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WEALTH MANAGEMENT

So, You Are a Trustee?

By Paul Chmielewski

A common consideration when creating a trust is who to name as trustee. Attorneys often say that clients request individual trustees be named because they do not want to pay for a corporate trustee (bank or professional trust company) to serve. That belief is somewhat suspect because, even if an individual trustee is used, the trust still pays an investment advisor and often other outside tax and legal advisors. That means the additional fee charged by a corporate trustee to provide those services as well as trust administration is relatively small and may end up being the least expensive option. Also, many people do not understand the burden and risk they are placing on their friend or family member who agrees to do them a “favor” by serving as trustee. Trust litigation is increasing. Corporate trustees are not immune, but lawsuits against individual trustees are now common. This means that whoever is named to serve as trustee needs to be aware of the issues they will confront and how their actions will be governed.

The case of W. Averell Harriman’s trust serves as a cautionary tale. Averell was a very accomplished individual. He was a principal at investment bank Brown Brothers Harriman, served as the governor of New York, was appointed as the ambassador to the Soviet Union and Britain, and served as a secretary to the U.S. Commerce Department. Averell appointed trustees who were also successful and well-connected politically. His children’s trusts named their stepmother, Pamela Harriman, and two of Averell’s friends, Clark Clifford and Paul Warnke, as co-trustees. Pamela was appointed as ambassador to France under former President Bill Clinton, and her first husband was Randolph Churchill, the son of former U.K. Prime Minister Winston Churchill. Clark was an attorney and a longtime business colleague of Averell, and Paul was a respected lawyer and former assistant secretary of defense under President Lyndon B. Johnson. Clark and Paul stated they agreed to serve as co-trustees as a “favor” to Averell. None of the co-trustees received compensation for their services.

With such distinguished individuals serving, what could go wrong? It turns out quite a lot. The trusts were eventually depleted due to an investment in a failing real estate project. A bank controlled by Clark was, however, fully repaid for loans it had provided for the failing real estate project. In the end, the only thing left in the trust were IOUs from Pamela. The beneficiaries ended up suing the trustees. Pamela had to sell some of her treasured art collection and Clark had to contribute $3 million of his own money to settle potential claims by the trust beneficiaries.

> As the Harriman case highlights, it is critical for trustees to understand the legal standards governing them when they serve as a trustee. **A summary of those standards is discussed next.**

Loyalty

The duty of loyalty influences every aspect of trustee behavior. The duty of loyalty requires a trustee to act in the best interests of the trust beneficiaries—even if it interferes with the trustee’s personal interests. This commonly comes up in claims for trustee self-dealing or trustee conflicts of interest. For example, in the Harriman trust situation, Clark approved a trust investment in which his bank also apparently had a financial interest. The bank was eventually made whole, but the trusts were financially ruined. The obvious question is whether Clark put his personal interests (bank ownership) ahead of the interests of the trust beneficiaries.

Impartiality

When there are two or more trust beneficiaries, a trustee cannot favor any beneficiary over the other(s). This is illustrated by the following example. A trust is created for the benefit of a surviving wife and her issue (i.e., lineal descendants). The issue consists of a son who has a close relationship with his mother and a daughter who is estranged from her mother. The mother is a co-trustee. Regardless of the mother's relationship with her daughter, the co-trustees should not make disproportionate distributions favoring the son, unless there is a valid reason (e.g., major medical expenses arose for the son) or the trust language itself specifically allows it. Even if the trust language contains a general provision allowing for unequal distributions, favoring the son over the daughter without a valid reason will likely be viewed with skepticism.

Good Faith

A trustee is required to adhere to the trust terms and administer the trust in good faith. Good faith is measured in a variety of ways. Generally speaking, it requires the trustee to comply with the terms of the trust document but also requires the trustee be free from knowledge or circumstances that ought to put the trustee on notice that more needs to be done to protect the trust property.

Consider the following real-life example. A man died and his trust required that all income be paid out to the surviving spouse. At the same time, the trust owned a commercial building that needed repair. The building had one major tenant whose lease was about to expire and was expected to move to a new location. It was going to take a year or more for repairs to be complete and to have the space available for a new tenant. In anticipation of the upcoming repairs and temporary tenant vacancy, the trustee increased funding of the property's reserve account. This, in turn, reduced the surviving spouse's trust income distributions. Litigation ensued. The surviving spouse claimed that gross rents constituted the trust's income and should be distributed to her. The trustee claimed that the reserves were properly deducted from gross rents before making an income distribution to the surviving spouse because they were necessary to preserve the property's value and would lead to higher long-term income once a new tenant was found. The court held that although the trust required all income to be distributed to the surviving spouse, the trustee had a valid reason and acted in good faith when deducting the increased reserves from the gross rent payments before making income distributions to the surviving spouse.

Care

A trustee must administer the trust as a prudent person would given the terms of the trust, using reasonable care, skill, and caution. Trustees possessing specialized trust, legal, tax, or investment knowledge (typically professional trustees) will be held to a higher standard than a trustee without such knowledge. Part of the duty of care is to adhere to the prudent investor rule when investing trust assets. A basic tenant of the prudent investor rule is that trust assets should be properly diversified. In the case of the Harriman trust, the trust ended up investing several million dollars into a single distressed real estate project. Numerous capital contributions were then required to try to save the project. In the end, the trust invested $20 million into a project that went bankrupt. This would violate a trustee's duty of care, regardless of the standard used to judge the trustee's actions.

Maintain Records

A trustee is required to maintain records that will allow it to account to trust beneficiaries with full transparency. This includes records regarding investments, distributions, taxes, ownership assets owned by the trust, and trust expenses. Trustees are also forbidden from comingling trust funds with their personal funds. A common allegation against individual trustees is personal use of trust assets.

Accounting

Trustees are generally required to provide beneficiaries with specific information about the trust and its administration upon request (i.e., account to beneficiaries). Most states require a trustee to provide certain default information automatically. Trustees often satisfy this requirement by mailing copies of a trust account statement to the beneficiaries, at least annually.

Professional trustees often use trust accounting software to generate statements. In addition to showing trust asset values, these statements also show which distributions were made from the trust income and principal "buckets." That helps keep track of whether revenue and expenses were properly allocated to income or principal under the applicable state principal and income act—the set of accounting rules a trust must follow. Proper allocation of revenue and expenses between income and principal is important to ensure that the current (e.g., income beneficiary) and remainder beneficiaries are being properly protected. In the absence of statements utilizing trust accounting, a beneficiary can request the trustee to prepare an accounting showing the income and principal allocations of revenue and expenses.

Serving as a trustee requires an understanding of multiple areas: tax, law, investments, and trust accounting. Before appointing trustees, it should be confirmed that they are aware of the duties being placed on them and have the time and knowledge to carry them out.

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