ADVANCED MARKETING
ACTIVATOR

APRIL 2003

THE (NOT SO CLEAR BUT CERTAINLY PRESENT) DANGERS OF TRUSTEESHIP

Introduction

Trustees assume awesome responsibilities. Many people agree to serve as trustees without fully understanding the scope or nature of the services they must perform, or the extent of their exposure to potential litigation and/or personal liability. In certain instances, the trustees' personal funds/assets may be at risk because of actions (or inactions) on their part. Sometimes, even if their actions are proven correct (such as in the event of a lawsuit), their right to reimbursement for the significant cost of defending themselves may be limited.

If the trustee does something that is improper or fails to do something the trustee is properly required to do, and the action (or inaction) causes the beneficiaries of the trust to lose money or suffer damages, the trustee can be "surcharged." This means the trustee is required to make up the loss (or damage) to the beneficiary out of the trustee's own assets.

Keep reading and you will understand how a trustee may unknowingly (and inadvertently) become personally liable, as well as some of the tools or techniques available to eliminate - or at least reduce - his/her risks of exposure.

The topics presented are:

- The duties of a trustee.
- The fiduciary guidelines a trustee must follow.
- The "Prudent Man" rule (the traditional view).
- Problems with the traditional "Prudent Man" rule.
- The "Prudent Investor" rule.
- The implications of a trustee's breach of fiduciary duty.
- The trustee's liability in managing a family or closely-held business.
- Why constant communication with trust beneficiaries is essential.
- The importance of acting in a timely manner.
- A trustee's potential personal liability to third parties.
- Joint liability in the case of multiple trustees.
- Environmental liability concerns to trustees.
- Ways a trustee can avoid or reduce the risks of lawsuits and liability.

TRUSTEE'S DUTIES

A trustee has – among others – the following (sometimes simultaneously executable) key duties:

First, the trustee must take possession of, and assemble the trust assets. If the trust consists of a bank account or the proceeds of a mutual fund, this will typically present no major problem. But the trustee's task can be extremely difficult if the trust estate consists mainly of assets such as one or more closely-held businesses, or widely-scattered (and/or diverse) real estate investments/holdings.

Second, the trustee must immediately assure that the trust's assets are adequately and properly protected. Are the locks changed on the house? Are there adequate amounts and appropriate types of fire and casualty insurance on trust property? Are valuable collectibles such as art, stamp, coin, or gun collections insured and physically secured against theft or casualty loss?

Third, a trustee must properly invest trust assets. This requires that trust assets be invested and used in the best interest of the beneficiaries with due respect for the directions and intent of the grantor. Among the many questions that must be asked in this regard are: Are trust assets invested in risky stocks that should be sold? Is all or a substantial portion of the money in a non-interest-bearing checking account? Should a closely-held business or business interest be sold?

Fourth, the trustee must ascertain the situs (legal location) of the trust and begin to determine how the applicable state law impacts on the trust, its investment and dispositive provisions, as well as the relevant state and federal tax consequences.

Fifth, the trustee must inform the beneficiaries of the extent of their interests in the trust. Additionally, the trustee should continually communicate with the beneficiaries to ensure that they understand (and are informed of) the cash and/or asset inflow, outflow, and other relevant information and decisions that affect them.

Sixth, the trustee must comply with the necessary administration and record-keeping procedures, and make certain that state and federal income and other tax returns are timely filed.

Seventh, the trustee must prepare a final accounting when the trust is to be terminated and make a final distribution to the beneficiaries.

FIDUCIARY GUIDELINES

A trustee is a "fiduciary." As such, he, she, it, or they must act for the benefit of the trust beneficiaries – even if that duty is to the detriment of the trustee's own interest. Among the central principles identified in Court decisions and state statutes intended to guide the trustee in administering the trust are:

- Loyalty: The trustee must be loyal to the trust and the beneficiaries. So if an investment opportunity is communicated to the trustee in his capacity as trustee, he cannot take advantage of the investment opportunity for his personal profit but must make appropriate use of the opportunity for the benefit of the trust and its beneficiaries.

- Confidentiality: Confidentiality is an inherent part of loyalty. A trustee must never disclose information concerning the trust or its beneficiaries to party (or parties) with no legal interest in the trust.

- Avoidance of Self-Dealing: A trustee must not engage in any self-dealing with respect to the trust. A trustee should never (even at a "fair" price) buy any assets from the trust for his or her own benefit or sell any of his or her own assets to the trust, or otherwise profit from any transaction of the trust without the full knowledge and informed consent of all of the beneficiaries. The rule against self-dealing is so strict that a trustee can be penalized for self-dealing even if the transaction appears to be at arm's-length and there is no obvious profit to the trustee. Attorneys and accountants who serve as trustees are usually allowed to serve the trust in a professional capacity and charge fees for their services. But they must be very careful to document their time and charges, and may be prohibited from receiving both a trustee fee and a fee for professional services rendered.

- Separation of Assets: A trustee must keep all trust assets separate and must never co-mingle trust assets with personal assets or other non-trust assets. Trust money must never be deposited into a trustee's personal account, and trust investments must not be co-mingled with the trustee's personal investments. This is another rule that is strictly enforced to make sure that the trustee does not make any undisclosed or incidental profit from the trust.

- Avoidance of Conflict of Interest: A trustee must avoid conflicts of interest and situations in which the best interests of the trustee conflict with the best interests of the trust and its beneficiaries. For example, it would be a conflict of interest for a trustee to form a business that competes with a business owned by the trust. It would also be a conflict of interest to receive any referral fee, commission, finder's fee, or other compensation or consideration for employing the services of an outside party for the trust.

- Duty of Impartiality: The trustee has a duty of impartiality to the beneficiaries, and must treat each of them as equitably and fairly as possible. This clearly means, absent specific direction or exoneration in the trust document, a trustee cannot favor income beneficiaries over remainder beneficiaries in terms of investments, or vice versa. Nor can a trustee (who has discretion in making distributions to beneficiaries) arbitrarily distribute more money to one beneficiary and less to another.

A wise trustee will consult with a lawyer to avoid any penalties, criticisms, or litigation when there are doubts about whether an action is proper or appropriate, or if a breach of fiduciary duty has occurred.

THE PRUDENT MAN RULE

This rule requires a trustee to act prudently. In other words, a trustee has a duty to exercise care, diligence, and prudence in handling trust assets/properties. Specifically, these standards will be met if the trustee has acted with the same care and skill that a hypothetical prudent man or woman would exercise in his or her own affairs. Note, however, that professional trustees such as banks, trust companies, and attorneys are often deemed to have special skills or superior expertise and are, therefore, held by courts to an even higher standard.

Unlike an executor—whose principal duties are limited in scope (e.g., collect the assets of an estate, pay its debts and taxes, and make distributions to the beneficiaries), and time (usually measured in several years or less), a trustee's duties are much more complex and often extend over decades or even several generations. For instance, in order to decide how trust assets should be invested, (as opposed to estate assets), the trustee must consider all the different factors that affect the trust and its beneficiaries – including the time span over which trust assets are to be safeguarded and invested prior to distribution.

Let's say, Zada (Grand pop) Steve wants to leave $250,000 in trust for the benefit of his daughter, Charlee, during her lifetime, and distribute the balance in the trust to Charlee's sons Max and Aaron after her death. The trustee has to have an investment plan that can satisfy the needs and expectations of both classes of beneficiaries: Charlee will want an investment that will produce high income for her during her lifetime, but the long-term growth of trust assets will be important to Max and Aaron. Investing the funds in a safe government investment that pays a high current rate of interest might be the prudent way to proceed for Charlee's benefit; but it (generally) would not yield the highest long-term capital growth for the benefit of Max and Aaron.

A trustee has the duty to make the trust assets productive within the guidelines of the trust instrument and in accordance with the prudent man rule (currently applicable in some states). In most cases, it is the trustee's conduct, rather than the investment performance, that is judged by the courts. The trustee will be held personally liable only when lawsuits result from imprudent conduct, not when investment performance has not been as good as expected. (But typically, it is when investment performance is poor that the issue of the trustee's prudence arises and can lead the trust beneficiaries to take legal action against the trustee.)

PROBLEMS WITH THE PRUDENT MAN RULE AND TRUST INVESTMENTS

There have been several fundamental problems with the principles of the traditional "prudent man" rule vis-à-vis trust investments.

One of the problems stems from the courts' tendency to evaluate the trustee's prudence in terms of a particular investment and not the overall performance of all the investments held in the trust. This has prompted some trustees to make "middle of the road" or "safe" investment choices that are neither too safe nor too risky. By selecting these types of investments, the trustee can (hopefully) eliminate or minimize the potential risk of litigation with the beneficiaries, since there will likely be less complaints about the level of income (by the current beneficiaries), or the lack of growth or the loss of asset value (by the remainder beneficiaries). In reality, no one really wins, and the inevitable conflict between the different classes of beneficiaries with divergent needs and goals continues.

Conversely, under the modern portfolio theory and investment philosophy, the trustee attempts to achieve the overall investment objective of the trust through a "balanced" portfolio– made up of some dependable, low-risk investments and some high-return, high-risk investments. The exact investment/asset mix, to some extent, is predicated on the needs, goals and risk tolerance of the beneficiaries. Regardless of the investment mix, the portfolio is generally geared to provide the highest possible after-tax return and capital growth that is consistent with the investment and dispositive provisions of the trust and, last but not least, the grantor's risk-taking propensity.

Another problem with traditional measures of trustee responsibilities is the principle that the trustee's investment decisions cannot be delegated. The trustee cannot claim that he/she was following the advice of respected investment advisor – as an excuse if the investment decisions result in losses to the trust and its beneficiaries. In fact, reliance on investment advisor might be used as evidence that the trustee had failed to exercise independent judgment on behalf of trust beneficiaries.

Finally, many states have (or had) statutory lists of "fiduciary investments," some of which are limited by bonds backed by the full faith and credit of the federal government or the particular state or jurisdiction. The inevitable problem occurs where these "fiduciary investments" are often considered as too conservative for modern investors who are accustomed to the historically (but certainly not "currently") high yields from common stocks; yet, if the trustees deviate from these approved investments, they risk litigation with trust beneficiaries under the "prudent man" rule.

THE PRUDENT INVESTOR RULE

In response to the above and other problems with the traditional "prudent man" rule, the American Law Institute formulated a "prudent investor" rule. In the mid '90s, the Commissioners on Uniform State Laws recommended that each state adopt the Uniform Prudent Investor Act.

Here are some of the key principles and major changes made by the Uniform Prudent Investor Act (UPIA):

- The performance of the trustee is measured by all of the trust investments, taken as a whole, rather than by the performance of any one investment.

- It is expressly recognized that the trustee will evaluate and balance both risk and return in selecting investments. This means a risky investment can be justified by a higher expected return.

- No investment is automatically prohibited. Any investment can be defended as long as it is consistent with the overall investment risks and returns appropriate to the trust.

- Trustees, absent clear and specific trust language to the contrary, must diversify the trust's investments. So investing solely in federal securities can be criticized as much as investing in only the stock of one corporation (a frequent subject of litigation with beneficiaries).

- Delegation of investment decisions is permissible as long as the trustee selects the investment advisor carefully, provides guidance to the advisor in setting the investment goals for the trust, and monitors the performance of the advisor.

The Uniform Prudent Investor Act has been enacted in a number of states, and the courts in several other states have adopted the "prudent investor rule."

COST OF VIOLATING FIDUCIARY DUTY

A violation of – or failure to perform – any duty owed to the beneficiaries of the trust can make the trustee personally liable for any resulting damages. In other words, a beneficiary can recover in a lawsuit those values that he or she would have enjoyed had there been no breach of fiduciary duty or failure to act properly. For example, if the trustee sold a trust asset to himself or a close member of his or her family for less than its fair market value, the trustee would be personally liable to the trust for the difference. If the trustee permitted a large sum of money to remain un-invested or invested it at a lower than the "going rate," the trustee could be held liable for the loss of income to the beneficiaries when compared to a more productive—but still conservative—investment, such as a certificate of deposit, Treasury notes, or even a conservative investment in securities if such investment is permitted under the terms of the trust agreement.

FAMILY OR CLOSELY-HELD BUSINESS LIABILITY

Few trustees want to – or should – maintain a family or closely-owned business as a trust asset because of the difficulty, complexity, and risk associated with such an entity. Indeed, a family or closely-held business is usually one of the riskiest possible investments. Continuing to operate a business through the trust, and thereby putting all of the trust's financial "eggs" in one "basket," is a strategy often criticized by courts, and one that exposes the trustee to a significant risk of legal action by the beneficiaries and personal liability if the business fails or is less profitable than expected. And quite often, the very event of the business owner's (typically the grantor's) death will also trigger the demise or, in a best case scenario, cause considerable financial shock and harm to the continued success of the business. Similarly, a business which suffers from the death of its founder will often fail despite all of the trustee's good intentions and hard work. When there are family members who are active in the business and some who are not, tension and conflict with the trustee and among the various beneficiaries is almost inevitable.

The terms of the trust must be carefully examined. If the trust document specifically directs that the business be continued, or shows that the grantor clearly intended that the business be continued, the trustee is less likely to be liable for business losses.

To avoid being held liable for business losses, the trustee should regularly communicate with the beneficiaries of the trust and, whenever possible, secure their written permission before making any major decisions about managing or continuing the business. Documentation of the subject, nature, and time of any conversations or other communications is essential.

CONSTANT COMMUNICATION VITAL

In many instances, the underlying causes or proximate triggers of lawsuits against trustees relate directly or indirectly to the trustee's failure to communicate clearly, fully, and continually with the beneficiaries about potential problems. Beneficiaries who seek—but are unable to obtain—information about the assets and the management of the trust, whose anxieties or requests for information are ignored, and whose telephone calls, letters, or e-mails are not promptly answered, become frustrated and angry and are prime candidates for instituting a lawsuit against the trustee.

Conversely, if the beneficiaries are kept abreast of the day-to-day management and treatment of the trust assets, they are more likely to understand and feel a part of the entire trust process, and their predominant fear of having their interest from the trust reduced or terminated can be eliminated (or at least greatly alleviated). Also, if the beneficiaries are kept fully informed of the administration of the trust and fail to object to investment decisions or other actions of the trustee until a loss occurs, it is probable a court will find that they effectively consented to the actions of the trustee by failing to object in a timely fashion.

In those instances where the beneficiaries are legally capable of making decisions, the trustees would be well advised—even if the trust instrument does not call for it—to consult with them and, where appropriate, either obtain their permission or at least inform them in writing before making any major investment and other decisions.

TIMELINESS ESSENTIAL

Trusts, even more so than most other legal entities, have certain deadlines to meet. Depending on how the trust is structured, there can be several income tax returns to be prepared and filed. The trust may have its own state and federal income tax returns, informational returns may have to be provided for the beneficiaries to use in completing their tax returns, and accountings may be required for the beneficiaries and the court. In addition, there are always decisions to be made when handling investments or other assets, such as exercising certain stock options or filing tax returns for different businesses that are part of the trust estate. In many instances, failure to act timely can result in added interest and penalties, all of which can be surcharged to the trustee.

THIRD PARTY EXPOSURE

Many trustees understand that they can be held personally liable to the beneficiaries of the trust for violating their fiduciary relationship. But few are aware that they also face personal liability for injuries or damage to third parties and also for contract claims of third parties that occur during the administration of the trust. The trustee's individual assets may also be at risk for payment of the injury or claim if the damage exceeds the assets of the estate or trust. For example, assume the trustee is operating an unincorporated pizza business as an asset of the trust Suppose the driver of the pizza delivery truck strikes and seriously injures someone, and the trustee has failed to keep the automobile insurance premiums up to date, or if the level of coverage is inadequate, the trustee can be held personally liable for the injuries to the injured person.

MULTIPLE TRUSTEES AND LIABILITY

In most instances, multiple trustees of a trust all share in the management of the trust assets, and are fully and jointly responsible for all of their actions. If one trustee does something improper, all of the trustees can be subject to liability, particularly if they failed to supervise the other trustee. Even if the trust document gives any of the trustees the right to make independent decisions, it is still possible for the co-trustee (or associate trustees) to be held jointly responsible for that decision.

ENVIRONMENTAL LIABILITY

Trustees have potential liability for environmental damages, cleanup costs, and penalties for properties which they hold as trustees. The Comprehensive Environmental Response Compensation and Liability Act of 1980 (CERCLA), better known as the "Superfund Act," was enacted by Congress to provide a response system for cleaning up hazardous waste sites. Under CERCLA, the "owner" of a property can be liable for the clean-up costs of environmentally polluted property, and trustees have been ruled to be "owners" for the purpose of the Act. If the trust assets are insufficient to pay for the costs of clean-up (which can be tens or hundreds of thousands of dollars, if not millions of dollars, for spills or leakage of chemicals as common as fuel oil, lubricants, or even ink), the trustee may have to make up the difference out of his or her own pocket.

Recent legislation limits the personal liability of trustees and other fiduciaries for contamination that occurred before the property was placed in trust, or before the trustee became trustee. However, trustees still face almost unlimited personal liability for contamination that occurs while the property is controlled by their trust. The assessment for liability can be "strict," that is, it can be made without regard to any negligence or other fault of the trustee. For example, assume a commercial property is an asset of a trust, and that there are storage tanks on the property and the tanks leak. The potential liability can be enormous; therefore, trustees must be extremely careful when accepting responsibility for any property. It would be necessary to thoroughly investigate the history of the property, determine how it is currently being used, and whether there are any possible (or potential) problems under any environmental law.

PROTECTIVE TOOLS AND TECHNIQUES

There are several ways to protect against personal liability as trustee:

- Before agreeing to act as trustee, review the terms of the trust agreement and make sure they are clearly defined and unambiguous. Request (or recommend) any changes that might be needed to clarify (and/or limit) duties and liabilities.

- Make certain the trust document allows a trustee to resign if future contingencies warrant doing so.

- Clarify (in writing) each trustee's responsibilities with respect to other trustees (if there are multiple trustees).

- Learn as much as possible about the nature of the trust assets, and the circumstances and expectations of trust beneficiaries.

- If there is potential environmental liability, request that the agreement be drafted or amended (if possible) to protect the trustees to the extent possible under federal and/or applicable state law.

- Keep careful records of every receipt and disbursement of the trust.

- Keep all trust assets separate from personal assets, and be sure that trust assets are always registered in the name of the trust or in the trustee's name (as trustee), and never in the name of the trustee personally.

- Obtain competent tax advice and be sure all necessary tax (and informational) returns are filed when due.

- Document all actions and decisions. If a disbursement is made to a beneficiary, make it by check or obtain a receipt. If a timely response is required, send it by certified mail. If discretion is exercised under the trust document to make an extraordinary distribution, explain the reason(s) for the distribution in a letter to the beneficiary.

- Do not buy or sell any asset from or to the trust, or allow any other transaction between the trust and the trustee personally (or any of the trustee's family members, friends, or any business in which the trustee has an interest). Avoid entering into any other transaction that might suggest a conflict of interest or an attempt to make a personal gain at the beneficiaries' expense.

- Obtain the written consent of all competent beneficiaries when making any major investment decision, or when selling (or changing the status of) a major trust asset.

- At the termination of a trustee's duties, a written release should be obtained from the beneficiaries. If there is any danger of liability to any potential beneficiary, creditor, or any other person, a formal accounting should be filed with the appropriate court and the trustee should request and receive a formal discharge.

- Retain a knowledgeable and experienced attorney to assist with trust matters, particularly in reviewing the trust document, preparing any releases, and providing some oversight in record-keeping, investments, and other decisions.

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