ArchBridge Family Office

Best Practices in Trust Administration for Individual Trustees

When the grantor of a trust selects a trustee, he commonly names a family member, friend, or trusted advisor. While it is quite an honor to be named trustee, the position also requires both a substantial amount of work and knowledge of a wide array of legal and investment matters. Often, newly named trustees have little or no experience in many of the areas in which a trustee is expected to function competently. Relative inexperience in the position, combined with the fact that fiduciary standards for trustees are among the highest standards of care legally imposed under any area of the law, may result in liability exposure beyond that with which the trustee is comfortable.

The purpose of this article is to highlight some best practices for trustees whose full-time job is something other than acting as a trustee and to assist such non-professional trustees in properly administering trusts and mitigating their liability exposure.

Best Practice #1 — Documentation

A familiar saying is that the three most important rules of real estate are "location, location, location." Similarly, the three most important rules of trusteeship are "documentation, documentation, documentation." Although trustees are not expected to guarantee perfect results, they are required to act with care, skill, and impartiality. It is important for trustees to have rational reasons for their decisions. Documentation is important because it substantiates the trustee's careful, rational, skillful, and impartial decision making, without which, decisions that seemed perfectly reasonable at the time of action may seem to have lacked judgment in retrospect. A trustee will almost never regret documenting a decision or communication but may well regret a lack of documentation.

Examples of decisions that should be thoroughly documented include: (a) distribution decisions; (b) decisions that set investment policy; (c) initiation or termination of investments and/or the hiring and firing of investment managers/funds; (d) principal and income allocations; (e) verbal communications with beneficiaries; and (f) decisions to hire experts or agents (investment managers, lawyers, accountants). The trustee should take every opportunity to document the best practices discussed below.

Best Practice #2 — Set an Investment Policy

In the past, trustees were governed by the "Prudent Man Rule," which held that trust investments were considered imprudent or prudent on an individual security basis. This led to trustees investing primarily in high-quality blue- chip stocks and investment-grade bonds and a focus merely on selecting high-quality individual investments.

The Prudent Man Rule was replaced by the "Prudent Investor Rule." the Prudent Investor Rule was created by the Uniform Prudent Investor Act, which was promulgated in 1994 by the National Conference of Commissioners on Uniform State Laws and has been enacted in at least some form by every state but Louisiana. The Prudent Investor Rule differs notably from the Prudent Man Rule in that the new standard dispenses with the concept of inherently prudent or imprudent types of investments. Instead, the trustee is expected to establish an investment policy that appropriately balances the risk and return objectives for the trust's investments. Thus, the main consideration for trustees under the Prudent Investor Rule is the tradeoff between risk and return for the entire portfolio of assets owned by the trust.

At the heart of the Prudent Investor Rule is "asset allocation." the old standard of investing in 60% blue-chip stocks and 40% investment-grade bonds is now outdated. A modern asset allocation typically will include many more types of investments, such as international stocks, small company stocks, real assets, and various types of alternative assets. The objective is to construct a portfolio of asset types that are not highly correlated to one another (meaning that the values of different asset types do not move in lockstep with one another). Note the two portfolios displayed in the right column. The more diversified portfolio on the bottom has both a higher return and lower volatility than the traditional portfolio on the top. Lower volatility is achieved even though the asset classes added to the more diversified portfolio are mostly higher volatility assets: commodities, Reits, small cap stocks, and emerging markets stocks. The only lower volatility asset added to the more diversified portfolio is equity market neutral hedge funds.

Thus, the trustee should: (a) determine the risk and return objectives for the trust assets based on factors that are set out in the Prudent Investor Rule statutes; (b) document these objectives and set an appropriate asset allocation based on these objectives in a written investment policy; and (c) implement investments consistent with the allocation established in the investment policy.

Best Practice #3 — Delegate Investment Management

The Prudent Investor Rule reversed this non-delegation rule by providing that "a trustee has a duty to personally perform the responsibilities of trusteeship except as a prudent person might delegate those responsibilities to others."2 thus, if a trustee is not an expert investor, it is appropriate for the trustee to delegate investment authority to an expert investment manager.

A delegation of investment management changes the scope of the trustee's liability from full fiduciary liability for the trust's investments to merely having liability for the process of investment manager selection and monitoring as well as setting the investment goals and objectives (growth, income, cash flow needs). Accordingly, most of the fiduciary liability for the investment of trust assets is shifted from the trustee to the investment manager. In order to execute an effective delegation, there must be a delegation agreement with the investment manager whereby the investment manager accepts the terms of the delegation and undertakes the trustee's responsibility and liability for investment of the trust's assets.

Best Practice #4 — Properly Account for Principal and Income

Trusts often have differing requirements and standards for distribution of income as compared to principal, and it is not unusual for income to be distributable to the current beneficiaries while the principal is to be held

for the remainder beneficiaries. In these situations, it is imperative that the trustee correctly account for trust income and trust principal. To do otherwise could result in incorrect amounts going to the beneficiaries with resulting liability exposure for the trustee.

An important and often confusing aspect of principal and income accounting is that "trust accounting income" is a distinct concept from that of "taxable income" and often the two differ significantly. the area with perhaps the greatest potential pitfall is where a trust owns interests in estate planning entities such as family limited partnerships ("FLPs"), limited liability companies ("LLCs"), and S corporations. Even though FLPs, LLCs, and S corporations have pass-through income for tax purposes, only non-liquidating distributions from such entities are income items for trust accounting purposes (and there are exceptions to that rule). Thus, an FLP that has $100,000 of income and dividends but pays out no distributions will yield zero trust accounting income for a trust that owns those partnership units, but the trust will have taxable income equal to its proportionate ownership share of the
$100,000 of income.

The simplest way to correctly account for trust accounting income is to have the trust assets held by a custodian with a principal and income accounting system. Note, however, that use of an automated principal and income accounting system doesn't solve the problem entirely. Such systems are not automatic; they rely on instructions from users. Thus, the trustee still must understand and apply the principal and income rules correctly. For a trustee unfamiliar with principal and income accounting, it is advisable to periodically consult with a lawyer or other advisor who is familiar with principal and income accounting and request review of the allocations made by the trustee.

Best Practice #5 — Invest for Total Return

Traditionally, trusts have been designed in such a way that current beneficiaries may live off the income while principal is preserved for remaindermen. This has commonly led to the situation where the needs of the current beneficiaries (who want income) are at odds with the needs of the remainder beneficiaries (who want growth of principal). As a result of the trustee's duty of impartiality and the difficult task of investing both for growth and income, many traditional trust portfolios have ended up resembling the aforementioned 60% blue-chip stocks and 40% bond portfolio. Such portfolios are likely providing sub-par performance for the level of overall portfolio risk as shown in the charts under Best Practice #2.

If the trustee invests for total return by adding investments like small company stocks, emerging markets, hedge funds, and commodities, the amount of income for the current beneficiaries likely will decline despite an overall increase in growth.

Fortunately, this problem of investing for total return was addressed by a new Uniform Principal and Income Act, which was promulgated in 1997 by the National Conference of Commissioners on Uniform State Laws and has been enacted in 44 states. the new act provides trustees with broad power to make adjustments between income and principal.3 this allows a trustee to invest for total return and supplement the income of a low yielding portfolio with principal (even if discretionary principal distributions are not allowed by the trust document).

Trustees may adopt a policy of distributing a level of income equal to a percentage of the underlying trust

assets. For example, our firm is the trustee of a number of trusts where we distribute 3.5% of the average value of the trust assets over the prior three years. We allocate principal to income each year, as needed, in order to achieve our 3.5% payout policy. This smooths out distributions and better allows the beneficiaries to manage their cash flow. Before taking action, the trustee (or legal counsel) must determine that the trust and the particular circumstances justify such a policy of allocating principal to income under the trust document and the relevant state's principal and income act allows it. If the trustee adopts a policy of allocating principal to income to achieve income distributions equal to a percentage of trust assets, the liability with respect to making correct principal and income allocations as discussed in Best Practice #4 should be reduced.

Best Practice #6 — Understand the Distribution Standards

The trust document typically provides standards for determining distributions. The standards span the spectrum from objective (a fixed-dollar payout) to subjective (payouts as the trustee sees fit), with the trustee's level of discretion following the same line. In addition, specific terms used in distribution standards carry with them certain meaning and legal rights for a beneficiary. For example, a provision that the trustee make distributions for the beneficiary's "support" is materially different from one that provides for distributions for the beneficiary's "comfort." the former is an "ascertainable standard" and may give a beneficiary the legal right to force the trustee to make distributions. By contrast, the more subjective comfort standard greatly limits the beneficiary's ability to force distributions

Thus, the factors a trustee must consider under different standards may differ widely. For a trustee unfamiliar with the legal implications of various distribution standards, a lawyer can provide the trustee with direction regarding the meaning of these terms and the factors to consider in making distributions. Another related issue is whether the trustee should consider the beneficiaries' other assets in applying the distribution standards. Again, it is advisable for a lawyer to provide the trustee with guidance on this issue based on the terms of the trust document and the default state law.

Best Practice #7 — Keep Beneficiaries Appropriately Informed

The trustee has a fundamental duty to keep the beneficiaries reasonably informed of the administration of the trust. In addition, some states have adopted the recently promulgated Uniform trust Code with statutory requirements relating to the disclosure of information to various classes of beneficiaries. Failure to keep the beneficiaries reasonably informed can expose the trustee to liability.

Keeping beneficiaries informed may also benefit the trustee, as many states provide favorable statutes of limitations for claims against the trustee if certain disclosures are made to the beneficiaries along with a statement informing them of the applicable limitations period.

Best Practice #8 — Avoid Conflicts of Interest

Another fundamental duty of a trustee is the duty of loyalty. Essentially, this means that the trustee should avoid conflicts of interest between the trustee's own interests and those of the beneficiaries. The trustee should not enter into any transactions on behalf of the trust from which the trustee would personally profit. The trustee should also act to avoid even the mere appearance of impropriety.

Commonly this problem occurs where the individual trustee is providing services to the trust in a capacity other than as trustee, or where the trustee has a financial interest in a firm that provides services to the trust. The topic of conflicts of interest is one with many detailed rules and exceptions. In all cases, the best practice is for the trustee to consult legal counsel when even a hint of a conflict of interest arises. This area of law can be fraught with liability for the trustee, and both the trust and the trustee are best served when the trustee seeks legal assistance to address any potential problems at the outset.

Conclusion

Serving as a trustee requires a wide range of knowledge in a number of different areas and carries with it substantial risk of potential liability. Following the best practices discussed above will help an individual trustee mitigate liability and will likely generate better results for the beneficiaries.

ArchBridge Family Office is an independent, multi-family office and trust company that advises 65 clients on more than $13 billion of investment assets and more than $16 billion of total wealth. Founded in 2002, ArchBridge Family Office provides holistic, high-touch client service including customized, independent investment management and a full range of family office and fiduciary services. The firm serves a limited number of clients with substantial wealth in order to maintain very low client-to-employee ratios. Visit archbridge.com to explore how the firm manages complexity with unmatched expertise and a Family, Forward focus.