DALLAS BAR ASSOCIATION

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WHAT IT MEANS TO BE A FIDUCIARY

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Overview

- Trustees are the stewards of the grantor's legacy
- They are required by law to fulfill the wishes of the grantor who set up the trust, to invest responsibly, and to always put the needs of the trust and its beneficiaries above their own
- But serving as a trustee is increasingly risky
  - Beneficiaries have discovered that the courts are a place where they can seek redress for actual or perceived wrongs
  - Even conservative and cautious trustees can stumble over the execution of their fiduciary duties when dealing with real people and their complicated circumstances
- Keys:
  - Know the trust instrument
  - Know your core duties and responsibilities as a trustee
  - Following consistent processes for administration and decision-making often will lead to a better substantive result and not just liability mitigation (Need to go beyond policies and procedures manual)
  - Good communication with beneficiaries is absolutely critical
  - Involve all the right people and experts in decision-making
  - Learn when you have entered risky territory
  - Practice good risk management to avoid or at least mitigate future challenges

Good results are the product of a consistent and thoughtful process

Our agenda: What it means to be a trustee, with emphasis investment issues

Part I – The Role of a Trustee in Properly Administering Trusts (everything but investments)

- Accepting Trusteeship and Assuming Control of Trust Assets
- Performing Initial Administrative Functions
- Ongoing Administrative Duties
- Distributions and Discretionary Decision-Making
- Financial Duties to Beneficiaries
- Tax Matters
- Strict adherence to the Code of Trust Ethics

Part II – Key Issues Trustees Need to Know About Investing for Trusts

- Investment Risks Facing Trustees
- Prudent Investment Process
- Following the Governing Document
- Investment Objectives and Investment Policy Mandate
- Understanding Income v. Principal
- Planning and Managing Cash Distributions
- Prudent Investor Rule
- Self Dealing and Duty of Loyalty
- Trust Considerations for Alternative Investments
- Investing for Tax-Exempt Trusts
- Trust Regulations and Investment Documentation
- Trust Terminations
- Outsourcing
- Top Trust Investing Issues in the Current Environment

Part I: The Role of a Trustee in Properly Administering a Trust (Other than Investing)

Trustee accepts the trusteeship and assumes control of trust assets

- Analyze the governing instruments to establish records for each account and determine the parameters governing the exercise of discretionary powers granted to the trustee
  - Fiduciary litigation trends indicate that the courts are recognizing the importance of documentation and administrative review. Thus, it is increasingly important to conduct a thorough review of the trust document at the outset of the administration
  - It is also important to take action when the review leads to an issue or a problem (i.e., ambiguous terms may require clarification in court)
- Get acquainted with beneficiaries and perhaps grantor
- Become aware of any special needs or requirements of the beneficiaries
- Analyze trust assets to determine if any special protection is needed or identifiable problems are involved or even whether there are assets that should not be accepted
- Understand the tax status and issues of the trust (i.e., GST exempt? Grantor trust?)
- Analyze the potential risk factors (i.e. nature of assets such as concentrations, family dynamics, difficult trust terms, unrealistic expectations).

Perform initial administrative functions

- Take custody of trust assets
- Have assets titled to indicate trust ownership
- Get tax identification number from the IRS
- Open accounts for trust
- Review all contract and leases pertaining to trust assets
- Make a complete inventory of trust assets and establish the income tax basis and holding period of each asset
- Set up books of account for the trust
- Where necessary, arrange for bond. This usually only applies to individual trustee
- Place trust assets under constant supervision
  - A trustee has a duty to protect trust property against damage or destruction
  - The trustee has the right to make necessary expenditures to preserve trust property
  - Actively manage trust assets to preserve them
- Through trust counsel, arrange for court formalities as required

Ongoing Administrative Duties

- All fiduciary record keeping functions, in compliance with accounting and tax law standards
  - Including dual ledger income and principal accounting of receipts
- Record and allocate receipts and disbursements to principal and income, as required by applicable state Principal and Income Act and trust provisions (i.e. hedge funds distributions often received on principal ledger and later moved to income after reviewing K-1s and trust provisions).
- Continue to protect trust property
- Track cost basis of trust assets
- Communication reporting and regular meetings with beneficiaries
  - State law and governing instrument may limit class of beneficiaries entitled to information
- Communication and reporting to co-trustees
- Preparations and review of final accounting upon termination of trust
- Keep accurate records and accounts (courts have denied compensation for failure to keep accurate accounts)

Advice: Have a regular process for as many tasks as possible and document as many as possible, including communications with beneficiaries, co-trustees and other advisors

Distributions and discretionary decision-making

- Process non-discretionary distributions in manner that best suits the beneficiaries, within trust parameters
- Appropriate trust officer or distributions committee reviews all discretionary requests and determines whether to make distribution
- Factors to consider when exercising discretion (not exclusive):
  - What amount is requested? (From income? From principal?)
  - Who is requesting the funds and for what purpose(s)?
  - What documentation is provided? Is it sufficient?
  - What are the capital gains consequences?
  - What effect will the payment have on income?
  - Are outside resources of the beneficiary be considered and, if so, what are they?
  - Do you want or need more information?
  - What is the standard for exercising discretion in the trust?
  - Are there other beneficiaries? What are their interests?
  - Is there a co-trustee? Has he or she approved?
  - Is there a direct payment of tuition or medical expenses?
  - Is the trust GST protected? If so, is this the best source of funds?
  - Is the beneficiary a skip person?
  - The intent of the settlor, if known
  - The nature of the request for funds (purpose)
  - The size of the request compared to the value of the trust
  - The history of past requests and payments
  - The opinion of the co-trustee regarding the request
  - Any other relevant factors based on the distribution committee or trust officer’s knowledge of the situation including factors specific to the beneficiary’s location, community and station in life

Distributions and discretionary decision-making (cont’ d)

- Discretionary decision-making process **MUST** be documented
- “Sole discretion” trusts: Where the trustees are given “sole discretion” the general rule is that their determinations as to distributions cannot be upset unless they are unreasonable
  - The exercise of discretion by a trustee with “absolute discretion” to distribute income to wife and descendants who distributed to wife (even though she had sufficient assets) was held not to be an abuse of discretion (<u>In re Ledyard’ s Estate</u> (N.Y. Sur. Ct. 1939))
- Be fair and impartial: A trustee has a duty to deal impartially with all beneficiaries of a trust and to protect each of their interests
  - Rule applies whether interests are simultaneous or successive
  - Cannot favor one beneficiary over another unless trust provides otherwise (i.e. “Trustee may favor my spouse even if it depletes the trust corpus…”)

Advice: Do not turn into a mechanical perfunctory decision. Consider the elements and document your reasons for making or withholding a distribution

Financial duties to beneficiaries

- Consult with beneficiaries when planning expenditures
- Distribute income (under trust terms) to the beneficiaries; may involve discretionary distribution decisions (unless there is a distribution committee)
- Make principal distributions under trust terms to the beneficiaries; will involve discretionary distributions (unless there is a distribution committee)
- Deposit funds into the beneficiary's bank account
- Apply funds for the beneficiary's needs when the beneficiary is incapacitated or in ill health or advanced years (pursuant to the trust terms)
- Give written notice of withdrawal rights to beneficiaries where trust provides for these and effectuate the exercise of such rights
- Be strictly confidential with respect to trust affairs
- Be loyal and impartial to the beneficiaries
- Provide regular statements of income and principal

Trustees have financial duties to the beneficiaries in addition to managing their investments

Responsible for matters of taxation

- Part of the trustee' s duty to protect and preserve trust property is the responsibility to pay all taxes and assessments which may become liens against the property
- Determine appropriate tax strategies each year
- Monitor tax law changes and act quickly and effectively as changes become effective
- Consider trust situs issues and the potential impact on state taxation
- Pay all estimated taxes
- Prepare or oversee preparation of all tax returns for trust
- File all tax returns for trust
- Time sales and purchases of investments to minimize taxes to trust and beneficiaries
- Prepare and supply pertinent tax information to beneficiaries, co-trustees and other appropriate advisors
- Protest improper tax assessment
- Maintain detailed tax records

Adhere strictly to the code of trust ethics

- Be active in management
- Be diligent and skillful
- Consult with co-trustee, if any
- Be confidential on all trust matters
- Seek legal and other professional advice as needed
- Be guided by good faith and fair play
- Deal impartially with all beneficiaries and protect each of their interests
- Be alert to all danger signals
- Prevent all wrongdoings
- Supervise persons involved with the trust
- Do not be susceptible to undue influence
- Disclose pertinent information to beneficiaries – COMMUNICATE, COMMUNICATE, COMMUNICATE!
- Do not ignore conflicts (between the trustee and trust, the trustee and beneficiary, the trustee and third parties, or between beneficiaries)
- Fairness, disclosure of all facts and obtaining the beneficiaries consent or ratification are the best defenses

Part II: Key Issues Trustees Need to Know About Investing for Trusts

Prudent Investor Rule

The Uniform Prudent Investor Act effective Jan 1, 2004 – Makes major changes to old Prudent Man Rule, including:

•Trustees investment management is evaluated in light of the portfolio as a whole, rather than individual investments

•Invest trust assets in light of the portfolio as a whole

•Trustees must consider overall risk and return objectives

•Trustees may consider any type of property or investment as part of the overall portfolio even though the investment might be imprudent standing alone

•Diversification is the rule unless, under the circumstances, it is not prudent to do so

•Act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents

•Trustees have the duty to continue to monitor the suitability of existing and new investments and oversee managers

•May only incur costs that are appropriate and reasonable in relation to the investment responsibilities

Overview of prudent investment process

- Identify and take into account the specific investment powers in the trust and note any directions or restrictions (i.e., ability to retain asset x; no speculative investments)
- Within the parameters of the Prudent Investor Rule, adopt an investment policy for the trust that complies with the directions given and the needs of the beneficiaries and facilitates meeting of the trust's objectives
- Establish a sophisticated investment process that ensures that accounts are diversified and risk return objectives are established
- Maintain an investment balance designed to meet the current liquidity needs of the income beneficiaries while producing risk adjusted future growth for the remainder
- Maintain complete, accurate and detailed record of all income and expenses of all purchases, sales and other transactions of the trust
- Scrupulously avoid any act of self-dealing or conflict of interest
- Exercise a high degree of diligence and care in carrying out the terms of the trust, making investment decisions and in keeping the funds skillfully invested
- Establish formal guidelines for investment managers and maintain close supervision
- Maintain proper and adequate insurance on trust assets, as needed
- Manage cash including sweep functions
- Determine which assets require special skills to manage
- Manage special assets of trust, including closely-held business interests, real estate, farms and ranches, oil, gas and mineral interests or hire managers with specialized skills
  - Analyze financial and operating results of closely-held assets, in order to benchmark performance, react to material business change, and to make fully informed decisions as a shareholder or partner that are in the best interests of the beneficiaries

Overview of prudent investment process (cont’ d)

- Provide transactional guidance on illiquid assets, working with advisors on pre-and post-liquidity strategic and tax planning
- Monitor dividend receipts and corporate actions for stock held in each account
- Vote proxies on behalf of the trustees if requested
- Assist with buying, selling, managing or transferring real estates, as well as oversee construction, land development, marketing and leasing activities
- Provide hands-on supervision of livestock production, crop and timber production and wildlife management, using production practices based on a detailed resource analysis
- Manage oil, gas and mineral interests, including working, royalty and non-producing assets, as well as negotiate and grant leases

Overview of prudent investment process (cont’ d)

- Custody – Where are assets held
  - Equity manager
  - Hedge fund
  - Private Equity
- Accountability – Are the assets really there?
  - Can you rely on statements?
  - What does the trust own?
  - Who does due diligence on the managers before investing?
  - Who continues the due diligence process?

The trust agreement or will is the governing document

- Account type: irrevocable, revocable, charitable, non-profit, IRA, guardianship, etc.
- Beneficiary information: Current v. Remainder beneficiary? How many? Ages? Income needs? Tax residency? Other relevant information
- Review trust to determine whether there are any investment restrictions
- Determine who makes investment decisions?
  - Trustee with Sole/Full Authority
    - Communication about investment strategy and performance is critical
      - Revocable trusts – communicate with grantor
      - Irrevocable trusts – communicate with grantor (where living) and especially beneficiaries
    - Consider whether to honor requests to avoid sin stocks (gambling, tobacco, alcohol) and invest in socially responsible stocks (green companies) but be wary
  - Shared Authority (i.e., co-trustee)
    - Understand how decisions are made: equal authority, unanimous consent, 3rd party tiebreaker, majority rules, etc.
    - Have co-trustee consider delegating investment authority to trustee with greater experience or to an investment advisor
- Understand who else is involved in the relationship (receiving statements)?
  - Accountant
  - Attorney
  - Outside financial advisor
  - Charitable beneficiary board members
  - Outside committee named in trust
- For questions on the trust document – check with trust counsel and remember that each trust agreement is different

The investment objective and investment mandate—balance the interests of multiple beneficiaries

- The investment objective should reflect the trust instrument and the beneficiaries' needs taking into consideration:
  - Time horizon, risk tolerance, return expectations, liquidity needs, tax implications, unique circumstances, etc.
  - Invest for current income beneficiaries and remainder men
  - Trust may direct favoring one beneficiary over another; if not:
    - Balancing act—Income vs. Growth/Capital Appreciation
    - Need to be impartial to multiple beneficiaries - not favor one over the other
    - If conflict exists, consider a balanced portfolio approach
    - If local law permits, consider whether to convert income only trust to a Unitrust (permanent payout percentage set) or implement Power to Adjust "PTA" (annually adjustments between principal and income.) Both allow trustee to fulfill duty to impartiality

- Develop an investment mandate for each trust or investment policy statement for each foundation incorporating the investment objectives
  - Review the investment objectives and mandate annually
- Tax treatment of distributions impacts investment decisions
  - Tax-exempt income producing assets may not be appropriate for charitable trusts and private foundations because not taxable
  - Understand who pays the tax for income distributions:
    - Income beneficiary (if income distributed) vs. trust (if income accumulated)
    - What is the current beneficiary's/trust's federal tax bracket?
    - In what state does the current beneficiary/trust reside for state tax purposes?
    - Consider tax basis of trust assets in retention/sale decision
  - Understand who pays the tax for capital gains distributions

Income vs. Principal—Understanding Trust Accounting

- Need to separate principal and income – where there are current beneficiaries vs. remaindermen (fees usually split between principal and income; split may vary depending on jurisdiction). Called dual ledger accounting
- Understand restrictions on distributions from principal and income
  - Example: Before transferring principal to income to cover overdrafts, etc., must verify that the document allows for this type of transaction
- The Uniform Principal and Income Act, effective in Texas on January 1, 2004, also enabled the implementation of modern portfolio theory and total return philosophy:
  - Created greater flexibility to investment and distribution strategies
  - Allows income paying trust the "Power to Adjust" (allocating between income and principal to allow for fairness) or
  - "Unitrust" (pays out fixed percentage of market value to income beneficiaries)

Planning and Managing Cash Disbursements

Cash/Liquidity Management must consider numerous issues:

- Is income mandatory? If discretionary, is it likely that the beneficiary will request an income distribution?
  - Communicate with beneficiaries
- Are principal distributions allowed? If so, are any being made or are they likely to be requested?
  - Communicate with beneficiaries
- Are there sufficient cash reserves (Income and Principal)?
- Other upcoming cash needs?
  - Recurring discretionary payments
  - 5x5 power (the greater of $5,000 or 5% of the trust's total market value)
  - Withdrawal rights or disbursements based on age attainment
  - Large tax payments
  - Large annuity payments
  - Specialty asset considerations – tax payments, etc.
  - Charitable Trusts
    - Private Foundation required minimum distributions of 5%
    - Charitable beneficiary spending policies and budgetary needs
    - Scholarships and scholarship loans are typically paid in July, August and December
    - Grant distributions can occur periodically throughout the year, quarterly or all at one time at year end
    - Make sure sweep is in place so that all cash is invested daily
- Remember that all cash is not equal. Need to assess risk of cash equivalents

Diversification and Concentrations

- Under The Uniform Prudent Investor Act, a trustee shall diversify the Investments in the trust unless the trustee reasonably determines that, because of special circumstances, the purpose of the trust are better served without diversifying
  - Diversification minimizes the uncompensated risk of having too few investments
  - This is a tough one for trustees: 1) nobody wants to diversify; 2) concentrations usually exist for a reason (historical, emotional, judgment calls, restrictions, control blocks) and 3) nobody agrees on exactly when or how to diversify
  - What is diversification? Asset class level? Security/Manager level?
  - Heartstring assets - The Prudent Investor Act says that the wish to retain a family business is a situation in which the purposes of the trust sometimes override the conventional duty to diversify. How do you balance this with diversification?
  - Tax consequences - duty to diversify but the tax costs of selling a block of low basis securities may outweigh the advantages of diversifying
  - Dual needs/impartiality to multiple beneficiaries
- Need to continually educate beneficiaries regarding diversification
  - Importance of performance reporting/communication to co-trustee and/or beneficiaries
- Concentrations
  - How is a concentration defined? 10% of trust market value? 20%? More?
  - When appropriate, consider using derivatives to hedge concentrations
- The Uniform Prudent Investor Act elevated diversification to a "duty" instead of a policy. This has been a huge contributor to fiduciary litigation regarding concentrated investments (The <u>Lilly</u> CRATS, <u>Wood</u>, <u>DuMont Americans' for the Arts</u>).

Self-Dealing and Duty of Loyalty to Trust Beneficiaries

- Trustees owe a duty of loyalty to the beneficiaries
- A fiduciary cannot SELF-DEAL and should avoid direct or perceived CONFLICTS OF INTEREST
  - Therefore, absent authority in the trust document, a fiduciary should not
    - Buy or sell the property under trust for itself
    - Borrow funds under trust
    - Use property under trust for its own purposes
    - Personally gain through the relationship
  - The following activities are also self-dealing unless certain circumstances occur:
    - Selling property from one fiduciary relationship to another, unless the sale is fair to both relationships and is not prohibited by document or law
    - Making loans to the fiduciary account, unless the transaction is fair to the account and not prohibited by local law
- Dealing with or investing through affiliates and compensating such affiliates is considered self-dealing in most jurisdictions and is prohibited unless:
  - The trust instrument provides a clear waiver of the duty of loyalty with regard to the use of affiliate
  - State law provides such a waiver
  - The trustee obtains a court order with the appropriate waiver
- Self-dealing in a Private Foundation can cause the trust to incur severe penalty taxes and can even result in an involuntary termination of tax exempt status

Alternative Investments—Trusts Considerations

- Many alternatives do not distribute income, which impacts the income beneficiary
- Lock-ups affect liquidity and are common in many alternatives. Alternatives may present transferability issues
- Private Equity involves continuing commitments of capital over an extended period
- The trust must meet the Accredited Investor and Qualified Purchaser requirements under securities laws in order to purchase most alternative investments like hedge funds and private equity
- Potential tax issues when using alternative investments:
  - K-1 Delays
  - Source Income (impacts some trusts)
  - UBTI (use the offshore vehicles if need to avoid)
  - PFIC

Type of trust impacts desirability of incorporating alternatives

- Revocable Trusts
  - Accredited Investor/Qualified Purchaser (AI/QP)
  - Income needs
  - Liquidity events
  - Ability to diversify exposure
  - Understanding of asset class
  - Composition of portfolio – will there be diversification benefits derived
- Irrevocable Trusts
  - Accredited Investor/Qualified Purchaser (AI/QP)
  - Distribution of trust – payout event
  - Income needs
  - Understanding of asset class
  - Composition of portfolio – will there be diversification benefits derived
- Charitable Accounts/Private Foundations
  - Private Foundations – Offshore vehicles are critical
  - Charitable Remainder Trusts – UBIT impact
  - Endowments
- Ability to perform due diligence and ongoing review of asset class and managers is critical

Investing for Charitable Trusts, Foundations and Endowments

- Private foundations
  - Have a mandatory 5% annual payout
  - Penalty excise taxes may be imposed or involuntary termination of tax-exempt status can occur for:
    - Failure to make the 5% required minimum distribution
    - Excess business holdings
    - Self-dealing
    - Foundation managers investing in a manner that jeopardizes the foundation's ability to carry out its charitable purpose
    - UBTI (use offshore hedge fund vehicles)
  - Supporting organization trusts may have been converted to total return trusts or are utilizing power to adjust
- Pooled Income Fund Trusts cannot invest in tax-exempt bonds
- Charitable Trust considerations:
  - Timing of distributions
  - Liquidity needs for distributions
  - Tax implications of distributions – tiering
  - Time horizon
  - CLATs and CLUTs
    - If Grantor CLT – choose appropriate bonds based on client's tax situation
    - If Non-grantor CLT – use taxable bonds
  - UBTI (use offshore hedge fund vehicles)

Trust Termination Provisions

- Know the termination provisions
  - When does the trust terminate? Upon a tem of years, death, age attainment, etc.
  - If trust terminates upon a death, will the assets receive a step-up in cost basis?
- Time horizon impacts investment decisions
  - If terminating due to tem of years or age attainment, work with the beneficiaries on an investment strategy that meets objectives of trust
  - Structured notes and alternative investments have liquidity constraints or early redemption penalties

You don't need to go it alone: Outsource

- It is most common to outsource administrative tasks but outsourcing one or more discretionary activity or obtaining outsourced support for discretionary activities is not uncommon and can be particularly helpful in transitioning to in-house capabilities
- Among the fiduciary activities that trustees commonly outsource to a capable provider are:
  - Investment management
  - Asset allocation and portfolio construction
  - Management of specialty assets (i.e., closely held business, real estate, farm and ranch, art, oil and gas)
  - Financial duties to beneficiaries (making payments, etc.)
  - Custody services
  - Credit and banking services
  - Tax strategy, tax preparation and filing
  - Record keeping and accounting
  - Advice on discretionary decision-making
  - Foundation administration (grantmaking and grants administration)
  - Valuation advisory services (i.e., used to value closely held or illiquid interests)
  - Next generation education

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