MEMORANDUM
Dealing with Controversy: A Trustee’s Investment Dilemma

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Major References:

INTRODUCTION
A sustained stock market decline, global downturn, and post-Enron and WorldCom distrust in business leadership have all contributed to a dramatic shift in investment performance over the past few years. The values of many trusts have declined as well. This has led to stress for trustees, particularly with respect to traditional income trusts in which the income beneficiaries and the remainder beneficiaries are inherently placed at odds, even in the best of circumstances.

The conflict among the income beneficiaries and the remainder beneficiaries can be further exacerbated if the income beneficiary remarries either before or after the grantor’s death. Children who are remainder beneficiaries generally are more hostile toward a surviving spouse who requests an invasion of principal, and the children may be more insistent on investing the trust assets for future growth.

This memorandum addresses how trustees should balance income versus growth of principal in managing trust assets where there are conflicting interests between income beneficiaries and remainder beneficiaries, and what solutions are available to a trustee seeking to balance the beneficiaries’ rights and reduce a trustee’s risk of breach of fiduciary duty.

OVERVIEW
A trustee has a fiduciary obligation to satisfy both the interests of the trust’s income beneficiaries during the life of the trust and the interests of the remaindermen at the trust’s termination. A review of several sources of law is helpful in understanding the continuing evolution of trustee fiduciary duties.

The Uniform Prudent Investor Act
The promulgation of the Prudent Investor Rule and the enactment by many states of the Uniform Prudent Investor Act (UPIA) have focused attention on the investment duties of trustees. The UPIA provides a reasonable approach to the investment of trust assets that meets both the needs of income beneficiaries while preserving trust assets for the remaindermen. Under the UPIA, a trustee must consider the trust portfolio as a whole in making a determination of the appropriate investment of trust assets. The UPIA and Restatement (Third) of Trusts require trustees to become devoted to modern portfolio theory, and to invest as a prudent investor would invest “considering the purposes, terms, distribution requirements, and other circumstances of the trust” using “reasonable care, skill and caution.”

Central to the analysis of modern investment theory is the concept that a particular investment is valued as a function of its risk and return. An investment’s risk is defined as the variability of its total return, including income and principal appreciation or depreciation. Generally speaking, the higher the risk, the higher the return the market demands, because risk is a negative to the investor and must be counterbalanced by a higher reward.

The Prudent Investor Rule
The Prudent Person Rule, a conservative rule that focused on the safety of capital, dates back to Harvard Coll. v. Amory. The ambiguities and inconsistencies in applying the Prudent Person Rule did little to liberate the traditionally cautious trustee. In 1959, the Restatement (Second) of Trusts directed trustees “to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived.” However, modern portfolio theory and the Restatement (Third) have dramatically changed this investment principle.

Under modern portfolio theory and the Restatement (Third) emerged the Prudent Investor Rule, which recognizes the need to balance risk and return. The Prudent Investor Rule removed the restrictions and limitations on a trustee’s investment alternatives set forth...
in the Prudent Person Rule. Under the Prudent Investor Rule, the entire portfolio must reflect a balance between income production and growth of principal. In addition, individual investments are not judged separately under the Prudent Investor Rule. Instead, a trustee must balance the income beneficiary’s right to production with the remainder beneficiary’s interest in growing the principal. This rule allows for the income and remainder beneficiaries’ interests to become aligned, as all beneficiaries desire to increase the trust’s total return. As a result, the Prudent Investor Rule makes it possible for a trustee to more easily satisfy its fiduciary obligations.

Some states, however, suggest that further measures are necessary to protect the interests of income and remainder beneficiaries from a trustee’s discretion over the allocation of principal and income. For example, §5 of the Illinois Trusts and Trustees Act imposes the standards of the Prudent Investor Rule on a trustee, requiring that a trustee exercise reasonable care, skill and caution in the overall investment strategy for the trust property. In an effort to protect the interests of income and remainder beneficiaries, the Illinois legislature recently amended the Trusts and Trustees Act to take a total return investment approach of equity-based investing and income apportionments of 3-5% of the trust’s fair market value for a reasonable return on the total portfolio to each beneficiary.

Similarly, Florida’s enactment of the Prudent Investor Rule in 1993 repealed the former statute applying the Prudent Person Rule. Florida has also enacted the Prudent Trustee Rule requiring a trustee to use any special skill or expertise he may possess. In April 2002, Florida enacted the Uniform Principal and Income Act (UPAIA), effective as of January 2003. This total return investment approach of equity-based investing and income apportionments of 3-5% of the trust’s fair market value for a reasonable return on the total portfolio to each beneficiary.

Similarly, in 2002, New York adopted §104 of the UPAIA, allowing trustees to make adjustments between income and principal. As of July 2002, §104 of the UPAIA has been adopted in thirty states, and legislation regarding this section is pending in five additional states. In addition to the power to adjust, New York added a section to the New York Estate Powers and Trusts Act to provide for optional computation of income using a unitrust amount, rather than the standard amount provided for under the UPAIA.

A TRUSTEE’S DUTIES

A trustee owes both income and remainder beneficiaries: (1) a duty of loyalty; (2) a duty of impartiality; (3) a duty to monitor investments and pursue an investment strategy that considers both the reasonable production of income and the safety of capital; and (4) a duty to diversify the investments in the interest of both the income and remainder beneficiaries. The significant decline in investment performance over the past few years has made it nearly impossible for a trustee to satisfy the conflicting interests that arise from these fiduciary duties.

Duty of Loyalty

Under the UPIA, a trustee has a duty to serve the interests of the beneficiaries with complete loyalty and is prohibited from dealing with trust property for its own interest, or for the interest of third parties to the detriment of the beneficiaries. To emphasize a trustee’s obligations with respect to investing, the UPIA merges the duty of loyalty with the duty to act as a prudent investor. Therefore, if a trustee sacrifices the interests of the beneficiaries in any way, a trustee cannot be considered as prudently managing the trust asset.

The grantor of a trust can, by implication, waive the duty of undivided loyalty by knowingly placing a trustee in a position that might conflict with the interests of certain beneficiaries. A waiver of the duty of loyalty, however, does not excuse a trustee from acting in good faith and exercising reasonable care in managing investments. Furthermore, a waiver of the duty of loyalty does not eliminate a trustee’s duty to remain impartial. The requirements of loyalty, fair dealing, and good faith are at the core of every trust

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13 Id.
15 See, e.g., Giagnorio v. Emmet C. Tokelson Trust, 686 N.E.2d
instrument, whether specifically stated or not. A trustee, therefore, should refrain from acting in any circumstances where a trustee cannot exclude all self-interest.

Duty of Impartiality

One of the most difficult duties imposed on a trustee is the duty of impartiality between income and remainder beneficiaries, particularly in a bear market. Trustees have a duty to act impartially with respect to the different interests they serve. Absent language in the trust instrument directing a trustee to favor one beneficiary over another, a trustee has a duty to treat all beneficiaries impartially. When a trust has more than one beneficiary, regardless of whether the beneficiaries' interests are concurrent or successive, a trustee has a corresponding duty to deal impartially with all such beneficiaries.1

Because the interests of the income beneficiaries are inherently different from those of the remaindermen, a trustee is required to balance the competing interests of differently situated beneficiaries in a fair and reasonable manner. However, the duty to act impartially does not mean that a trustee must treat the beneficiaries equally. Instead, a trustee must remain impartial to the income beneficiary and the remaindermen when implementing investment strategies, diversifying the investment mix, and selling or retaining trust assets. A trustee must treat the beneficiaries equitably in light of the purposes and terms of the trust.

The duty of impartiality is a shift away from traditionally favoring the income beneficiary, in favor of balancing the conflicting interests of the income beneficiaries and the remaindermen. With respect to investment and management of trust assets, a trustee must create as much income as possible for the life beneficiaries without neglecting the interests of the remaindermen. This is an increased burden on a trustee in its selection of investments. Market risks and tax treatments are common concerns that a trustee must address when creating an investment strategy that fits the needs of both the life beneficiary and the remaindermen.

Balancing tax treatment is often just as difficult as balancing investment goals. In In re Davies, a testamentary trust was created for the benefit of the decedent's children for life, and upon the death of each child, the principal was to be paid to his or her children. The primary asset of the trust consisted of shares of stock in a closely held family corporation whose principal asset was rental real estate. Until 1986, the corporation was a C corporation for tax purposes. However, in anticipation of the enactment of the 1986 Tax Reform Act, the corporation elected subchapter S status. With this election, the income beneficiaries (the children of the decedent) became primarily and individually liable to pay income tax on income from the corporation. The corporation prepared to sell several properties, causing a substantial capital gain, making the income beneficiaries liable for $750,000 of income tax. The corporation wanted to declare an "extraordinary cash dividend" to all shareholders, including the trust, to offset the income tax the shareholders would be required to pay, but the income beneficiaries would not be able to use this dividend to pay the tax unless the dividend was allocated to income. As a matter of precedent, if the dividend is generated as a result of sale of substantial capital assets, such dividend should ordinarily be allocated to the principal. The court held that there would be "a glaring injustice in burdening the income beneficiaries," and authorized an equitable adjustment, directing the trustee to allocate the cash distribution to income because an allocation to principal would have resulted in an unfair tax burden to the income beneficiaries.

In carrying out the duty of impartiality, a trustee must consider the trust portfolio as a whole. The Restatement (Third) provides that a trustee must consider two aspects of "productivity" in meeting the standards of a prudent investor. First, a trustee must determine the appropriate level or range of income productivity for the particular trust by ascertaining the

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22 Restatement (Third) of Trusts §227, comment i (1992).
24 Id. at 934-35.
25 Id.
27 Restatement (Third) of Trusts §227, comment i (1992).
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planning goals of the grantor. This determination is a matter for interpretation and fiduciary judgment, taking all relevant factors into consideration. Second, a trustee must incorporate the productivity objective into an overall portfolio strategy while remaining impartial to the remainders, creating as much income as possible for the life beneficiary while keeping growth of the trust just above the inflation rate. In addition, a trustee must remain impartial to the life beneficiary and the remainders when implementing investment strategies, diversifying, and selling or retaining the trust.

Failure to deal impartially with beneficiaries is a breach of a trustee's duty of care. “[A] trustee who ignores the demands of one beneficiary in order to comply with demands of another can be held liable for resulting damages.” To determine how the interest of beneficiaries should be balanced, a trustee must consider the terms, purpose, distribution requirements and other circumstances of the trust. For example, in most trust documents, the grantor typically expresses his or her intention that the marital trust will qualify for the marital deduction. If a trustee fails to make the marital trust property productive at the surviving spouse's request, a trustee may be in breach of its duty under the trust agreement; the Prudent Investor Rule, and Regs. §20.2056(b)-5. Instead, if a trustee invested for growth in favor of the remainders, a trustee effectively denies the surviving spouse the full benefit of the lifetime interest in the marital trust. This is a breach of a trustee's duty to act impartially toward all beneficiaries, as well as a trustee's fundamental duty to carry out the grantor's intent as expressed in the language of the trust.

Duty to Monitor and Pursue Investments

With respect to investment matters, a trustee's duty is one of conduct, not one of achieving investment performance. A trustee has no obligation to produce a consistent, positive net return every year. Rather, a trustee must take action to regularly monitor a trust's investments as a reasonably prudent person, given the existing facts and circumstances. A trustee has an affirmative duty to investigate information likely to have a significant impact on the value or safety of an investment. A depressed market does not excuse a trustee from the exercise of reasonable care, skill, and caution in making investment decisions because this duty is inherent in the role of a fiduciary. A trustee's duty to monitor investment performance often raises the closely related issue of the duty to diversify.

Duty to Diversify

In addition to the duties of loyalty, impartiality, and the duty to monitor and pursue investments, a trustee has a duty to diversify the investments of the trust unless, under special circumstances, a trustee reasonably believes it is in the interests of the beneficiaries and furthers the purposes of the trust not to diversify. The duty to diversify has been significantly broadened by the Prudent Investor Rule's advocacy for risk management over risk avoidance. A trustee must diversify the investment portfolio even if the terms of the trust would authorize a trustee to retain unproductive property, if retention would constitute a breach of a trustee's duty of impartiality. By obligating a trustee to decide risk and return factors for a particular trust, the Prudent Investor Rule attributes affirmative investment responsibilities to a trustee. An exculpatory clause or provision in the trust instrument absolving a trustee from liability for its actions, absent willful misconduct or gross negligence, does not relieve a trustee from its duties under the Prudent Investor Rule.

Courts have held that trustees are not liable for honest mistakes of business judgment. However, courts will not excuse trustees in the event of willful misconduct, gross negligence, or abuse of discretion. A trustee may be found to have abused its discretion, for example, if a trustee of a marital trust fails to make property productive despite a surviving spouse's demand to make such property productive pursuant to her right granted in the trust agreement. A trustee generally has a duty, particularly in a marital trust, to diversify and make property productive.

33 Uniform Prudent Investor Act §§2, 3, 4, 6 (2002).
34 Bornstein v. First United, 232 Ill. App. 3d at 628.
39 Hatfield v. First Nat'l Bank, 544 N.E.2d at 617; Giagnorio, 686 N.E.2d at 48-49.
41 See Jackson v. U.S., 376 U.S. 503 (1964); PLR 9147065.
TRUSTEE LIABILITY

The Prudent Investor Rule requires trustees to employ reasonable care, skill, and caution to protect the trust portfolio as a whole.42 A trustee’s liability is therefore measured by comparing the portfolio’s total return with what the portfolio could reasonably expect to earn. The Prudent Investor Rule assures that trustees cannot escape liability if their fiduciary obligations are ignored through inadequate investment strategies.43

Trustees are not insulated from liability merely because there is fluctuation in the market, nor is grantor authorization a relief from a trustees obligation to treat income beneficiaries with fairness and impartiality. A breach of fiduciary duty can be prevented, however, by seeking court approval to resolve conflicts between beneficiaries. Absent negligence, fraud, or other improper conduct, if a trustee is directed by the court to retain certain assets, she is not liable for losses resulting from such retention.

However, the Restatement (Third) explicitly provides that a trustee is held “accountable for any profit accruing to the trust through the breach of trust” or is “chargeable with the amount required to restore the values of the trust estate and trust distributions to what they would have been if the trust had been properly administered.” 44 A trustee is therefore required to reimburse the beneficiaries for the loss of income or the reduction in the principal if she retains unproductive property without a court order.45

In Janes Est.,46 the trustee failed to diversify a trust that consisted of a large amount of Kodak stock, which declined considerably in value over a period of seven years, thereby jeopardizing the interest of the income beneficiary. The trustee also failed to assume an investment strategy beyond the grantors objectives or to monitor the declining stock. The court imposed a $4 million surcharge on the trustee based on the capital lost and not on lost profits or market index measure of damages. The appellate court affirmed the surcharge because the trustee clearly breached his fiduciary duties by not making investment decisions under the Prudent Investor Rule. The surcharge was calculated by subtracting the sale proceeds of the stock from the value of the stock on the date it should have been sold. The surcharge also included prejudgment interest, which the appellate court held was within the trial court’s discretion.

SOLUTIONS

A trustee undeniably faces more intense scrutiny from trust beneficiaries in a weakening economy, however the duties to the beneficiaries remain the same. More solutions than ever before have become available to a trustee seeking to faithfully discharge its duties to the trust’s beneficiaries.

Total Return Investing

The total return legislation provisions of the UPIA attempt to address the conflict between achieving a good return on investment and achieving fair or necessary income distributions. The goal of total return legislation is to: (1) increase a trustee’s freedom to invest as a trustee thinks best, without regard to whether return is from income or principal appreciation; (2) to disconnect trust investment policy from distribution needs; (3) to reduce potential conflict and disputes between beneficiaries and trustees; and (4) to grant a trustee power to further trust purposes when the legislation applies. Simply stated, total return investing is the investing of funds for maximum return, regardless of whether that return is in the form of accounting income or appreciate of principal. The need to preserve both the value of capital and an income stream over long periods has always been a central concern in trust investing. However, a declining economy only exacerbates the conflict between achieving a good return on investment and achieving fair income distributions.

Total return legislation has evolved in two forms: (1) granting a trustee the power to make adjustments between principal and income or vice versa (discussed above),47 and (2) granting a trustee the power to convert an income trust to a unitrust (discussed below). As of December 2002, 34 states have adopted total return laws, 23 states have equitable adjustment power, four states have unitrust conversion, and seven states have both unitrust conversion and equitable adjustment. Six states have total return laws pending, three have equitable adjustment powers, one has unitrust conversion power, and two have both unitrust conversion and equitable adjustment powers.

Power to Adjust Principal and Income

To assist a trustee in performing investment tasks, the UPAIA, adopted in 1997, provided guidance in treating income and remainder beneficiaries fairly given the prudent investor’s goal of investing to achieve the highest total return. Since 1997, the UPAIA has been adopted, in whole or in part, in 30 states, including California, Florida, and New York.
The power to adjust allows a trustee to invest for total return and still treat all beneficiaries fairly, despite the traditional notions of what constitutes income and principal. Section 104 of the UPAIA sets out that a trustee may make an adjustment between the trust’s income and principal, which allows for an equitable balance between total return and asset allocation of a trust portfolio as circumstances change without compromising a trustee’s duty to deal impartially with all beneficiaries of a trust.

The power to adjust, however, is not unlimited. A trustee must first follow the prudent investor rule, manage a trust that contains income distribution provisions, consider several specified factors (such as the nature of the trust and the beneficiaries’ needs), and conclude that, under the circumstances and absent an adjustment, a trustee would not be able to administer a trust impartially in a manner that is fair and reasonable to all of the beneficiaries.

The Unitrust

The total return investment philosophy comes together well with the unitrust. A unitrust, or total return trust, directs or permits a trustee to pay the income beneficiary a specific percentage of the trust, based on its asset value, typically calculated at least annually. This payout method allows a trustee to pay out significantly more than the accounting income and focus on investing for the overall growth of the trust. Because equity investments, in particular, are likely to encounter periods of volatility over time, the grantor may want to consider including a “smoothing rule” (such as a three-year average) to establish a more consistent distribution to the income beneficiary. Over time, a unitrust should allow the income beneficiary to receive significantly more than the traditional trust accounting income because a trustee has more freedom to invest for the trust’s total return.

The unitrust has emerged as an increasingly popular alternative to the traditional income trust, as it aligns the interests of the income and remainder beneficiaries because each beneficiary benefits as the trust grows. A unitrust is able to direct the benefits of long-term growth to the income beneficiary by basing the annual payment on the value of the trust rather than on the income generated. For example, a $1 million portfolio that produces 5% annual income that is entirely distributable, while the remainder beneficiary’s interest remains stagnant. This exemplifies the classic tension between income and remainder beneficiaries. A portfolio should not merely favor the income beneficiary at the expense of the remaindermen. A unitrust might not experience growth every year, but if it increases by 8% on average over many years, then it could afford to pay out 4% income to the lifetime beneficiary, while the corpus increases by 4% as well. This approach benefits everyone involved. The income beneficiary gets a higher payoff, and the remainder beneficiary’s interest grows, instead of remaining dormant. As the trust grows, so does the amount of income generated, and the income and remainder beneficiaries both benefit.

In a unitrust, a trustee’s focus shifts to growing the whole portfolio, rather than worrying about the performance of each individual asset. By directing a trustee to pay out a specific percentage of the trust set forth by the grantor, a unitrust removes the difficulty in fulfilling a trustee’s duty of impartiality. The trustee is not required to balance the interests of the beneficiaries, and need only consider risk factors and the duration of the trust. The income beneficiary and the remaindermen both benefit because what is good for one, is generally good for the other. In a remarriage situation, with increased potential for conflict among beneficiaries, a unitrust should not only alleviate financial disputes, but also create more harmony among the surviving family members. Investing for total return should generally be better for most beneficiaries and trustees in the long run.

The financial success of the unitrust largely depends on the trust’s asset allocation and its payout percentage. Investment strategies must be based upon the duration of the trust, as well as the ability of the trust to withstand volatility associated with asset allocation. A total return trust allows the trustee to invest in growth-producing assets as opposed to income-producing assets. To pay the unitrust obligation, a trustee may have to either sell a portion of the trust assets or distribute a portion of the trust assets in satisfaction of the unitrust amount.48 Such action has capital gain consequences. The trust may direct the trustee to pay a percentage based on a formula, such as the inflation rate plus one percent, or five percent of a three-year rolling average of the principal.49 The consensus among the estate planning community has been that a payout of 3%-5% should, over time, adequately preserve trust principal.50 However, estate planning opportunities may exist in varying the payout percentages based upon income needs and the desire for future growth of a particular trust.

Economic realities cause uncertainties that must be considered when scrutinizing the effectiveness of a unitrust. For instance, inflation, cash flows or dividends...
Dend payouts, asset price fluctuations, and portfolio contributions or distributions can all weigh on the effectiveness of the unitrust. Historical trends can be useful in determining the overall efficacy of a unitrust, but these trends are not always the most accurate predictors. For example, historically a fall in prices has produced a higher dividend yield. However, dividend yields have been reduced or eliminated, although prices have been falling for some time now. Another historical trend that current markets seem to be ignoring is that, on average, one in three years is considered a “down” year. During this “down” time, the value of the trust will likely decrease, presenting a problem for the income beneficiary, and necessitating a “smoothing” rule. In addition, using an assumed average growth rate to demonstrate long-term growth is generally misleading because growth is cyclical, and not steady. Assumed average growth rates are generally based on selected periods and indices, which is a highly subjective determination, and is likely skewed.

There are also economic problems associated with asset allocation, which can make distributions more volatile. A trust that has 60% of its assets allocated to equity, and 40% allocated to fixed income are far less volatile a trust that has 80% of its assets allocated to equity. As long as prices continue to rise, there is little issue with volatility. However, with a sustained drop in prices, problems invariably develop. In addition to volatility, mandatory income distribution also causes long-term loss in value of the trust estate, thereby not protecting either the income or remainder beneficiaries.

While the legislation is a good first step toward allowing a trustee to manage a trust for total return, it is also somewhat controversial because it may allow a trustee to convert to a unitrust without the express written consent of all the beneficiaries, which may be contrary to the grantor’s intent. A simple notice requirement during which beneficiaries may object may not allow them enough time to determine whether the conversion would be contrary to their interests or to the grantor’s wishes. While a trustee should have discretion in administering a trust, critics of the new unitrust conversion legislation maintain a trustee with limited liability should not be able to rush the beneficiaries to make an important and irrevocable decision without first obtaining express written consent.

CONCLUSIONS

Changes in both the investment climate and the state of the law regarding the duties to income and remainder beneficiaries create an obligation for a trustee to reexamine their objectives. A close look at state law regarding the duties to income and remainder beneficiaries should induce caution. It is important to consider the grantor’s preference regarding distributions, relevant law, and the avoidance of potential conflicts between beneficiaries, and expressly stating the grantor’s preferences in the trust instrument is also good consideration. In addition, take into account whether a unitrust approach is appropriate, particularly in a second marriage or other situation that has extra potential for conflict between income and remainder beneficiaries.