The Changing Role of Trustee
&
Trustee Liability

Who's Afraid of the Big Black Swan?

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Not so long ago, serving as a trustee was often an accommodation to a client or close friend, an honorable thing to do. Beneficiaries worked with trustees and rarely questioned the decisions made by the trustee. Trustees rarely gave thought to personal liability that might arise from their role.

Times have changed. If there is money (or if there was money), if tax planning did not produce the anticipated result, if investments didn't fare as expected, if a beneficiary finds his access to funds is restricted, if the perfect world we helped plan is not realized, the trustee may find himself in an uncomfortable position. The discomfort and feeling of exposure often comes after the first generation – the grantor generation – is gone. Taking actions in an attempt to appease beneficiaries or taking actions to uphold the directions of the grantor may produce an environment ripe for litigation.

The drama of the current market is wreaking havoc on modern portfolio theory. The means used to manage volatility and market risk employed for the past few years haven't sheltered us from the worst crash since the Great Depression. We are experiencing a "Black Swan Event" – an extreme outlier, an event that lies beyond the realm of normal - seven standard deviations from the expected return that a normal distribution of prices would predict. Beneficiaries are sensitive and reactive to this extraordinary situation. And while we may have lived through somewhat similar problems, the impact has generally been more limited, more contained.

These have not been calm, cool and collected days for trustees. Desperate times foster finger pointing and the search for another party to bear the brunt of loss. In a trust situation, the "right" response is not always intuitive. Yes, the fiduciary environment is ripe for bashing – advance planning and adoption of risk management strategies and practices are crucial to blunt the blow.

TRUSTEE LIABILITY

Trustee liability is often framed in the context of duty, and academic discussion is generally focused on the obligations and responsibilities attendant to a fiduciary position. To deal with issues of potential trustee liability proactively, it may be better to see trustee liability as exposure – exposure to judicial intervention, "equitable" relief, damages – due to a beach of a fiduciary duty to those who have a beneficial or equitable interest in the trust. By identifying areas of exposure and risk, we may be in a better position to adopt strategies and procedures to minimize exposure, reducing fiduciary liability.

How real are these liabilities – the potential exposure? When crafting a remedy for a trustee's breach of fundamental duties, courts are not confined to a limited list of remedies but may mold the relief to protect the rights of the beneficiary according to the situation involved. Consequential and punitive damages may be included where malice or fraud is involved. Double damages may be imposed in cases of self-dealing or conflict of interest. Courts are not hesitant to create a remedy or consequence that is considered to fit the nature and gravity of the breach and the consequences to the beneficiaries and trustee. The object of equitable relief is not merely to prevent loss to the trust beneficiaries or wrongful gain by the trustee, but may be to deter other trustees from acting similarly in the future.

"'When a breach of trust occurs, the beneficiary of the trust is entitled to be put in the position he would have been if no breach of fiduciary duty had been committed.' *Berish v. Bornstein*, 437 Mass. 252, 770 N.E. 2d 961, 977 (2002) Other remedies including holding the trustee liable for any loss or depreciation in the value of the trust estate resulting from the breach of trust or requiring the trustee to disgorge any profit that the trustee made through the breach of trust. Note possible treble damages under Massachusetts Consumer Protection Act (M.G.L.A. c.93a) imposed on a “professional trustee” who had flagrantly breached fiduciary duties owed. Quinton v. Gavin, 835 NE2d 1124 (2005)

DUTIES OF A TRUSTEE

The duties of a trustee stem from a variety of sources. The terms of the trust, will, or other agreement will govern the conduct of the trustee, unless the terms are against public policy, in violation of a controlling statute, regulation on common law provision. Certain fiduciary duties are imposed by law and cannot be excused by the document, grantor or beneficiary.

A Trustee’s Paramount Duty

All trust fiduciary law rests on two core principals, the duty of care and the duty of loyalty. The many sub rules – for example, the duties to keep and disclose information, to protect trust property, to be impartial among trust beneficiaries – are all application of prudence and loyalty.

Many would argue that the paramount duty of the trustee, which underlies all other duties, is the trustee’s duty of loyalty to the trust beneficiaries. The trustee stands in a fiduciary relationship with the trust and its beneficiaries. This relationship involves a duty on the part of the trustee to act for the benefit of the trust beneficiaries and to administer the trust solely in the benefit of the trust beneficiaries.

Note that a trustee is judged by the standard of a person with reasonable skills, unless the trustee represents that it has “greater skill than that that of a man of ordinary prudence.” If it does make such a representation, it is “under a duty to exercise such skill.”

Trustee Duties

The typical duties of a trustee include:

- ✓ **Trustee's Duty to Administer the Trust.** *Restatement 3rd* §76. A trustee must administer the trust according to the trust's terms and applicable law, and for the benefit of the beneficiaries.

  A Trustee Must Understand the Trust.

  A Trustee Must Seek Clarification of Ambiguous or Uncertain Trust Terms.

  A Trustee is not Bound by Trust Terms that are Illegal, Impossible, Against Public Policy

- ✓ **Trustee's Duty of Loyalty.** *Restatement 3rd* §§78 and 86.

  A Trustee Must Avoid Conflicts of Interest. (can be waived by the express terms of the trust, with the informed consent of the beneficiaries, or by court approval)

- ✓ **Trustee's Duty Not to Delegate.** Prudent Investor Rule §171 and *Restatement 3rd* §80. (modifiable)

  A Trustee Must Give Personal Attention to Acts Involving the Exercise of Discretion

  Permissible Delegation Must Be Done Prudently.

- ✓ **Trustee's Duty to Keep and Render Accounts.** *Restatement 3rd* §82.

  A Trustee Must Keep Clear and Accurate Accounts.

  A Trustee Must Keep Beneficiaries Reasonably Informed

- ✓ **Trustee's Duty to Exercise Reasonable Skill, Care and Prudence in Administration of the Trust.** *Restatement 3rd* §77.

  A Trustee Must Act with Care, Skill and Caution If the trustee has special skills or is named trustee on the basis of representation of special skills or expertise, the trustee is under a duty to use those skills.

  A Trustee Must Act Reasonably and Competently.

  A Trustee Must Consider Tax Issues

  A Trustee Can (and Should) Hire Professionals.

  A Trustee Must Avoid Unreasonable Expenses.

- ✓ **Trustee's Duty to Take and Keep Control of Trust Property.** *Restatement 3rd* §76(b).

- ✓ **Trustee's Duty to Preserve the Trust Property.** ***Restatement 3rd*** **§§76(b) and 77.**

  A Trustee Must Protect the Trust Property. (Insurance, maintenance, upkeep, taxes)

  A Trustee Should Not Permit Inappropriate Person to Use Trust Property.

- ✓ **Trustee's Duty to Enforce Claims Owed to the Trust.** *Restatement 3rd* §76

- ✓ **Trustee's Duty to Defend Actions against the Trust.** *Restatement 3rd* §76

- ✓ **Trustee's Duty to Keep Trust Property Separate and Earmarked.** *Restatement 3rd* §84. The trustee has the duty to identify trust property, and to not commingle trust property with the trustee's own property (waiver permissible)

- ✓ **Trustee's Duty to Make Trust Property Productive.** Prudent Investor Rule §§181 and 227 and *Restatement 3rd* §§77, 79 and 86 (comment c).

- ✓ **Trustee's Duty to Pay Income to the Income Beneficiaries.** Prudent Investor Rule §227 (comment (i)) and *Restatement 3rd* §§49 (comment c(1)) and 76 (comment f).

- ✓ **Trustee's Duty to Deal Impartially with Beneficiaries.** Prudent Investor Rule §§183 and 232 and *Restatement 3rd* §79. A trustee has the duty to treat beneficiaries impartially and equitably, and to balance the competing and conflicting interests of the beneficiaries. (Express terms of trust may give trustee direction or discretion to favor a particular beneficiary or class of beneficiaries.)

- ✓ **Trustee's Duty with Respect to Co-Trustees.** Prudent Investor Rule §184. The trustee has the duty to participate in trust matters with other co-trustees, and to use reasonable care to prevent a breach of trust by a co-trustee.

- ✓ **Trustee's Duty with Respect to a Person Holding the Power of Control.** Prudent Investor Rule §185 and *Restatement 3rd* §§74 and 75. A trustee must act in accordance with directions of certain special powerholders (grantor, protector, beneficiary with general power of appointment, etc) A trustee does not have to follow the instructions of a powerholder if the attempted exercise of the power violates the terms of the trust or is a violation of the fiduciary duty that person holding the power owes to the trust beneficiaries.

- ✓ **Trustee's Duty of Prudent Investing.** Prudent Investor Rule §§227, 228 and 229. *See also*, Uniform Prudent Investor Act. The trustee has the duty to invest trust assets taking into consideration the purpose and terms of the trust and other relevant factors.

Relevant Factors. Uniform Prudent Investor Act §2(c).

- general economic conditions;
- possible effect of inflation or deflation;
- expected tax consequences:
- the role that each investment plays within the overall trust portfolio;
- expected total return:
- other resources of the beneficiaries;
- needs for liquidity, regularity of income, and preservation or appreciation of capital; and
- the special value that an asset may have to the purposes of the trust or to one or more of the beneficiaries.

Five Key Investment Concepts.

- Diversification
- Risk and Return
- Costs and Expenses
- Conflicts of Interest
- Delegation

✓ **Trustee's Duty To Keep Accurate Trust Records.** *Restatement 3rd* §83.

✓ **Trustee's Duty to Make Decisions Concerning Discretionary Distributions.** *Restatement 3rd* §§85 and 86. A trustee has a duty to determine whether discretionary distributions should be made, and under what circumstances.

✓ **Trustee's Duty of Confidentiality.** *Restatement 3rd* §78 (comment i). A trustee must keep matters pertaining to the trust and its beneficiaries confidential, unless otherwise required by law or permitted by the trust instrument.

✓ **Trustee's Duty to Uphold and Defend the Trust.** *Restatement 3rd* §76.

THE DANGEROUS DUTIES – LOYALTY, DISCLOSURE, PRUDENCE IN MANAGEMENT

There are a number of issues that may lead to litigation, some that fall within a trustee's control, some that come from greed or lack of understanding of beneficiaries. The principal areas that lead to litigation and liability are conflicts of interest, the duty to disclose material facts to beneficiaries so that they can protect their interests, and prudence in the management of the affairs of the trust.

Investment – The Power of the Black Swan

The most significant recent changes are those reflecting the movement begun over a decade ago to facilitate a trustee's ability to invest trust assets for total return consistent with modern portfolio theory. In a perfect world, investing in this way will result in more favorable results for all beneficiaries – more cash flow to the income beneficiaries – more principal remaining for the remainder men. The enormous volatility in the market, the return of inflation, catastrophes involving hedge funds and investment managers, the plummeting prices of financial institutions, and the fall in fixed income returns expose fiduciaries to risks that may not have been anticipated when the relationship was established.

The Prudent Investor Rule and the Trustee's Power to Adjust

The rules regarding trust administration have been evolving rapidly in the past 15 years. The changes in the law of trustee investments are probably the most significant recent changes.

Restatement (Third) of Trusts—

Under the Restatement, a trustee "is under a duty … to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust." This standard requires "the exercise of reasonable care, skill, and caution." Further, it is to be applied "to investments not in isolation but in the context of the trust portfolio and as part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust." Further, the trustee has a duty "to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so." A trustee also has the powers expressly or impliedly granted by the terms of the trust. Restatement of the Law (Third) of Trusts, §227(a) (1992).

Trustees have the duty, "within a reasonable time after the creation of the trust, to review the contents of the trust estate and to implement decisions concerning the retention and disposition of original investments in order to conform to the requirements of **§§**227 and 228."

The Restatement addresses the place of actual trust language in directing trust investments: such directions are "legally permissible and are ordinarily binding on the trustee in managing the trust assets, thus often displacing the normal duty of prudence." However, the trustee may not be under a duty to "comply with a term of the trust if a court order directs or authorizes non-compliance when, as a result of circumstances not known or anticipated by the settlor, compliance would defeat or substantially impair the accomplishment of the purposes of the trust." Indeed, under such circumstances "the trustee may have a duty to apply to the court for permission to deviate" from the trust terms. Further, if a trust agreement merely authorizes a particular investment, it is permissive only, and the trustee is not under a duty to retain permitted investments. Note - a permissive provision does not "remove the trustee of the fundamental duty to act with prudence," and authorization to act in certain ways regarding a particular investment does not constitute an exculpatory clause.

The Uniform Prudent Investor Act. The Prefatory Note to the Prudent Investor Act indicates that it relies on the Restatement. The Prudent Investor Rule is a "default rule," which "may be expanded, restricted or eliminated by the trust terms. If the Prudent Investor Act is not overridden, the trustee owes a duty to the beneficiaries of the trust to comply with the Prudent Investor Rule. The Prudent Investor Act makes five fundamental alterations to prior prudent investing law.

Portfolio as a Whole

Investment decisions will no longer be evaluated in isolation. The prudence standard is applied to any investment as part of the total portfolio, rather than to individual investments. An investment that might be imprudent in and of itself can become prudent if undertaken in sensible relation to other trust assets, or to non-trust assets.

Risk and Return

Preservation of capital is replaced with risk/return as the trustee's primary concern. This rule stresses sensitivity to the circumstances of the particular trust – its tolerance for risk, the purposes of the trust, and the financial situation of the beneficiaries.

Assets Classes

All categorical restrictions on types of investments per se are eliminated; a trustee may invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing.

Diversification

Investment diversification is integrated into the definition of prudent investing. A trustee is charged with diversifying the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.

Delegation

Trustees are now permitted to delegate investment and management functions, contrary to prior trust law which forbade a trustee from undertaking such delegation. The trustee must exercise reasonable care, skill and caution in choosing the advisor and setting the terms and goals of the engagement, and must monitor the manager's performance.

Uniform Principal and income Act

It is an established duty of trustees to think in terms of administering impartially, based on what is fair and reasonable to all of the beneficiaries. This duty has always been embodied in the Uniform Principal and Income Act; it underlies the Act's accounting system as to whose benefit—income or remainder beneficiary—the return on investment is to be allocated. This makes investing significantly more complicated.

Traditional Trust Accounting Mode

Under the principal and income accounting system the only "income" or "return" that income beneficiaries are entitled to receive is rents, royalties, dividend and interest income, etc. Any return in the form of capital gains and/or appreciation of value is allocated to the remainder beneficiaries. Because income beneficiaries do not directly benefit from any gains in capital they often have a preference for investment in bonds or other income-producing assets. Remainder men often prefer a portfolio with growth potential. This conflict of interests has meant that trustees have had to look at potential investments from two points of view: whether it is a good investment and whether its yield will affect fairness to beneficiaries.

Fairness to Beneficiaries

When a trustee adopts modern portfolio theory to optimize "total return," the resultant portfolio may not achieve fairness to both income beneficiaries and remainder men. The Uniform Principal and Income Act (1997) modernized the principal and income rules to mesh with the principal of investing for total return. Under the Act the trustee was granted certain powers to adjust accounting income up or down, as circumstances require. Under the Uniform Principal and Income Act, the starting point is still the traditional system of allocating dividends and interest to income and allocating capital gains and appreciation to principal. If, however, the results are not fair and reasonable to all the beneficiaries, the trustee "may adjust between principal and income to the extent the trustee considers necessary.

When making such an adjustment the trustee is required to consider the same factors set forth under Sec. 2 (c) of the UPIA for investing and managing trust assets. Some of these factors are: the nature, purpose and expected duration of the trust; the intent of the settlor; the identity and circumstances of the beneficiaries; the needs for liquidity, regularity of income and preservation and appreciation of capital; and the anticipated tax consequences of an adjustment.

DIVERSIFICATION

Duty to Diversify: Special Circumstances

The Uniform Prudent Investor Act §3 provides that "A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." The comment to Section 3 notes that "circumstances can, however, overcome the duty to diversify. For example, if a tax-sensitive trust owns an under diversified block of low basis securities, the tax costs of recognizing the gain may out-weight the advantages of diversifying the holding. The wish to retain a family business is another situation in which the purposes of the trust sometimes override the conventional duty to diversify." The Restatement also recognized that, "the trustee's decision to retain or dispose of certain assets may properly be influenced, even without trust terms expressly bearing on the decision, by the property's special relationship to some objective of the settlor that may be inferred from the circumstances, or by some special interest or value the property may have as a part of the trust estate or that it may have, consistent with trust's purposes and the trustee's duty of impartiality, to some or all of the beneficiaries. Examples of such property might be land used in a family farming operation, the assets or shares of a family business, or stockholdings that represent or influence control of a closely or publicly held corporation."

The collapse of the market demonstrates the shortcomings of standard asset diversifications. Relying on cross correlations among different asset classes proved unavailing, as most investment classes suddenly correlated in the face of the liquidity crisis. Where the failure to diversify was among equities, the benchmarks would have crashed anyway.

Diversification – Minimizing Exposure

Given the recent volatility of the capital markets, it is not hard to imagine a complaint against a fiduciary who allegedly failed to take action that would have prevented the loss in value of the asset held by the fiduciary. Many cases seem to fall into one of three buckets – What must be done to diversify? Will language in the trust mitigate the duty to diversify? What must a trustee do if it decides not to diversify?

A diversification strategy may be prudent, negligent, or grossly negligent, depending on the investments actually selected, the timing of sales and acquisitions, the goals of the grantor, and the factual circumstances surrounding the particular trust and its beneficiaries.

In *Nelson v. First National Bank and Trust Co. of Williston*, 543 F.3d 432 (8th Cir. 2008), the court held that a trustee had not breached its duties by delaying sale of stock held in the trust. The plaintiffs were income beneficiaries of a trust established by their father in 1998. Ninety per cent of the trust's marketable assets were concentrated in the common stock of Medtronic, Inc. When Nelson passed away, the trustee estimated that estate taxes would amount to $20 million to $30 million. The trust had a provision which stated that

> *"any investment made or retained by the trustee in good faith shall be proper despite any resulting risk or lack of diversification or marketability and although not of a kind considered by law suitable for trust investments."*

Four months after the death of the grantor, the beneficiaries exercised a power to remove the trustee, and directed that the assets be transferred to a successor trustee. The successor trustee promptly sold 600,000 shares of Medtronic stock in a single day in November 2006 at a price of $48.13 per share. The value of Medtronic stock had fluctuated between $49.66 and $51.83 per share in the two weeks following the grantor's death and the beneficiaries claimed that the original trustee had acted in bad faith by delaying the transfer while it tried to convince the beneficiaries to change their minds.

The case shows the value of procedural prudence in monitoring concentrated positions, even in the early stages of administration. Good faith can be an adequate defense when given standard retention provisions like those found in this trust. The trust had adequate assets to pay estate taxes due in nine months based on the market price of the stock during the first two weeks of post-death administration. The trustee monitored the stock price daily to ensure that it did not drop so low as to interfere with the trust's ability to pay the taxes. The court found that it was not unreasonable for the trustee, giving weight to the expressed investment authorization, to retain the Medtronic stock despite any resulting lack of diversification so long as it did not interfere with the trustee's ability to meet its tax obligation.

In re Hyde, 44 A.D. 3d 1195, 845 N.Y.S.2d 833(N.Y.A.D., 2007), *app. den* 881 N.E. 2d 1197) (N.Y. 2008) involved challenges to the accountings of three trusts which held non-voting shares of a closely held company, Finch Pruyn. Although there was no express retention language in the trust regarding the shares, the trustees were granted "absolute discretion" in managing the trust assets.

The voting stock had restrictions which would restrict the voting stock shareholders to one cent per share in liquidation. The non-voting stock got the balance of the value of the company in liquidation. "This capital structure engendered a state of 'gridlock,' which may have been intended by Finch Pruyn's founders in order to sustain Finch Pruyn as a family business." Both sets of shares provided substantial dividends. There was no market for the shares, except for the company itself, which refused to buy most tendered shares, and only at book value. The beneficiaries filed objections which included allegations that the trustees had breached their duty by failing to diversify.

In evaluating the decision to diversify the trustees considered a number of factors, such as the general economic situation of the trust assets, the expected tax consequences of investment decisions and the needs of the beneficiaries. The stock paid out considerable dividends, but would have realized a huge discount if sold. The trustee concluded that the needs of the beneficiaries suggested that diversification was not the best course of action.

The Court on appeal noted that there was an indication that the grantors of the trust wanted the ownership of Finch Pruyn to remain in the family and the trusts were used a vehicles to achieve such a result. This conclusion stemmed from the restrictions on the two classes of stock, rather from any terms of the trust. The Restatement provides flexibility in determining settlor intent where the trust terms do not provide explicit guidance, where such intent may be "inferred from the circumstances." Restatement (Third) of Trusts §92.

In the *Matter of Bloomingdale*, 853 N.Y.S.2d 92 (N.Y.A.D. 2008) the court dealt with objections to a final accounting based on retention of high concentrations of certain stocks as a failure to diversify. Of interesting note is the involvement of the beneficiaries. In 2001 the beneficiaries became co-trustees. One of the beneficiaries had a MBA and a PhD and was an assistant professor of marketing, while the other had a bachelor's degree in business administration with a major in finance. The court noted that when the beneficiaries became cotrustees they became obligated to familiarize themselves with the prudent investor rule - and could not maintain their objections to the investment actions of the independent trustee for the period during which they were co-trustees. The issue was not as easily dismissed for the earlier period when the plaintiffs were mere beneficiaries. Communication and informed consent could not be easily shown. The court noted that to find ratification of stock retention, the beneficiary must have been 'fully apprised of the effect of the acts ratified, and of his or her legal rights in the matter.'

An Absolute Duty to Diversify?

Recall there is no absolute duty to diversify; it is simply a default rule.

In *Atwood v. Atwood*, 25 P.3d 936, 940 (Okla. Ct. App. 2001), the grantor set up a trust in 1957 and funded it primarily with stock in the AMP Company. The trustee, son of the grantor, kept the AMP stock (more than 70% of trust assets) until 1998, when much of it was sold. Although the trust began with a value of approximately $75,000, reached the value of approximately $514,591 in 1999, and approximately $600,000 was distributed over the life of the trust, the beneficiaries (the grantor's grandchildren and great-grandchildren) claimed that trustee breached his duties to diversify. They claimed that had he diversified, the trust's value would have been substantially higher.

The trustee requested summary judgment on two theories: performance of the trust assets equaled or excelled the performance which conservative diversification would have produced, and the trust instrument granted him wide discretion as to asset management, exonerating him of all liability. The trust document did not include express exoneration language, but granted the trustee the power to retain any assets for as long as he may deem advisable. The court rejected the beneficiaries' argument that whatever a trustee may deem "advisable" is subject to the Prudent Investor Rule, and held that the Prudent Investor Rule did not create an absolute diversification requirement.

Other cases have shown that the courts are looking at the totality of the situation. In *Brackett v. Tremaine*, 269 Neb. 376 (2005), the trustee, a grandson of the grantor, wanted to purchase for himself a 42-acre parcel of farmland that was by far the largest asset of the trust. The trustee was also an income beneficiary of the trust – upon his death the property was to be divided among the other beneficiaries. Prior to seeking approval from the courts or any other party, the trustee/beneficiary purchased a house and moved it onto the property. He then petitioned the court to authorize the sale, arguing that the sale would permit asset diversification. The other beneficiaries objected on 2 grounds – the grantor's intent that the farmland remain in trust for all the beneficiaries and the potential future value of the property.

The court noted several facts. There was express authority to retain the assets. The trust agreement gave the trustee the power to retain any property "without regard to the proportion of such property or property of a similar character so held may bear to the entire amount of the trust." The was a potential loyalty/conflict issue - the trustee wanted to purchase the property for personal reasons. The court, citing the Prudent Investor Act, noted that non-diversification of trust assets is often justified in the case where the asset has a "special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries." The court held against the trustee and against diversification.

In *In re Scheidmantel*, 868 A2d 464 (Pa., 2005), the court concluded that the trustee's decision to diversify lacked sufficient justification, given the purposes of the trust. The trustee exercised his power to diversify essentially in a vacuum, and without regard to the actual facts. Upon the death of Stella Scheidmantel the trust property was to be divided into a marital deduction trust and a credit shelter trust. Income from each trust was to be paid to Stella's husband Paul. Upon Paul's death, trust property was to be distributed outright to children. Shortly after Stella's death, Paul became quite debilitated. His health deteriorated rapidly. The trustee did not consult with the family concerning Paul's health, his financial circumstances or income needs. The largest single asset of the trust was dividend-paying stock in the corporate trustee. The successor corporate trustee, upon reviewing the investments, but without consulting the beneficiaries, changed the investment objective from "safety and income" to "balanced," and the "investment horizon" from "three to seven years" to "seven to ten years." The dividend-paying stock was sold and replaced by various mutual funds. The trustee sought to justify this action under the rationale of "diversification." The court found that the trustee had acted with gross negligence, stating that "diversification cannot become a goal in and of itself. Rather, diversification is a tool that can provide the means to effectuate a grantor's goals for a trust, if used properly and prudently with due regard to the specific facts and circumstances that exist in a particular case." The court's comments are instructive, "We do not evaluate a trustee's management of trust funds with 20/20 hindsight, nor do we require a trustee to be clairvoyant in selelcting only optimal investments that always appreciate in value and never decline in worth. But . . . a trustee . . .must be able to explain how an investment strategy was developed for a specific trust and why that strategy was prudent under existing circumstances."

Exculpation and Asset Retention Clauses

When a trust instrument provides express language or direction regarding the retention of a concentrated position, the trustee may feel somewhat protected against a claim. Clear language and expressed intentions of the grantor do not necessarily provide relief from liability or grant a trustee the right to abdicate its duty to look at the trust's investment situation.

Liability can arise in either direction – retention or diversification. The extent to which the language of the trust instrument or specific directions to the trustee can either exonerate the trustee of fiduciary responsibility or provide for a lessened standard of liability is a topic that frequently arises in conjunction with allegations that a trustee breached a duty relating to trustee investments.

In *Trust of Williams*, 591 N.W.2d 743 (Minn. Ct. App. 1999), *after remand* 631 N.W.2d 398 (Minn. Ct. App. 2001), the court addressed whether a corporate trustee could rely on exculpatory language in the trust document. Stock in Creamette Company, founded by James Williams, accounted for 98% of the trust's value. Creamette was acquired by Borden, resulting in nearly 100% of the total value of the trust being in Borden stock. In the early years, the trustees sold some shares of Borden because of a perceived need to diversify. The plaintiff trustee voted to continue to diversify, but the other two trustees voted to hold the stock until Borden stock recovered some of its lost value. The stock ultimately dropped from $36 per share to $14 per share. The plaintiff trustee claimed that the bank trust was responsible for the trust's loss in value. The bank trustee asserted that the trust's exculpation clause protected it from liability. The clause stated that

> *[n]o Trustee shall be liable for the fault or doing of any other Trustee, whether the act be one of misfeasance or nonfeasance, nor shall he be held liable for any loss by reason of any mistake or errors in judgment made by him in good faith in the execution of the trust.*

The appellate court held that the clause would not protect the Bank if the losses were due to negligence. The first portion of the clause provided no protection to the Bank, since it only protected a trustee from the actions of another trustee. The second portion of the clause protected only against "mere errors in judgment," not negligence. Ultimately the court found that the losses were due to negligence and upheld surcharges of more than $4 million against Norwest Bank.

One of the most significant cases in this area provides guidance as to the extent to which a trustee may (or may not) rely on language in a trust agreement permitting the trustee to maintain a high concentration in a single stock is *In re Will of Dumont,* 809 N.Y.S. 2d 360 (App. Div. 2006), *reversing* 2004 NY Slip Op 50647U; 2004 N.Y. misc. LEXIS 896 (June 25, 2004). In this case, the testator created a will in 1951 with a trust for the benefit first of his wife, then for his daughter and finally for her issue (or, if she had none, for several named charities). The testator died in 1956. His testamentary trust contained the following language:

> *It is my desire and hope that said stock will be held by my said Executors and my said Trustee to be distributed to the ultimate beneficiaries under this Will, and neither my Executors nor my said Trustee shall dispose of such stock for the purpose of diversification of investment and neither they or it shall be held liable for any diminution in the value of such stock. * * * * The foregoing provisions shall not prevent my said Executors or my said Trustee from disposing of all or part of the stock of Eastman Kodak Company in case there shall be some compelling reason other than diversification of investment for doing so.*

The trust was funded in 1958; 95% of the trust assets consisted of shares in Eastman Kodak Company. In 1972, the primary beneficiary died. The trustee continued to hold the Kodak stock for almost 34 years, despite a significant decline in it value. In 1997, attorneys for the testator's granddaughter asked the trustee to sell the Kodak stock. In the face of inaction by the trustee, a suit was filed seeking damages in excess of $39,000,000, resulting from the improper retention of Kodak stock.

The Surrogate court focused on the trust language that permitted disposition of the Kodak stock "in case there shall be some compelling reason other than diversification of investment for doing so." The court interpreted this clause to mean that the trustee was not to sell simply in order to diversify if the Kodak stock was performing well; rather, the trustee was to sell the Kodak stock if there were some other compelling reason, such as poor performance. The retention language was "clearly precatory." Of interesting note, a "new on the field" trust officer read the trust and felt that the primary purpose of the trust was to hold Kodak stock. His interpretation and actions/inactions were not reviewed. Damages were in excess of $20 million. The case was overturned on appeal in 2006 on procedural grounds, but it shows that a trustee would be ill-advised to ignore the greater diversification issue.

Wood v. U.S. Bank, N.A., 160 Ohio App. 3d 831, 828 N.E.2d 1072 (2005) is another example where a court considered potentially exculpatory language – in this case language that authorized retention of stock in the corporate trustee. In this case, the grantor created a trust worth over $8 million for the benefit of his wife. Firstar was the trustee and 80% of the trust assets consisted of Firstar stock. The trust included a retention clause that allowed Firstar

> *"to retain any securities in the same form as when received, including shares of a corporate trustee …, even though all of such securities are not of the class of investments a trustee may be permitted by law to make and to hold cash un-invested as they deem advisable or proper."*

Firstar held the assets it received and did not diversify. It liquidated assets other than its own stock to pay taxes. Within a year of the grantor's death, the surviving spouse asked the trustee to sell some of the Firstar stock. Shortly after the request was made, the Firstar stock dropped 25% below its date of death value, resulting in a loss of approximately $770,000. The beneficiaries sued Firstar for failing to diversify trust assets. The appellate court found that the language allowing Firstar to retain its own stock "merely served to circumvent the rule of undivided loyalty. The trust did not say anything about diversification." The court held that, "to abrogate the duty to diversify, the trust must contain specific language authorizing or directing the trustee to retain in a specific investment a larger percentage of the trust assets than would normally be prudent."

In *McGinley v. Bank of America, N.A.*, 109 P3d 1146 (Kan., 2005), the court found that express direction from the grantor and beneficiary of a revocable trust was sufficient to relieve the trustee from the duty to monitor the stock or to diversify the holdings. In 1990, 79-year-old Marie McGinley set up a revocable trust, with the Bank of America serving as trustee. The language of the trust stated that the trustee was empowered to invest the trust corpus in investments "although the same may not be of the character permitted for Trustees' Investment by the ordinary rules of law." The trust instrument also stated that the grantor "shall be consulted by the Trustee as to any purchase or sale and the Trustee shall abide by the Grantor's decision."

McGinley transferred Enron Corporation stock to the trustee. Some 7 months later, a form letter signed by McGinley was delivered to the trustee directing it "to retain" the 1,541 shares of Enron stock. The letter continued with a "hold harmless" clause and further stated that the grantor was relieving the bank "from any responsibility for analyzing or monitoring these securities in any way."

At the apparent height in value of Enron stock, the bank held 9,500 shares of that stock valued at almost $790,000; these shares comprised almost 77% of the market value of the trust. By December 2001, the trust contained 8,000 shares of Enron stock valued at $4,800. McGinley sued the bank for the lost value, alleging breach of fiduciary duty, negligent failure to supervise employees, breach of loyalty, tortious conduct, violations of the Consumer Protection Act, and fraud and misrepresentation by silence. She claimed the bank's failure to recommend portfolio diversification lacked good faith and was indifferent to her best interests. The trial court ruled against her on a summary judgment motion, citing the directive signed by McGinley, which expressly released the bank from liability for retaining the Enron stock and failing to monitor the stock. The Kansas court also dismissed McGinley's claims regarding a breach of the duty to diversify investments, saying that it, too, was trumped by the her directive – the clearly expressed intention of the grantor.

Communication or lack thereof can make a bad situation worse. In *Estate of Saxton*, 712 N.Y.S.2d 225 (2000), the decedent created a trust for the lifetime benefit of the spouse, with a remainder interest to his children. The trust was funded entirely with IBM stock. In 1960, two years after the trust was created, the trustee sent an "Investment Direction Agreement," under which the trust beneficiaries agreed that it was their desire for the trustee to continue to hold the IBM stock rather than follow normal diversification procedures. The trustee did not discuss the agreement with the beneficiaries, nor did it discuss the risks associated with not diversifying.

For the next 19 years, the trustee did not communicate with the beneficiaries. In 1984, the beneficiaries urged the trustee to consider diversification. The trustee did not prepare or present any plans for diversification; the trust officer felt diversification was unnecessary because IBM was on the Bank's "buy" list. Eight years later, the trustee finally implemented a diversification strategy, at which point the value of the stock had dropped by more than $4 million.

The trustee alleged that the agreement protected it from liability, and that the beneficiaries consented to the continued retention of the stock. The court found the trustee liable.

In *In re Dentler Family Trust*, 873 A2d 738 (Pa., 2005) an irrevocable inter vivos trust was established by the grantor's son, acting through a power of attorney. The lawyer who drafted the power of attorney drafted the trust and acted as a co-trustee of the trust as well as an "investment advisor." The trustees, when charged for breaching fiduciary duties, sought to rely on a trust provision that would hold them liable only for "bad faith ...intentional misconduct, or reckless indifference to the interest of [the] beneficiaries." Upon these facts, the lower court and appellate court had little difficulty concluding that "it would be inequity to allow the trustees to hold themselves to such a low standard."

In certain circumstances express trust language will protect a trustee who fails to diversify. In *Americans for the Arts v. Nat'l City Bank of Indiana*,855 NE2d 592 (Ind. App., 2006), trans. denied 2007, National City Bank of Indiana created an estate plan, by court order, for the sole surviving great-grandchild of Eli Lilly who was incapacitated at the time. At the time that Ruth Lilly became incapacitated, her estate plan, which disposed of over $1 billion, was complex and inefficient, likely to result in both litigation and a great deal of estate tax liability. The Bank, after involving numerous interested parties and their counsel, petitioned the court to establish a new estate plan, a significant portion of which included the creation of two testamentary CRATs. Paragraph 10(b) of both CRATs granted to the trustee the power:

> *"[t]o retain indefinitely any property received by the trustee and invest and reinvest the trust property in stocks, bonds, mortgages, notes, shares of stock of regulated investment companies or other property of any kind, real or personal, . . . and any investment made or retained by the trustee in good faith shall be proper despite any resulting risk or lack of diversification or marketability and although not of a kind considered by law suitable for trust investments."*

Upon the decedent's death, the CRATs were funded with about $286 million of Eli Lilly stock. Within 3 months of funding the trustee prepared a draft investment plan for the CRATs. Significant amounts of the stock were sold within seven months of funding, and within ten months most of the stock had been sold. Unfortunately, during that time, the value of the stock had dropped significantly.

When the trustee petitioned for approval of its accountings, the charitable beneficiaries objected, claiming the trustee had breached its fiduciary duty by allowing the value of the stock to drop as a result of the delay in selling the stock. The trustee contended that the trust language exculpated it from any liability as a result of its failure to diversify timely. The court considered the extensive level of review during the drafting process of the CRATS. Finding no evidence of abuse, self-dealing or bad faith, the court held that the language of the trust was sufficient to override the general duty to diversify.

Should Large Concentrations Be Hedged?

Many families have large concentrations in securities that are highly appreciated and may also have sentimental value to the family. Such positions present real financial risks and also create significant liability for a trustee if the concentration is held in trust.

There are alternatives other than an outright sale of the stock to help alleviate the host of concerns associated with a concentrated position. Derivatives often can be used to mitigate the effects of an investment portfolio that has an overconcentration in a particular stock.

A structure can often be designed to both protect and diversify concentrated positions. These strategies can range from basic options strategies, such as covered call writing, to hedging structures like a variable forward or equity collar.

Determining Appropriate Distribution levels

The trustee ultimately must determine the intent of the grantor, select and monitor trust investments, and allocate the return from the investments in a manner that balances the competing interests of successive beneficiaries. The discretionary judgements involved in each of these responsibilities are rarely capable of perfect resolution. For as long as trusts have existed, there have been legal disputes regarding the amount of distributions. In *Graninger v. Nat'l City Bank of Indiana,* 849 NE2d 1191 (Ind. App., 2006), the grantor established 2 trusts for the benefit of his wife. The wife was entitiled to all income and had an annual "five-and-five power". Additionally, the trustee had the following discretionary power:

> *Whenever the trustee determines that the income of [wife], from all sources known to the trustee, is not sufficient for her reasonable health, support, and maintenance, the trustee shall pay to her such sums as the Trustee determines to be required for those purposes from the principal of the trust. In the exercise of its discretion, the Trustee shall be concerned primarily with the support, health and maintenance [of] wife during her lifetime, according to the standard of living which she and I enjoyed before my death or according to her actual needs. In addition, prior to distribution of any principal of the trust under this section, my trustee shall also consider the extent to which funds would be available to my wife to meet her support, maintenance and health needs by the use of her power of withdrawal and the amount of those funds still available to her which have previously been withdrawn which could meet those needs but such consideration shall not be absolutely determinative of the exercise of the trustee's discretion.*

The remainder beneficiaries of the trusts are the grantor's daughters from a prior marriage. The wife fell into ill health after the grantor's death. Her in-home health care expenses exceeded $10,000 per month. The wife was regularly withdrawing between $4,500 and $5,000 per month from a combination of trust income and five-and-five power withdrawals. The then current husband of the grantor's wife asked the trustee to "guarantee that the 5 & 5 distribution would not affect the $4,500 monthly amount paid to" the wife. Because the trust accounting income was insufficient to pay out $4,500 per month without significantly invading principal, the trustee considered whether it should make discretionary distributions from principal.

The trustee's denied the request for discretionary principal distributions. In determining not to make a distribution, the trustee considered the following facts. First, the wife had income of $141,923 in the year she requested a distribution. Second, the wife had undertaken an extensive gift-giving program, some of which had come from her personal funds. Third, the trustee looked at alternative health care arrangements. Finally, the trustee considered the fact that the wife's marriage to the decedent was a second marriage, and the remainder beneficiaries were the decedent's children from a prior marriage. The trustee then filed a petition seeking court instruction regarding the payments of principal to the wife. After reviewing the facts, the court held that the trustee had not abused its discretion in denying the wife's requests for discretionary distributions.

This decision simply underscores the need for very clear, unambiguous drafting of trust discretionary distribution provisions.

Favoring Certain Beneficiaries / Conflict of Interest

The decision of the Georgia Court of Appeals in *SunTrust Bank v. Merritt*, 612 SE2d 818 (2005), is typical of many cases involving the competing interests of income and remainder beneficiaries. In this case, the remainder beneficiaries filed suit against one of the trustees, alleging a breach of fiduciary duty by favoring the interest of the income beneficiary over that of the remaindermen and seeking compensatory damages, punitive damages and attorneys fees Martha Hynds left the bulk of her estate to be divided among 3 trusts. Each trust provided for income for life to one of her 3 children with the remainder passing to the next generation. The income beneficiary served as co-trustee. William Merritt, co-trustee and income beneficiary, attempted to maximize his income by investing trust assets in tax-free investments and dissuaded the co-trustee bank from investing in higher risk investments.

Each of the 3 trusts was funded with approximately $675,000. Upon William's death, the trust was worth approximately $732,000. His sisters trusts, which had been invested almost exclusively in stocks, had more than trebled in value. On appeal, the court of appeals affirmed in part and reversed in part. The appellate court held that the defendant's investment decisions did not improperly favor the interest of the income beneficiary over that of the remainder beneficiaries. More specifically, the appellate court found that the duty owed to the remainder beneficiaries was to "preserve and protect—not increase—the corpus of the trust."

In *Estate of Wallens*, 877 N.E. 2d 960 (N.Y. 2007), the court imposed conflict of interest restrictions on a trustee/father. Burton Wallens established a testamentary trust for the benefit of his granddaughter Maggie. Maggie's father was a co-trustee of Maggie's trust. Under the terms of a divorce settlement, the trustee/father was obligated to provide for private elementary and secondary school tuition and medical expenses for his minor child. The trustee began to use trust funds for school tuition and medical expenses. It was not until his child went to college that he sought court authorization for the use of trust assets. The Court of Appeals noted that even though the trust instrument gave the trustee broad discretion to make decisions regarding the distribution of trust funds, the trustee is still required to act reasonably and in good faith in attempting to carry out the terms of the trust. The case was remanded to the Surrogate's Court for a hearing to determine whether the expenditures were authorized in good faith and in furtherance of the beneficiary's interests.

In *Matter of Revocable Trust of Margolis*, 731 N.W. 2d. 539 , (Minn. App. 2007), the court followed *Wallens* in finding potential liability for a trustee who used funds from a trust established by his wife to pay for her nursing home care, in the face of a Minnesota statute which barred such use of trust funds to discharge "*any* legal support or other obligations of the trustee to *any* person." This was a second marriage, with the trustee having children from a prior marriage. Hence there was a conflict in using the spouse's trust funds to discharge the trustee's obligation to provide support to his wife. The Court found that "the record indicates that respondent co-mingled trust funds with his own funds, failed to keep the beneficiaries reasonably informed of material facts, refused to respond to appellant's requests for information, and failed to maintain an accurate accounting of his management of the trust funds. The case was remanded for findings on the breach of trust.

Disclosure

In *First Union National Bank v. Turney*, 824 So. 2d 172 (Fla. App 2001), *rev. den.* 828 So.2d 385 (Fla., 2002) the court dealt with the duty of a trustee to disclose material facts. Even where the terms of the trust may attempt to limit a fiduciary duty, such as the obligation to disclose material facts, the courts may nonetheless apply such duty to the fiduciary. In *Matter of Gustafson Revocable Living Trust*, 2007 WL 4248561 (Mich. App. Dec. 4, 2007), the court ordered a trustee to account to a beneficiary and provide a copy of the relevant portions of the trust, despite language in the trust eliminating a duty to account to income beneficiaries. The Court held that "'a trust provision relieving the trustee of the duty to keep formal accounts does not abrogate the statutory duty to account to the beneficiaries in the probate court.' *In re Childress Trust*, 194 Mich. App. 319, 327028; 486 N.W. 2d 141 (1992)." 2007 WL4248561 at *2. The *Childress* court had held that "Although the terms of the trust may regulate the amount of information that the trustee must give and the frequency with which it must be given, the beneficiary is always entitled to such information as is reasonably necessary to enable him to enforce his rights under the trust or to prevent or redress a breach of trust. A similar result was had in *Matter of Kornrich*, 854 N.Y.S. 2d 293, (Sur. 2008) where the trustee claimed the trust language excused him from accounting during the term of the trust: The court would not excuse the accounting recognizing that accountability is an essential element of all fiduciary relationships which cannot be waived.

PROCEDURAL PRUDENCE

Many of the recent fiduciary litigation cases could have been prevented by careful attention to the duties of the trustees with regard to investments and the terms of the document. Establishing procedures and protocol to review the terms of the document, determine the risk tolerance and needs of the beneficiaries is critical to minimizing litigation risk.

The conduct of fiduciaries is often evaluated based on whether the trustee has complied wwith the terms of the document and whether the trustee has exercised discretion in a prudent fashion. The Restatements, Third, of Trusts makes it clear that a trust, its terms and its administration, must be for the benefit of its beneficiaries. This provision places the emphasis on the needs of the beneficiaries.

Regular review and monitoring of the status of current investments and their continued suitability in light of the changing needs and risk tolerance of the beneficiaries is critical.

In a number of cases the courts found breaches of trust based on the failure of the trustees to establish and implement procedures to comply with their duties and document their decisions. Theses cases highlight the steps a prudent trustee should take in administering a trust.

Initial Analysis

The trustee should review the terms of the trust to determine the scope and extent of duties. Trust holdings should be reviewed. In *Dumont*, the court found that the trustee had breached its duties where during the first 3 years of the trust's management, "there are no copies of correspondence, no copies of review forms, no internal memorandum regarding the trust's terms, no documentation whatsoever as to the investment strategy of the trust of the performance of Eastman Kodak..

Determination of Trust Terms

Where the trust document contains restrictions on investment discretion, procedures must be established to obtain a proper construction of the scope and effect of such terms. Continued review of the propriety of the direction is strongly advised.

Review of Trust for Easily Identfiable Impediments

In *Hatleberg v. Norwest Bank Wisconsin*, 700 N.W. 2d 15 (Wis. 2005) the courts found the trustee negligent for failing to warn the grantor regarding readily identifiable impediments or pitfalls that would thwart the grantor's intent. Phyllis Erickson, created an irrevocable inter vivos trust. The trust was supposed to have been structured so as to give the trust beneficiaries present interest gifts, thereby qualifying the gifts for the gift tax annual exclusion. For 11 years after its establishment, Phyllis made deposits of $40,000 ($10,000 for each of four family members) annually into the irrevocable trust. After Erickson's death in 1998, it came to light that the trust was, as the court put it, "defective in that it did not contain `*Crummey* provisions.'"

Three years after the trust was established, the vice-president and trust officer at the bank noted the absence of the "*Crummey* provisions" in the trust and immediately notified the drafter of the trust. The drafter responded by saying that he thought the trust provisions were adequate, that it was "too late to add" anything, and that he thought the trust was "completely funded." Neither the drafter nor the bank trust officer notified the grantor of their concerns. The trust officer continued to advise the grantor to keep making contributions to the trust, noting in a letter that "for estate tax purposes, it makes sense to do the gifts." Upon Phyllis's death, the defect was discovered, and the estate incurred additional estate tax liability because the gifts made by Phyllis during her lifetime to the trust had not qualified for the annual exclusion. The estate ended up paying some $173,644 in additional estate taxes. The claim against the drafting lawyer was settled for $173,000, and the case proceeded against the bank. The lower court held the bank liable for negligence, and the intermediate court of appeals affirmed. A unanimous Wisconsin Supreme Court decision affirmed the lower courts' ruling.

Care should be taken to assure that the services promised by the trustee do not involve review of the documents for tax defects.

Need for Defined Procedures to Determine and Review Construction of Ambiguous Terms

The *Dumont* court held that "the second problem with the bank's approach is that within its own internal structure, it did not clearly specify whose job it was to handle questions of document imterpretations on management directives . . . it is still not clear whose job it was to interpret Dumont's exception phrase, apparently the bank had holes in its personnel coverage of duties as well as an imperfect review procedure." *Dumont, supra,* at 13. A document review should be completed by someone with the experience and training to interpret ambiguous terms. Procedures should be adopted to review initial decisions to avoid issues of procedural imprudence. Court action may be appropriate when the document provides direction to the trustee that seems at odds with the grantor's intent. If the grantor is living, a simple trust amendment may clarify intentions or resolve inconsistencies. Look to rules of construction and document in writing any research done and why a particular conclusion was reached..

Investigation of Risk Tolerance and Financial Needs of Beneficiaries

In *Saxton*, the court discussed the duty of the trustee to educate the beneficiary, whose naïve view of risk or affection for a family company has led them to approve concentrations which are objectively too risky for their circumstances.

Fiduciary liability was also found in *Scheidmantel*, where the trustee did not investigate the circumstances of the income beneficiary when he was in critical condition in a hospital. The trustee should be aware of those factual circumstances by making inquiry with reasonable frequency and at reasonable intervals concerning the needs of the beneficiaries.

Failure to Document Decisions

The complete lack of documentation may in and of itself be a breach of trust.

In *Hartman v. Walker*, 73 Va. Cir. 245, 2007 VA. Cir. LEXIS 212 (Va.Cir. Apr. 5, 2007), the court denied a demurrer to objections by an income beneficiary that the trustee had failed to make the trust property productive by responding to an offer from a third party to purchase unproductive land held in a partnership and company owned by the trust, as well as objections alleging the trustees' "failure to diversify the investments of the Hartman Trust and their lack of impartiality towards the various Trust beneficiaries." The court identified procedural steps which a trustee is obligated to undertake in making decisions on diversification, noting the trustee's alleged failure to inform the beneficiaries of offers to purchase the unproductive land.

CONCLUSIONS

Although every situation is different, trustees can arrive at some general conclusions:

- ✓ **Read the document.** Review all governing instruments for potential liability issues. If a document is vague, ambiguous, or requires the trustee to deviate from the typical fiduciary standards, supplemental written agreements or indemnifications may be warranted. Identify contradictions. Look beyond the "boilerplate" for signs of grantor intent. Discuss interpretation of complex formulas with all involved parties.
- ✓ **Gain an understanding of the "soft side" of trust administration.** A fiduciary should have sufficient facts about the grantor and beneficiaries. A family tree is a helpful tool to identify parties and relationships. Beneficiaries who are minors or who are under other legal disabilities should be identified. It is important to gain an understanding of family (and non-traditional family) relationships, financial resources and needs.
- ✓ **Delegate.** Use professionals (lawyers, accountants, investment managers, valuation specialists, etc) in areas where special skills may be required. Set guidelines, monitor and review.
- ✓ **Look at the whole picture**. The duty to diversify is not mandatory, it is merely a default. Particular circumstances such as the age or economic condition of one or more of the beneficiaries, the length of the trust term, specific provisions in the trust agreement or the relationship of the assets to the grantor or the beneficiaries can permit a deviation from the duty to diversify. If the investment strategy set forth in the trust instrument is questionable in light of the facts and circumstances surrounding the concentrated position, the beneficiary's needs and the trust purposes, the trustee should take action to make sure it is acting in compliance with its duties, as the beneficiaries and the courts would expect.
- ✓ **Take necessary action.** Inertia can be dangerous. Certain actions must be taken within specific time windows.
- ✓ **Document and communicate rationale behind decisions.** The trustee should create a record of the basis for decisions. Communicate with the beneficiaries – information should be both incoming and outgoing. In certain cases, consider obtaining releases or indemnifications from the beneficiaries.
- ✓ **Manage Risks and Document Beneficiary Agreements.** Disagreements between trustees and beneficiaries are inevitable. Look to the language of the trust for "exculpatory provisions", but always act in good faith. Obtain consent or ratification of actions. Disclose all material aspects of the transaction for which consent is desired.
- ✓ **If a beneficiary requests certain action or complains about an action, take steps to remedy the problem.** The trustee may want to seek the guidance of the courts as to whether it must follow the direction of the trust instrument or whether it should invest according to a different standard.
- ✓ **Touch base with the beneficiaries. Understand risk tolerance.** Regular communication with beneficiaries can prevent many disagreements between beneficiaries and trustees. The trustee should present to the beneficiaries its written policy investment statement if it includes the possibility of holding an undiversified position in any particular asset.
- ✓ **When dealing with a trust instrument that gives express instruction regarding trust investments, monitor that investment portfolio *even more carefully* than a trustee subject to the default statutory provisions and using a standard investment mix.** A trustee with investment directions in a governing instrument should be careful to ensure the trustee understands terms like "compelling reason" and documents the monitoring of

the concentrated position as it relates to the market in general. Investigate options and alternatives.

- ✓ If the trust agreement requires retention of a concentrated position, or the facts indicate that retention may be in the best interests of the beneficiaries, **consider whether some hedging technique is available and appropriate.**
- ✓ **Establish prudent procedures and review protocols and provide a record which will support actions.** Be particularly careful to document anything unusual.

Drafting suggestions

- ✓ **Manage Risks.** Several aspects of the problems of conflict of interest and risk of liability can be addressed through drafting.
- ✓ **Exculpation clauses and investment direction clauses are not absolute shields.** Such provisions will be strictly construed against the trustee and in favor of diversification.
- ✓ **Language indicating grantor intent is valuable.** A statement favoring a particular beneficiary or class of beneficiaries, or a statement regarding the importance of a particular asset, can be highly instructive and can reinforce the exculpation and investment direction provisions. If non-diversification is a goal, the parties responsible for the drafting should have the drafting process well-documented (with notes or a memo detailing the conversation with the client and what the client intended with the clause) in order to firmly establish the grantor's clear intent.
- ✓ **Terms that merely authorize a trustee to retain a particular asset are completely ineffective as a defense in failure to diversify cases,** both under the Restatement and under the cases discussed above.