPIA mandates diversification.

Inconsistent distribution patterns may also disrupt the relationships among beneficiaries, particularly in different generations, and place them at odds with each other. Distributions in excess of annual returns necessarily reduce assets available to later beneficiaries. Inconsistent distributions increase pressure for higher current distributions to sustain lifestyle commitments made when distributions were higher. And, distributions that favor some beneficiaries over others are also disruptive to relationships and cause those receiving less to seek a higher overall distribution rate, so that they at least get the lesser portion of a larger amount.

As a best practice, the trustee will need to project potential upcoming annual distributions in light of the trust portfolio and trust terms, as well as manage expectations of the trust beneficiaries.

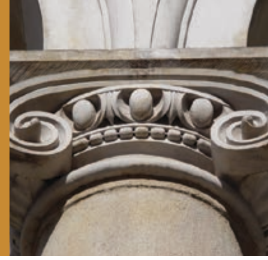
Potential Investment Intricacies

Investment of the trust fund must be considered in connection with its capacity to produce the return necessary to support the proposed annual distributions. By definition, the yield or total return on investable assets is limited. Classic finance theory tells us that an asset has two components of value: an income stream and residual value. The efficient market hypothesis tells us (however imperfectly) that, to the extent investment information is equally available, the marketplace will price publicly traded securities to an average return on a risk-adjusted basis. Experience teaches us that the markets don't provide a total rate of return on a consistent basis, so that actual returns from year to year, from asset class to asset class and from investment to investment vary from the market average. These realities have several implications for trusts.

To guard against the overconcentration of risk in any one investment, the UPIA mandates diversification.[6] This requirement creates the possibility of over-diversification, which can inadvertently create expensive index fund substitutes. Conversely, many trusts specifically allow the trustee to opt out of generally required diversification, and trustees often find themselves holding undiversified portfolios. Failure to diversify has resulted in some of the most prominent cases imposing liability on trustees for investment decisions.[7] Yet, diversification doesn't necessarily result in favorable investment results, as demonstrated by the recent *Trust of Burford*[8] decision, in which the trustee diversified out of concentrated holdings of publicly traded oil companies into derivatives and other alternative assets to enhance distributions to the current beneficiary. In that case, the institutional trustee was found liable for losses of $20 million.

As shown above, competing interests of beneficiaries in trust administration may create pressure to try to increase the overall return realized on trust assets in the short term. When the returns sought exceed what's readily available in the marketplace, the investment program may be more risky and less stable. Some excellent managers will outperform benchmarks, while others lag behind from time to time. It's important to analyze where the returns—positive or negative—come from to get a handle on the health of the investment program. And, it remains important to avoid financial speculation so that fiduciary investments stay based on the productive allocation of capital.[9]

Under the UPIA, individual trustees, who aren't trained investment professionals, may employ external investment managers, but the statute doesn't relieve the trustee from the duty of using professional due



diligence in hiring and monitoring those managers. The total return of the portfolio is what matters, and the trustee must work with the investment advisors to ensure that the process of getting to the returns sought is sound.

Planning the Trust Administration

Administrative and record-keeping tasks, while separate from investment and distribution, can support them when handled in a streamlined way. A trust administration plan can create a roadmap for the trustee and beneficiaries by projecting the course of administration over the long term, through termination. This clarity will help establish reasonable expectations concerning investment returns and distributions, as well as other administrative matters. When reasonable expectations are agreed on and met, little reason exists for differences, disputes or litigation to arise.

When an individual trustee takes on a new trust, it's a helpful exercise to follow the common corporate trustee practice of creating a "head sheet." The head sheet contains a summary of the key provisions and elements of the trust, including grantor, current and successor trustees, current and successor beneficiaries, remaindermen, purpose and goals, tax status, distribution provisions for income and principal and any guidance on investments, special assets and other circumstances specific to either the trust, its assets or its beneficiaries. (See "Sample Trust 'Head Sheet,'" this page.)

The head sheet serves two purposes: (1) the process of creating it will give the trustee and the beneficiaries (if shared with them) a chance to review the totality of the trust from the beginning, thereby helping to set expectations; and (2) to provide a "go to" document for future reference. Including specific cites to trust provisions can save hours in the future of searching through the document, especially when a beneficiary is on the line with a specific question.

In an ideal world, all trustees have a chance to speak with grantors to find out their intent in establishing the trust. In reality, the trustee may need to glean this information from the document and context in which it was written. Trusts are expressed in broad terms that don't address specific circumstances that may arise. Trusts also have beneficiaries who may have powers of withdrawal or appointment and whose lives will be impacted by the course of administration. Determine what goals the beneficiaries have and how the administration might support those goals consistent with the grantor's intent. Depending on whether the trust is intended to be "quiet" or open to review by the beneficiaries, the trustee should meet with the beneficiaries and their advisors early on to discuss the trust terms and administration. This exercise provides the opportunity to avoid later misunderstandings, even if several meetings or communications are needed to describe fully the trust and its projected administration.

Sample Trust "Head Sheet"

Here's what to include

Trust name:
Trust purposes: Grantor's intent and goals for the trust, as communicated by the grantor and/ or generally understood by the trustee(s) and beneficiary/ies .
Grantor(s):
Trustee(s):
  Successor trustee(s).
  Process for removal/ appointment.
Beneficiary/ies:
Remaindermen:
Trust assets: Include all bank and investment accounts, private investments, tangibles and real property.
Distribution provisions: Refer to trust provisions providing guidance for mandatory or discretionary distributions.
Distribution issues: Describe what's being planned for cash flow sustainability, life events (marriage, house, college), emergent events (loss of job, illness, other misfortune) and transfer to the next generation.
Beneficiary powers over trust: Note any beneficiary's rights of withdrawal, powers of appointment and rights of approval over specific transactions.
Trust termination: State when/how/what happens to trust on termination.
Investment issues:
Investment policy statement: Refer to and attach the statement, which covers investment goals, time horizon, risk tolerance and specific factors to take into consideration (for example, cash needs).
Trust asset investment issues: Highlight important issues related to trust assets (for example, illiquid assets, family owned businesses and low basis stock).
Investment advisor(s): Identify all investment advisors.
Trust expenses: List categories of trust expenses and how payment is divided between income/principal.

— Patricia M. Angus

As part of the trust administration plan, the head sheet needs to be reviewed and, when appropriate, updated, periodically. The key elements of any trust administration will change over time. As beneficiaries come and go, the laws governing trusts and their taxation develop, and the economy and investments specific to the trust change. The plan of administration shouldn't be viewed as decisions cast in stone that impair the office of any trustee with its attendant discretion but as a guide setting forth attainable targets that require revision from time to time.

When total returns exceed distributions, beneficiaries can look forward to an increasing source of cash flow.

Balancing Investments/Distributions

Too often, the process of trust administration is bifurcated. Investments are handled systematically, with the trustee having a direct relationship with the investment advisor, who helps with tasks, such as monthly statements, annual reviews and ongoing monitoring and adjustments. By contrast, the relationship with the beneficiary tends to be more ad hoc. For discretionary trusts especially, trustees may take a passive role and merely respond to requests rather than set up an interactive process with the beneficiary. Given the inherent relationship between the trustee's investment and distribution tasks, when the investments need to generate the funds for distribution, bringing both processes together will help to create and meet reasonable expectations and avoid disputes.

Projecting the funds available for distribution from a trust on a consistent and sustainable basis will allow beneficiaries to make lifestyle decisions that don't require distributions greater than the investments can support. Income should be forecasted, both as a matter of income required to be distributed by the governing document or by law and as a matter of total return on assets. The allocation of the income and returns should be calculated, including expenses, taxes and growth to offset inflation. The growth or decline of income should also be projected, so that beneficiaries can know what to expect. When total returns exceed distributions, beneficiaries can look forward to an increasing source of cash flow. Conversely, when distributions impair the capital base, beneficiaries should be warned well in advance that distribution levels aren't sustainable.

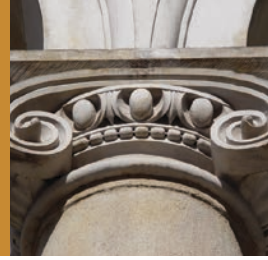
If discretion over the distribution of principal exists, the scope of the discretion should be described in the head sheet and the potential needs of beneficiaries projected from time to time. Beneficiaries live real lives in which challenges arise in an irregular and sporadic manner. Schooling, marriage, purchase of residence, birth of children, creation of business, illness, divorce, loss of job, retirement and various financial setbacks all happen. These difficult to predict events typically require larger sums. None may arise for five or 10 years, and then two or three may arise in rapid succession. Further, disruptions may occur in the larger economy, and asset values or income may fall. These considerations all indicate the need for cash reserves as a part of the investment planning to address unexpected circumstances and to provide sustainability in the event of widespread economic weakness.

Frequent in-person meetings with the beneficiaries provide an opportunity for the trustee to learn about the developments in the beneficiaries' lives, review trust investments and discuss required and discretionary distributions. This process can be time consuming, especially when there are multiple beneficiaries who may have competing interests. The administration plan provides the opportunity to balance those interests in a manner on which the trustee and beneficiaries may rely to avoid conflict.

Each trust should have an investment policy statement based on the trust's purpose and the administration's goals, with the input of both the trustee's and beneficiaries' investment and other professional advisors. The investment policy should take into account the term of the trust, the projected distributions from the trust and cash reserves appropriate to fund unanticipated events.

Trust Termination

The trust's termination should be anticipated. It may



occur when a beneficiary attains a specific age, with the remainder being distributed to that beneficiary. Or, it may occur on the death of a beneficiary, with the assets passing as that beneficiary appoints or to his issue or a charity. Whatever the circumstances, the successor beneficiaries may have different goals and requirements from the prior beneficiary.

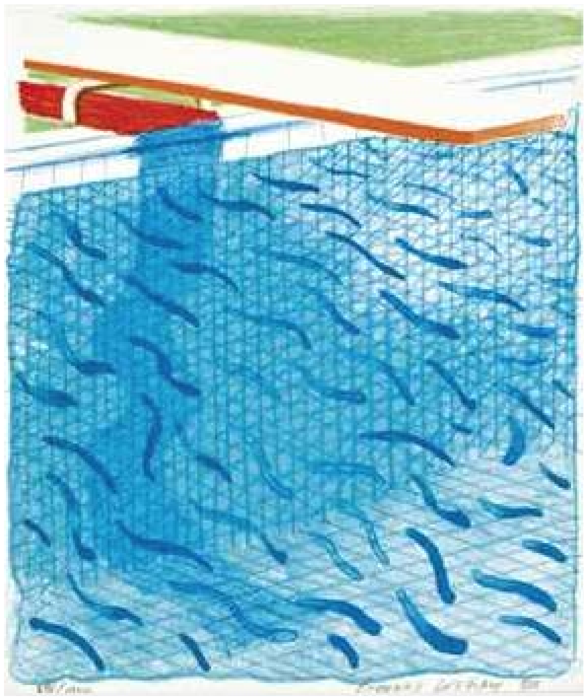
When the trust terminates, the quality of the trustee's relationship with the former beneficiaries, including the success of the trust administration process, will color the views of the successor beneficiaries. When a trustee works with the beneficiaries to adopt a meaningful and effective administration plan in the first instance, it becomes all the more likely that, at the end of the administration process, the trustees will be considered not merely correct, but also as having made decisions that were wise and provided desirable results.

A Complicated Role

In an ideal world, every trustee would have a background in law, finance, investments, psychology and several other disciplines, to help him perform the task well. He would also have experienced staff and technological, administrative and investment support at his fingertips. Every beneficiary would be similarly equipped and have a full understanding of the grantor's intent, the beneficiary's needs and how the trust fits into the beneficiary's overall life. Reality rarely reaches this ideal scenario. Given the important role of a trust in the life of the beneficiary, and the high level of responsibility held by the trustee, professional help is always advisable.

Endnotes

1. Guidelines for documentation of trust administration by a financial institution supervised by the FDIC are set forth in *FDIC Trust Examination Manual,* Section 2, Operations, Controls and Auditing, F. Trust Records (2008).
2. *See generally Bogert on Trusts*, Section 541 (Westlaw 2013).
3. Uniform Principal and Income Act Section 104.
4. Uniform Prudent Investor Act (UPIA) Section 2(e).
5. The impact of the distribution rate as a percentage of trust value on the long-term performance of the trust assets is illustrated in Robert B. Wolf, "Estate Planning With Total Return Trusts: Meeting Human Needs and Investment Goals Through Modern Trust Design," 36 *Real Prop. Prob. & Tr. J.*, 169, 208-13 (Summer 2001). The article contains a useful chart showing the impact of a 3 percent, 4 percent, 5 percent and 6 percent distribution rate. *See also* J. Dobris, "Real Return, Modern Portfolio Theory, and College, University, and Foundation Decisions on Annual Spending from Endowments: A Visit to the World of Spending Rules," 28 *Real Prop. Prob. & Tr. J.*, 49, 80 (Spring 1993) ("... people who spend more than 4% of their own investment return ... are probably eating into principal, often without realizing it").
6. UPIA Section 3.
7. *Matter of Janes*, 90 N.Y. 22, 41 (1987) *reargument den.*, 90 N.Y.2d 885 (1987); *In re JP Morgan Chase Bank, N.A.*, 981 N.Y.S.2d 636 (Monroe Co. Surr. Ct. 2013).
8. *In re Trust of Burford,* District Court for Tulsa County, OK, Docket No. PT-2006-013 (Hon. L. Morrisey, filed Oct. 9, 2012).
9. "... reforms have all but banished the term 'speculation' from our vocabulary, but speculation itself may not be dead. Lawyers now simply call speculation something else." J. Dobris, "Speculations on the Idea of 'Speculation' in Trust Investing: An Essay," 39 *Real Prop. Prob. & Tr. J.*, 439, 451-2 (Fall 2004). And, "The world neither ever saw, nor ever will see, a perfectly fair lottery, or one in which the whole gain compensated the whole loss; because the undertaker could make nothing by it." Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations,* Chapter X, Part 1 (1776).



SPOT LIGHT

Water's Fine

"Pool made with Paper and Blue Ink for a Book" (10 1/4 in. by 8 5/8 in.) by David Hockney, sold for $21,250 at Christie's Prints and Multiples Sale in New York on Oct. 23, 2014. An important contributor to the Pop art movement of the 1960s, Hockney is considered one of the most influential British artists of the 20th century.