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Report 8

Tuesday, January 6 and Wednesday, Jan 7

Reporter: John Warnick Esq.

Tuesday, January 6

11:30 a.m. - 12:15 p.m.
Old But Not Cold - Restructuring, Refocusing and Retiring Irrevocable Trusts
Ronald D. Aucutt

Mr. Aucutt is the President of the American College of Trust and Estate Counsel (ACTEC) and has been a frequent lecturer at the Heckerling Institute.

Mr. Aucutt started his comments with a reference to the just issued final regulations defining net income under Section 643(b) and mentioned that in his opinion the final regulations have been drawn too narrowly and will put an undue amount of emphasis on state law. Existing trusts in states that do not have a unitrust statute will not have the planning flexibility that is afforded under the final regulations to trusts with a situs in states which do have a unitrust statute.

He then drew a distinction between "old" trusts which are grandfathered from the GST Tax because they were irrevocable prior to September 26, 1985 and those trusts established subsequently. He noted that there is a tremendous amount of wealth in these "old" trusts, and that there is a tendency to ignore them. He suggested that planners need to thoroughly comb these instruments and be sensitive to planning opportunities which may prove valuable to the administration of such trusts.

At the same time he suggested that there are a considerable number of "old" trusts that have been established or become irrevocable since September 25, 1985, and that planners also need to be aware that there have been significant developments in trust law, such as the UPIA and Prudent Investor Act, which alter the administration and planning landscape. This category of "old" irrevocable trust will become increasingly important in the years ahead.

What are some of the common problems facing long-term irrevocable trusts?

Many of these old trusts have beneficiaries in multiple generations who often disagree, even within generations, about the direction the trust is taking or should take. Often the trustee is caught in the middle of this crossfire.

The trustee of an "old" trust may be handcuffed by outdated boilerplate or by a less "trust friendly" situs. There may be interest in changing the situs of the trust to achieve greater privacy, a more favorable or cooperative environment of court supervision, clearer or more advantageous substantive rules, or a favorable income tax climate. Today the pressures produced by the trustees' duty of impartiality to successive beneficiaries, the prudent investor rule, new principal and income rules, and declining investment yields are combining in a "perfect storm" to suggest the superiority of a "unitrust" approach to balancing the interests of successive beneficiaries.

Another problem with "old" trusts can be the sheer multiplicity of trusts created over a number of years, often by different generations of grantors. This can lead to annoyingly different distribution and administrative provisions which compound the trustee's difficulties.
Outdated trustee succession regimes are frequent problems encountered with "old" trusts. Sometimes grantors depended on individual trustees and demonstrated an antagonism towards corporate fiduciaries. Individual trustees grow old, retire, die or become incapacitated. Family trustees may be succeeded by younger generation family members, but this is not always easy. The suitability and acceptability of corporate trustees can also change over time.

Another aspect of the unique planning challenges of the old trusts is termination. It is very ackward for a trust to distribute illiquid real estate to multiple generations of beneficiaries. Solutions such as contributing the illiquid assets to an entity may not be clearly authorized by the instrument.

Ron Aucutt next spent a significant amount of time reviewing the history and changes brought about by both the Uniform Prudent Investor Act and the Revised Uniform Principal and Income Act (1997). He noted that one of the stated purposes of the Revised Uniform Principal and Income Act (the "Act") is to ease the tension trustees face in satisfying both income and remainder beneficiaries while adopting the modern portfolio theory under the Uniform Prudent Investor Act. The power to adjust under the Act can be used to liberate the trustee to fully implement modern portfolio theory. It gives trustees the power to correct situations where the income or remainder beneficiaries are adversely impacted by the total return investment strategy. But the trustee does not have power to adjust under the Act unless the following three factors are satisfied:

1. the trustee invests and manages the trust as a prudent investor;

2. the terms of the trust describe the amount that may or must be distributed to the beneficiaries by referring to the trust's "income"; and

3. the trustee determines that it cannot administer the trust impartially based on what is fair and reasonable to all of the beneficiaries unless the trust clearly manifests an intention that the fiduciary favor one or more beneficiaries.

Thirty states and the District of Columbia have adopted the Uniform Prudent Investor Act so the first factor is going to be present in most trusts. Even in those states which haven't adopted the Uniform Prudent Investor Act or similar legislation, the prudent investor rule may be approved by the courts in that state or the trust instrument itself may require it be observed. Mr. Aucutt has concluded that this first factor will be satisfied in virtually all states except those where a trustee is permitted to invest only in assets set forth on a statutory "legal list".

If a trustee of an old trust determines that all of these factors are present, then the trustee must determine if it is appropriate to resolve the conflict between income and remainder beneficiaries by transferring principal to income in order to increase the payout to income beneficiaries each year. This can become a significant administrative chore and require significant record-keeping and documentation each time the trustee makes an adjustment under the Act.

To alleviate that administrative burden, Mr.Aucutt suggests that conversion to a private unitrust may be appropriate. By reforming the old trust to become a private unitrust the trustee is creating a "partnership" among the income beneficiaries, remaindermen, and the trustee that will enable the trustee to invest the assets for long-term growth for the benefit of all beneficiaries. This should give the trustee and investment team a greater focus.

What considerations should the trustee make in converting a traditional "income" trust to a private unitrust?

First, the trustee will need the consent of all affected parties.

Second, the trustee may want to consider using a rolling average to reduce potential fluctuations in unitrust distributions due to short-term market swings. The trustee may also want to consider placing a ceiling and/or floor on the distribution amount from the unitrust that will satisfy the needs of all beneficiaries and reduce the risk to the remaindermen.

Third, in the case of a trust with grandfathered IRS status, careful attention needs to be paid to protect that status, and it may be desirable to obtain an IRS ruling.

Fourth, the trustee should consider whether the conversion is also an appropriate opportunity to divide inter-generational trusts along family lines so as to allow individual families to invest as they see fit.

Finally, the trustee must carefully consider the income tax consequences of the unitrust distribution and conversion to a private unitrust. This requires careful attention to the regulations under Section 643(b) and navigating around the Cottage Savings problem which Lloyd Leva Plaine covered previously.

There are special considerations that trustees must give to the old trust that is about to terminate. Watch out for special powers of appointment and be alert to planning opportunities that may arise through careful exercise of these powers. In exercising a special power in further trust, attention should be paid to avoid the Delaware Tax Trap and to comply with applicable rule against perpetuities constraints. Non pro rata distributions upon termination may trigger a taxable exchange if neither the trust instrument nor local law give the trustee authority to distribute assets on a non pro rata basis.

Mr. Aucutt briefly touched upon some practical problems with dynasty trusts. He quips that a "pot" trust after a few centuries will resemble a publicly owned corporationor maybe even a public charity.

One practical problem is the record-keeping necessary to track who the descendants are of some common ancestor if a family line dies out 300 years from now. He promised that more of these practical issues will be dealt with in tomorrow's workshop.

Wednesday, January 7

Reporter: John Warnick Esq.

9:45 -10:30 a.m.
The Rules of Engagement:Managing Liability for Nonprofit Boards
Kathryn W. Miree

Ms. Miree is the author of *The Professional Advisors' Guide to Planned Giving* (Aspen Publishers, 2002) and the co-author with Jerry McCoy of *The Family Foundation Handbook* (Aspen Publishers, 2001).

Directors of nonprofit boards are facing incredible challenges as they struggle to operate charities at a time when funding is drying up, endowments are shrinking, criticism of nonprofit misfeasance and malfeasance is high, and demand for accountability is strident.
Nonprofit contributions are down in three areas: individual gifts, foundation grants and government grants. Note: individual contributions in 2002 were up .7% over 2001 but down .9% when adjusted for inflation.

Investment markets have ravaged the reserves of charities. Ms. Miree has seen the endowments of some charities shrink by as much as fifty percent. Particularly hard hit have been those charities whose boards weren't keeping a close eye on their investment policy and investments

New nonprofits are emerging and old nonprofits are soliciting funds for the first time. The number of traditional charities has grown from 558,745 to 909,574 between 1994 and 2002.

The Sarbanes-Oxley Act reflects heightened expectations of accountability for the corporate sector but these standards may eventually be imposed on the nonprofit community. Ms Miree suggests an excellent article on the Sarbanes-Oxley Act and its
implications for nonprofit management is found at
www.guidestar.org/news/newsletter/sarbanes_oxley.jsp

Ms. Miree uses the term "directors" to designate the individual with responsibility for oversight and management of a 501(c)(3) organization whether the charity's governing documents refer to them as trustees or directors. The key is the voting responsibility imposed upon the individual. Ms. Miree's analysis and guidelines are not intended to apply to "honorary" or "emeritus" directors that do not have any voting power. Citing *Black's Law Dictionary*, Ms Miree noted that directors are serving in fiduciary capacities, managing the assets of the charity for the public good. For the last several decades, the courts have made a distinction between the trust and corporate form or organization and have applied a less stringent standard for nonprofit directors than trustees. See *Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries, et. al.*, 381 F. Supp. 1003 (D.D.C. 1974).

There are two basic categories of duties that apply to directors: codified and practical. The three primary codified duties are: 1) duty of care; 2) duty of loyalty; and 3) duty of obedience or adherence to the charity's governing documents and applicable law.

Examples of the exercise of the duty of care include:

participation in board and committee meetings;

familiarity with the board's business plan and strategic plan;

review of the charity's budget, fundraising results, financial statements and investment returns;

review of minutes (which should be requested if not produced);

review of agents appointed by the charity to carry out delegated duties and familiarity with policies governing the handling of money and donations, asset management, employee management, and other areas of risk; and

queries when necessary to clarify facts and form independent judgment about decisions to be made.

Directors are not liable for decisionseven if such decisions prove to be unwise in hindsightso long as the decisions are informed, made in good faith, and without a conflict of interest.

The duty of loyalty requires a director not to vote on matters affecting the nonprofit which in any way would benefit the director personally at the expense of the nonprofit, not to take excessive compensation, not to solicit or accept loans from the nonprofit, and to reveal all conflicts or personal benefits that may result from a vote of the nonprofit.

In addition to the duties imposed under state law, there are four other sets of rules which impact a director's duty of loyalty:

private foundation self-dealing rules under Internal Revenue Code § 4941;

IRS intermediate sanctions for private inurement under § 4958;

state law governing nonprofit directors; and

state law governing trustees.

There are also practical duties incumbent on directors of nonprofit organizations such as: 1) establishing the mission and purpose of the entity; 2) selecting and evaluating the executive officer (s); 3) ensuring continuity in operational and strategic planning as well as perpetuation of the governing body; 4) exercise of oversight of the organizational activities; 5) public relations; 6) ensure accountability to donors, the public and the IRS; and 7) manage the charity's assets to prevent theft, embezzlement or improper use of funds.

Ms Miree cited a recent article published in *The Exempt Organization Tax Review* by Marion R. Fremont-Smith and Andras Kosaras which compiled data regarding lawsuits and similar proceedings brought against nonprofit directors and managers for civil and criminal wrong-doing between 1995 and 2002. There were seven major categories or risk documented in this survey.

1. Employee lawsuits are among the most commonly filed against nonprofits. These suits ran the full gamut from ERISA, ADA, Equal Pay Act claims, age discrimination, OSHA, COBRA, civil rights claims, to Family Medical Leave Act violations.

2. Third-party liability for negligence or breaches of the duty of care, conflict of interest, libel, slander, etc.

3. Investment management breaches.

4. Private inurement the use of charitable assets for the personal benefit of directors.

5. State law violations such as failure to collect and submit sales tax, pay property tax, satisfy audit requirements, register under applicable charitable solication laws.

6. Failure to Comply with Federal Law such as IRS filings, meeting employee obligations, substantiating gifts in excess of $250 and complying federal postal laws.

7. Account for Funds. Directors are ultimately responsible for oversight of the use of the charity's funds and for compliance with the donors' instructions.

How can charities and their governing bodies manage these risks? Four avenues of protection are available to the charity and its directors: statutory protection; insurance, proper policies and procedures, and proper operation.

In terms of managing risk through proper policies and procedures, Kathryn suggested that nonprofits consider: 1) performing an annual risk assessment by reviewing its internal and external activities and exposure to list those activities creating the greatest risk;
2) ensuring that policies and procedures are in place to manage the identified risks; 3) adopt gift acceptance policies; 4) annually review investment management policies in terms of balancing risk and return, spending policies, asset allocation, and return objectives; reviewing financial management policies and controls on money movement; 5) adopting standards for the confidentiality of records.

In terms of managing risk through proper operation, perhaps the most important step is board structure. Kathryn thinks that too large a board is not only unwieldy but promotes sleeping through meetings. Reporting is also critical as is the director's ability to ask questions and obtain meaningful answers. If the charity is not willing to provide adequate information or reports, the director should likely resign.

What is the legal advisor's role in advising clients on the responsibilities for nonprofit management? The advisor should help the director in understanding what his or her potential liability is for serving on the board and assist in obtaining protection for that service. The legal advisor should also assess the liability, review policies, procedures and protections that are in place and then guide the charity in obtaining the necessary protection and safeguards to minimize the risks.

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