Ethical Considerations for Trustees & Their Advisors

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Prior to joining Fiduciary Trust in January 2002, Ms. Klein was Special Counsel in the Trusts and Estates Department at Rosenman & Colin LLP, New York, New York (now Katten Muchin Rosenman LLP) for over 11 years. Previously, she served as law clerk to the Hon. Chief Judge Fox of the Federal Court of Australia.

Ms. Klein earned B.A. and LL.B. degrees from the University of New South Wales, Sydney, Australia, and an LL.M. from the Boalt Hall School of Law at the University of California, Berkeley.
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Conflicts of Interests and Other Ethical Issues in Trust Administration

The law governing the administration of trusts creates dilemmas in how to resolve numerous conflicts of interests between the income beneficiaries and the remainder persons. Typically, these conflicts of interest fall into three broad categories:

- **Investments**
  - How does the lawyer advise his/her client regarding how trust funds are to be invested so as to satisfy the conflicting interests of the income beneficiaries and the remainder persons and to insure that the trustee remains compliant with the Prudent Investor Rule?
  - Who does the “family lawyer” represent – The settlor? The trustee? The income beneficiary? The remainder persons?

- **Distributions**
  - How does the lawyer advise his/her client regarding utilizing the power to adjust or unitrust regimes so as to balance conflicting interests?

- **Taxes**
  - Who is to bear the tax burden?
  - How does the lawyer advise the trustee in making tax elections when the results may negatively impact one or more beneficiaries?

I. Investment Conflicts

**Start with the Prudent Investor Act**

For many years, the investment of trust assets was guided by the prudent person rule. The prudent person rule required trustees to examine trust investments on an asset-by-asset basis. That evaluation involved an inquiry as to whether an asset was productive of reasonable income and was safe to principal. Since trustees were judged on an asset-by-asset basis, they were risk averse: they could be surcharged if an asset decreased in value, even if the portfolio as a whole increased in value. Because there was no specific skill required of fiduciaries, delegation of investment responsibility was prohibited.

*See Appendix 1 for detailed state-by-state analysis*
A model Uniform Prudent Investor Act ("UPIA") was promulgated in 1994 and is now the law governing the investment of trust assets in most states. The Prudent Investor Act shifted the law away from the traditional prudent person rule to a modern portfolio theory. In New York, the Prudent Investor Act can be found in Estates, Powers and Trusts Law ("EPTL") §11-2.3.


The Prudent Investor Act guides fiduciaries toward a total return approach to investment decisions. Evaluation of a fiduciary’s conduct is based on a strategy for the total portfolio, rather than on the selection of individual assets. The Act also makes several fundamental changes to the criteria for fiduciary investment.

**Under Prudent Investor Principles:**

- Trustees must formulate a strategy designed to meet the trust’s objectives:
  - The emphasis has moved away from individual security selection toward the formulation of an overall asset allocation strategy in accordance with risk and return objectives suitable to the trust.
  - Trustees must look at all the facts and circumstances, including the needs of the beneficiaries, anticipated future distribution requirements and tax consequences.

- Trustees must invest for total return:
  - Total return encompasses both income and growth.
  - This creates a conflict between the income beneficiaries, who are primarily interested in a trust’s yield, and the remainder persons, who are primarily interested in a trust’s growth.

- The baseline, fundamental objective is to preserve purchasing power:
  - The portfolio must be invested to keep pace with inflation. Safety is no longer measured in nominal terms.

- Risk management:
  - Risk can be taken, as long as it is properly managed.
- Diversification is required – a risk management technique.

- Investment skill is required.

- Delegation of investment responsibility is authorized:
  - Prudence must be used in selecting the delegee and establishing the scope of the delegation.
  - Monitoring is necessary.
  - Costs must be reasonable.
Understanding Client Objectives Drives the Investment Management Process: Devising a Strategy when Objectives Conflict

How does a Trustee develop a strategy where there is a conflict of interest between the objectives of the income beneficiaries and remainder persons?
Stocks, Bonds, Bills and Inflation, 1925—December 2008

Wealth Indices of Investments in the U.S. Capital Markets*

Historical performance data does not guarantee future results and results may differ over future time periods.

Indices are unmanaged and one cannot invest directly in an index.
World Equity Market Capitalization

<table>
<thead>
<tr>
<th>Year</th>
<th>Non-U.S.</th>
<th>U.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>$0.9 Trillion</td>
<td>$0.4 Trillion</td>
</tr>
<tr>
<td>2008</td>
<td>$18.5 Trillion</td>
<td>$15.5 Trillion</td>
</tr>
</tbody>
</table>

Source: Factset/ Morgan Stanley Capital International All Country World

Fiduciary Trust International Long-Term Asset Class Expectations

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Yield</th>
<th>Capital Appreciation</th>
<th>Total Return</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Large Cap Equity</td>
<td>2.0%</td>
<td>8.5%</td>
<td>10.5%</td>
<td>17.0%</td>
</tr>
<tr>
<td>U.S. Small Cap Equity</td>
<td>1.0%</td>
<td>12.0%</td>
<td>13.0%</td>
<td>22.0%</td>
</tr>
<tr>
<td>International Large Cap Equity</td>
<td>2.0%</td>
<td>9.0%</td>
<td>11.0%</td>
<td>19.0%</td>
</tr>
<tr>
<td>International Small Cap Equity</td>
<td>1.5%</td>
<td>12.0%</td>
<td>13.5%</td>
<td>22.0%</td>
</tr>
<tr>
<td>Global REITS</td>
<td>4.5%</td>
<td>4.0%</td>
<td>8.5%</td>
<td>17.0%</td>
</tr>
<tr>
<td>Emerging Markets Equity</td>
<td>1.0%</td>
<td>14.0%</td>
<td>15.0%</td>
<td>27.0%</td>
</tr>
<tr>
<td>U.S. Municipal Bonds</td>
<td>4.3%</td>
<td>0.3%</td>
<td>4.5%</td>
<td>4.0%</td>
</tr>
</tbody>
</table>

This analysis represents asset allocation strategies only and is not based on actual portfolios. Annualized yield, capital appreciation, and total return expectations are for illustrative and discussion purposes only and are Fiduciary Trust International’s outlook of future normalized performance over what we view as the long term, based on its own analysis of business, currency, economic, geographic, political and other conditions affecting passive market indices and its own assessment of various identified risk factors as of December 31, 2008. Standard deviation data is historical and the potential effect of future market risk is not taken into account. The actual performance of any security, asset class or portfolio may vary and could underperform or exceed Fiduciary Trust International’s expectations. Additional information on the assumptions and methodologies underlying this analysis is available upon request. This analysis is provided for illustration and discussion purposes only and does not guarantee future results.
**Target Portfolio Objectives**

- High Income (75% Fixed Income, 25% Equities) Primary emphasis on income production and low relative volatility with little regard for growth of principal.

- Income (65% Fixed Income, 35% Equities) High emphasis on income production with some regard for growth of principal.

- Balanced (55% Fixed Income, 45% Equities) Generally, equal regard for production of income and growth of principal with a goal of preserving purchasing power of principal.

- Balanced Growth (40% Fixed Income, 60% Equities) Emphasis on growth of principal with due regard for the production of income.

- Growth (20% Fixed Income, 80% Equities) High emphasis on growth of principal with some regard for the production of income.

- High Growth (100% Equities) Primary emphasis on growth of principal with little regard for the production of income. Relatively high volatility acceptable.

Our investment strategies and the resulting portfolio holdings may change depending on factors such as market and economic conditions.
Asset Allocation - Fulfilling the Obligations of Trustee Where the Interests of the Income and Remainder Beneficiaries are in Conflict

The Trustee’s Obligations are:

1. To Preserve Purchasing Power
2. To Produce Reasonable Income

<table>
<thead>
<tr>
<th>Target Portfolios</th>
<th>High Income (75% fixed income, 25% equities)</th>
<th>Income (65% fixed income, 35% equities)</th>
<th>Balanced (55% fixed income, 45% equities)</th>
<th>Balanced Growth (40% fixed income, 60% equities)</th>
<th>Growth (20% fixed income, 80% equities)</th>
<th>High Growth (100% equities)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Appreciation</td>
<td>2.4%</td>
<td>3.4%</td>
<td>4.4%</td>
<td>6.1%</td>
<td>7.9%</td>
<td>9.9%</td>
</tr>
<tr>
<td>Yield</td>
<td>3.7%</td>
<td>3.4%</td>
<td>3.2%</td>
<td>2.7%</td>
<td>2.3%</td>
<td>1.8%</td>
</tr>
<tr>
<td>Total Return</td>
<td>6.1%</td>
<td>6.8%</td>
<td>7.6%</td>
<td>8.8%</td>
<td>10.2%</td>
<td>11.7%</td>
</tr>
</tbody>
</table>

Note: This example illustrates split-interest trusts where yield is paid out to income beneficiary. Yield, capital appreciation, inflation and total return targets are based on the assumptions set forth on the page entitled “Fiduciary Trust Long-term Asset Class Expectations.” The potential effect of future market risk is not taken into account. The actual performance of any security, asset class or portfolio may vary and could underperform or exceed Fiduciary Trust International’s expectations. No performance results are guaranteed. Past performance does not guarantee future results and results may differ over future time periods. In addition, your actual return will be reduced by advisory fees and other expenses that you may incur as a client.
## II. Distribution Conflicts

### Principal & Income Act – The Basic Rules*

<table>
<thead>
<tr>
<th>Default Rule</th>
<th>NY</th>
<th>DC</th>
<th>MD</th>
<th>VA</th>
<th>DE</th>
<th>FL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Power to Adjust**</td>
<td>Power to Adjust</td>
<td>Unitrust</td>
<td>Power to Adjust</td>
<td>Power to Adjust</td>
<td>Power to Adjust</td>
<td>Traditional Principal and Income Rules (pre 1/1/03) or Power to Adjust (post 1/1/03)</td>
</tr>
<tr>
<td>EPTL §11-2.3</td>
<td>DC CODE §28-4801.04</td>
<td>MD CODE ANN. EST. &amp; TRUSTS §15-502.1</td>
<td>VA. CODE ANN. §55-277.4</td>
<td>DEL. CODE ANN. tit. 12, §6113</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trustee Opt Into Rule</td>
<td>Unitrust**</td>
<td>None</td>
<td>Power to Adjust</td>
<td>Unitrust</td>
<td>Unitrust</td>
<td>Power to Adjust (Pre 1/1/03) or Unitrust</td>
</tr>
<tr>
<td>EPTL §11-2.4</td>
<td></td>
<td></td>
<td>MD CODE ANN. EST. &amp; TRUSTS §15-502.2</td>
<td>VA. CODE ANN. §55-277.4:1</td>
<td>DEL. CODE ANN. tit. 12, §3527</td>
<td>FLA. STAT. ANN. §738.104, §738.1041</td>
</tr>
<tr>
<td>Amount</td>
<td>4% Unitrust</td>
<td>No guidelines</td>
<td>4% Unitrust***</td>
<td>3%-5% Unitrust</td>
<td>3% - 5%</td>
<td>3-5% Unitrust</td>
</tr>
<tr>
<td></td>
<td>No guidelines for Power To Adjust</td>
<td></td>
<td>4% Power to Adjust***</td>
<td>No guidelines for Power to Adjust</td>
<td>No guidelines for Power To Adjust</td>
<td>or 50% of AFR No guidelines for Power To Adjust</td>
</tr>
</tbody>
</table>

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* See Appendix 2 for detailed state-by-state analysis.

** See Appendix 3 for substantial changes made to New York’s Power to Adjust and Unitrust regimes, effective August 5, 2008.

*** A different payout percentage can be authorized by court order. In order to utilize the power to adjust, the trustee must determine that conversion to a unitrust is inappropriate.
**Principal & Income Act – Trustee Protection – Power to Adjust**

<table>
<thead>
<tr>
<th>Standard</th>
<th>NY</th>
<th>DC</th>
<th>MD</th>
<th>VA</th>
<th>DE</th>
<th>FL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Court must find abuse of discretion. Anticipatory relief may be available</td>
<td>None provided in Principal and Income Act</td>
<td>Notice requirement to qualified beneficiaries</td>
<td>None provided in Principal and Income Act</td>
<td>Court must find abuse of discretion</td>
<td>Court must find abuse of discretion</td>
</tr>
<tr>
<td>Remedy</td>
<td>Court may restore beneficiaries from fund. If unable to restore from fund and, in addition, fiduciary was dishonest or arbitrary and capricious, pay an appropriate amount from own funds</td>
<td>Sole remedy is to direct, deny or revise the adjustment</td>
<td>Sole remedy is to direct, deny or revise the adjustment</td>
<td>Restore beneficiaries from fund. If unable to restore from fund, pay an appropriate amount from own funds</td>
<td>Restore beneficiaries from fund. If unable to restore from fund, pay an appropriate amount from own funds</td>
<td>Restore beneficiaries from fund. If unable to restore from fund, pay an appropriate amount from own funds</td>
</tr>
</tbody>
</table>
### Principal & Income Act – Trustee Protection – Unitrust Regime

<table>
<thead>
<tr>
<th>Standard</th>
<th>NY</th>
<th>DC</th>
<th>MD</th>
<th>VA</th>
<th>DE**</th>
<th>FL**</th>
</tr>
</thead>
<tbody>
<tr>
<td>Court approval necessary*</td>
<td>N/A</td>
<td>N/A</td>
<td>Notice requirement to qualified beneficiaries</td>
<td>1. Adopt written policy 2. Send notice to beneficiaries 3. At least one person receiving notice is legally competent</td>
<td>1. Adopt written policy 2. Send notice to beneficiaries 3. At least one person receiving notice is legally competent</td>
<td>1. Adopt written policy 2. Send notice to beneficiaries 3. At least one person receiving notice is legally competent</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Remedy</th>
<th>NY</th>
<th>DC</th>
<th>MD</th>
<th>VA</th>
<th>DE**</th>
<th>FL**</th>
</tr>
</thead>
<tbody>
<tr>
<td>N/A</td>
<td>Sole remedy is to direct, deny or revise the conversion or reconversion</td>
<td>No liability if no objection within 60 days</td>
<td>No liability if no objection within 60 days</td>
<td>No liability if no objection within 30 days</td>
<td>No liability if no objection within 60 days</td>
<td>No liability if no objection within 60 days</td>
</tr>
</tbody>
</table>

* For trusts created after January 1, 2002, a trustee can opt in within two years of creation without court approval (on consent or at the trustee’s discretion with notice).

** If a trustee reasonably and in good faith takes or omits to take any action, and a person interested in the trust opposes the act or omission, the person’s exclusive remedy shall be to seek an order from the court to convert, reconvert, or change the payout percentage.
III. Tax Burden Conflicts

Tax Issues Can Exacerbate Conflicts of Interests

Who is to bear the tax burden? Conflicts regarding tax allocation among the beneficiaries must also be addressed by the trustee.

**Income Tax Considerations**

Following the adoption of the UPAIA by many states, the IRS issued new regulations under Section 643 applicable to trusts and estates for taxable years ending after January 2, 2004.

Under the regulations, ordinary income is taxed to the recipient as “distributable net income” (“DNI”).\(^1\) Internal Revenue Code of 1986 (“IRC”) Reg. §1.643(a)–3(a). Capital gains are taxed to principal (remainder persons) unless:

- Governing law and instrument provide otherwise; or

- Pursuant to reasonable and impartial exercise of discretion by the fiduciary, gains are:
  - Allocated to income;
  - Allocated to corpus but treated by the trustee as distributed to the recipient; or
  - Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the recipient’s distribution amount. Reg. §1.643(a)-3(b)

If using a unitrust, the discretionary power to allocate capital gains to income must be exercised consistently. Reg. §1.643(a)-3(e), Examples 12-14.

Reg. §1.643(a)-3(e), Examples 11-14 provide:

**Example 11:** The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning

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\(^1\) DNI is a tax concept used to allocate taxable income to the beneficiaries and represents the maximum amount that can be taxed to the beneficiaries.
of each taxable year, in full satisfaction of that beneficiary’s right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust’s governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of divided income and realizes $80,000 of net long term capital gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A’s right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.

Example 12: The facts are the same as in Example 11, except the neither state statute nor Trust’s governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust’s ordinary and tax-exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust’s Federal income tax return so that the entire $80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise of Trustee’s discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.

Example 13: The facts are the same as Example 11, except that neither state statutes nor Trust’s governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust’s ordinary and tax-exempt income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust’s Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee’s discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

Example 14: Trustee is a corporate fiduciary that administers numerous trusts. State statutes provide that a trustee may make an election to distribute to an income beneficiary an amount equal to four percent of the annual fair market value of the trust assets in full satisfaction of that beneficiary’s right to income. Neither state statutes nor the governing instruments of any of the trusts administered by Trustee has an ordering
rule for the character of the unitrust amount, but leaves such a decision to
the discretion of Trustee. With respect to some trusts, Trustee intends to
follow a regular practice of treating principal, other than capital gain, as
distributed to the beneficiary to the extent that the unitrust amount exceeds
the trust’s ordinary and tax-exempt income. Trustee will evidence this
treatment by not including any capital gains in distributable net income on
the Federal income tax returns for those trusts. With respect to other
trusts, Trustee intends to follow a regular practice of treating any net
capital gains as distributed to the beneficiary to the extent the unitrust
amount exceeds the trust’s ordinary and tax-exempt income. Trustee will
evidence this treatment by including net capital gains in distributable net
income on the Federal income tax returns filed for these trusts. Trustee’s
decision with respect to each trust is a reasonable exercise of Trustee’s
discretion and, in future years, Trustee must treat the capital gains realized
by each trust consistently with the treatment by that trust in prior years.

Conflicts between income beneficiaries and remainder beneficiaries are
not obviated with the power to adjust or unitrust regimes:

- **Capital Gains Tax Allocation***
  
  - With a unitrust regime, the capital gains tax treatment must be consistent: A
    trustee is locked into allocating capital gains the same way that the allocation is
    made in the first year of the trust.
  
  - The allocation of capital gains creates a conflict of interest: If a trustee is locked
    into one method of capital gains tax treatment for the duration of the trust, the
    income beneficiary will want capital gains taxed to the trust and the remainder
    persons will want the capital gains included in DNI and taxed to the income
    beneficiary.

- **Unitrust Investment***
  
  - The imposition of the tax burden creates a conflict of interest.
  
  - How the trust is invested can make a substantial difference to the income
    beneficiary:

    - If the fixed income portion of the portfolio is invested in tax-exempt
      municipal bonds, the yield might be lower than if it was invested in taxable
      bonds; but the income beneficiary will get the tax benefit.

    - In addition, assuming a fixed 4 percent unitrust regime, to the extent those
      lower yielding bonds (and whatever other income and dividends are

* See Appendix 4 for detailed analysis of conflicts regarding capital gains tax allocation and investment
  of the unitrust portfolio.
generated in the trust) produce less than the 4 percent payout the income beneficiary is to receive, the difference will be made up with a tax-free distribution from the principal of the trust (assuming gains are taxed at the trust level).

- If the fixed income portion of the trust is instead invested in taxable bonds, the yield might be higher, but all of it will be taxable to the income beneficiary.

- Also, if the income yield is higher, less will have to be paid to the income beneficiary (income tax free) from the trust’s principal.

- Clearly, the income beneficiary would prefer to see tax-exempt bonds in the fixed income portfolio and the remainder persons would prefer to see taxable bonds.

  - How to resolve the conflict?
    - A trustee should consider all the facts and circumstances and make a reasonable, reasoned determination.

■ More Flexibility with Power to Adjust

- A trustee is not locked into one method of capital gains tax treatment.

- The capital gains tax burden and the tax consequences of the trust’s investment strategy are factors which can be taken into consideration by the trustee in determining the appropriate adjustment amount.

IV. Additional Ethical Considerations in Investing and Administering Trusts

A. Qualified Domestic Trusts (“QDOTs”)

■ Marital Trust and QDOTs – The exercise of the power to adjust or a conversion to a unitrust will not disqualify the marital deduction nor result in a QDOT tax. Regs. §§20.2056(b)–5(f)(1) and 20.2056A–5(c)(2)

  - Consider opting into the unitrust regime or adjusting in a QDOT trust.

  - Ordinarily, a principal distribution from a QDOT trust to the non-resident alien surviving spouse will generate an estate tax. IRC §2056A(b)
- If an adjusted income payment or unitrust payment is made to the non-resident alien spouse, to the extent that payment is comprised of a principal distribution “redefined” as income, that payment is, in effect, a principal payment made without an estate tax consequence.

- This is one situation where the interests of the surviving spouse and the remainder persons may be aligned. To the extent the surviving spouse needs more funds, it is more efficient for all beneficiaries to define any extra payment as income and avoid the imposition of an estate tax.

B. Conflicts when a Remainder Beneficiary is a Trustee


  - Proceedings were initiated on behalf of a stepmother to annul and set aside a unitrust election made by her stepsons, the trustees of a trust set up by her deceased husband. The stepsons were also the remainder beneficiaries of this trust.

  - As a result of the election, the stepmother's income decreased from $190,000 to $70,000 a year.

  - The stepsons also made the election retroactive to 2002, resulting in the stepmother owing the trust $120,000 a year for the three preceding years.

  - Surrogate’s Court:

    - Denied summary judgment on a motion to annul the unitrust election, but determined that an election could not be made retroactively.

  - Appellate Division:

    - Held that trustees are not prohibited from making a unitrust election even when they are remainder beneficiaries who may benefit from such an election. Even though trustees have a fiduciary duty to both income and remainder beneficiaries, it is common, the Court said, for trustees to be interested parties.

      - The Court overruled the Surrogate on the issue of retroactivity.
• The Court noted that the statutory language is unambiguous in clearly authorizing trustees who have made the unitrust election to specify its effective date.

- Court of Appeals: Affirmed

- The Court notes a very interesting difference between the power to adjust and the unitrust: An interested trustee is prohibited from exercising the power to adjust, but there is no per se prohibition with respect to the unitrust regime.

- The Court held:

EPTL 11-2.3(b)(5), the 2001 statute that gives trustees the power to adjust between principal and income, expressly prohibits a trustee from exercising this power if "the trustee is a current beneficiary or a presumptive remainderman of the trust" (EPTL 11-2.3[b][5][C][vii]) or if "the adjustment would benefit the trustee directly or indirectly" (EPTL 11-2.3[b][5][C][viii]). Tellingly, the Legislature included no such prohibition in the simultaneously enacted optional unitrust provision, EPTL 11-2.4. Moreover, in giving a list of factors to be considered by the courts in determining whether unitrust treatment should apply to a trust, the Legislature mentioned no absolute prohibitions (see EPTL 11-2.4[e][5][A]), and created a presumption in favor of unitrust application (EPTL 11-2.4[e][5][b]). We conclude that the Legislature did not mean to prohibit trustees who have a beneficial interest from electing unitrust treatment.

It is certainly true that the common law in New York contains an absolute prohibition against self-dealing, in that "a fiduciary owes a duty of undivided and undiluted loyalty to those whose interests the fiduciary is to protect" (Birnbaum v Birnbaum, 73 NY2d 461, 466 [1989]). "The trustee is under a duty to administer the trust solely in the interest of the beneficiaries" (Restatement [Second] of Trusts § 170 [1]). In this case, however, the trustees owe fiduciary obligations not only to the trust's income beneficiary, Bertha Heller, but also to the other remainder beneficiaries, Suzanne Heller and Faith Willinger. That these beneficiaries' interests happen to align with the trustees' does not relieve the trustees of their duties to them. Here, we cannot conclude that the trustees are prohibited from electing unitrust treatment as a matter of common law principle.

- The Court also affirmed the ability of the trustees to make a retroactive election.
C. Effective Date of Unitrust Election/Power to Adjust Determination – Requires a State-by-State analysis

Unitrust Regime

Note that New York law was changed in August 2008 to make the unitrust option more fully prospective:

An election to opt into the unitrust regime can be made without court approval only for trusts created after January 1, 2002, if made within two years. All other trusts require court approval.

Before the law was changed, the statute provided that the unitrust election began on the date specified in the governing instrument, or in a trustee’s election, or on the date specified by the court or, if none of those specifications was made, on the date the assets first became subject to the trust.

This was interpreted in the Heller case as permitting a retroactive election to be made.

As a result of the changes, the election date specified by a trustee (without court approval) must now be within the year in which the election is made or the first day of the following year. The court can still specify an election date, but the default effective date for a court determination is no longer the first year of the trust in which assets first became subject to the trust.

The revisions to the statute were signed into law on August 5, 2008 and are effective immediately.

- Different states have adopted different statutory language.
- In Maryland, for example, the effective date for the conversion must be at least 30 days after notice of the conversion. Md. Estates & Trusts Code Ann. §15-502(d)(3),(4).
- Florida has statutory language permitting a trustee to determine the effective date of a unitrust election.
However, the Florida statute also provides that the trustee must adopt a written statement providing that “future distributions from the trust will be unitrust amounts”.

**Power to Adjust Regime**


  - Following Nevada’s adoption of the Uniform Principal and Income Act in 2003, trustees of a family trust created in 1934 sought to exercise their adjustment power and petitioned the court to appoint a special trustee.
    - The trustees were also trust beneficiaries. Under the Nevada statute, interested trustees are prohibited from making an adjustment and must seek the appointment of a special, disinterested trustee to do so.
  
    - Whittier Trust Company was appointed as special trustee in February 2005. In September 2005, it filed a petition for approval of an adjustment for the year 2004, the year prior to its appointment.
      - One of the four contingent remainder persons objected to the adjustment, arguing that the special trustee could not make a retroactive adjustment.
    
    - The District Court denied the petition, holding that a special trustee may only adjust between income and principal accrued from its date of appointment.
  
    - Supreme Court reversed the District Court.
      - The Court held that that due to (1) the corrective nature of the power to adjust and (2) the fact that trustees need not formally adopt a new investment strategy before exercising the power to adjust, “at a minimum, a special trustee may adjust between principal and income accrued in the year immediately preceding the special trustee’s appointment.”
  
    - Because of the ambiguous language of the statute, the Court examined the statutory construction and legislative history of both the Nevada statute and the uniform act, finding:
      
      The determination of whether an adjustment between principal and income distributions is necessary often will require a review of data related to trust investment and returns at the close of the year…[the UPAIA] language clearly indicates that the power to adjust may be exercised correctly, after the
trustee has an opportunity to review trust date and trustee investment decisions for the immediately preceding year.

- The Court was not asked to determine whether the power could be exercised retroactively for any earlier years.

  - Given that the power to adjust is a corrective power, however, query whether it may be possible to look back further in order to be fair and reasonable to all beneficiaries.

- In dicta, the Court noted that this corrective power did not only apply to special trustees:

  Although a special trustee must be appointed to make an adjustment when all trustees are also interested trust beneficiaries, the special trustee is simply a neutral party who ‘stands in the shoes’ of the interested trustees to make an adjustment that a disinterested trustee would deem necessary at the close of the year.

- In many states, the power to adjust regime does not appear to have retroactive application.

  - In New Jersey, for example, adjustments made with respect to any accounting period must be made within 65 days of the end of that period. N.J. Stat. Ann. §3B:19B-4(a).

  - In New York, for example, the statute provides:

    Where the rules in article 11-A apply to a trust and the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, the prudent investor standard also authorizes the trustee to adjust between principal and income to the extent the trustee considers advisable to enable the trustee to make appropriate present and future distributions in accordance with clause (b)(3)(A) if the trustee determines, in light of its investment decisions, the consideration factors incorporated in clause (b)(5)(B), and the accounting income expected to be produced by applying the rules in article 11-A, that such an adjustment would be fair and reasonable to all of the beneficiaries. EPTL §11-2.3(b)(5)(A)(emphasis added)

  - In Maryland, an adjustment may not be made before the time within which consents may be given to the trustee, which must be at least 30 days after notice of the adjustment determination is mailed. Md. Estates & Trusts Code Ann. §15-502.3(d)(3),(4).
Where beneficiaries have conflicting interests, is retroactivity a factor which should be taken into consideration in determining which regime to utilize?

D. In Terrorem Clauses


- A trust was created in 1959 with three tiers of beneficiaries, each with a distinct interest
  - The first tier beneficiaries received fixed monthly payments for life (ranging from $200 to $500). The remainder of the income was added to the principal.
  - Following the death of the last to die of the first tier beneficiaries, the remaining trust estate would be split into three equal trusts and the second tier beneficiaries would receive the net income from their respective trusts for life.
  - Upon the death of each second tier beneficiary, the remaining assets would be distributed to that second tier beneficiary’s issue.
- The trust instrument contained a no-contest clause directing that no trust assets be paid to any beneficiary who “contested or sought to impair, object to or invalidate this Declaration of Trust”.
- The trust instrument also provided:
  
  Except insofar as the Trustee shall exercise discretion herein conferred, matters relating to the principal and income shall be governed by the provisions of the Principal and Income Law from time to time existing.
- By the end of 2004, the total value of the original trust exceeded $33 million.
- In early 2004, an attorney for one of the second tier beneficiaries requested an adjustment (pursuant to the California power to adjust) to increase the beneficiary’s distribution for that year. The trustee wrote to all beneficiaries, proposing to transfer approximately $130,000 from principal to income in the beneficiary’s trust.
  - A number of beneficiaries objected to the proposal and the trustee did not implement the adjustment.
- The beneficiary then applied for a judicial determination as to whether a petition to adjust between principal and income would violate the no-contest clause. The beneficiary planned to petition the Court for an annual adjustment equal to 4% of the trust principal.

  - The Probate Court determined that the petition would violate the no contest clause because the petition “would change the characterization of property i.e. from principal to [interest] thereby changing the intent of the settlor.”

- The Court of Appeals affirmed the ruling of the lower court, holding that the power to adjust under California law is not exempted from the scope of a no-contest clause.

  The general provision providing that the trust should be governed by the principal and income law does not override the express intent of the settlor that the second tier beneficiaries receive net income only.

- The Court concluded that an adjustment would impair the trust

  This proposal is a major change which would impair the terms of the original trust because it would provide more income to plaintiff than allowed by the trust in years when net income falls below 4 percent of her trust interest…The trust gave the trustee the power to invade the principal in order to make payment to the first tier beneficiaries but did not provide the same authority in the case of the second tier beneficiaries. The intent of the testator is clear: the second tier beneficiaries were to receive only the net income from the trust. The adjustment petition would significantly alter those terms.

- The Court’s analysis leads to the conclusion that an adjustment to an income-only trust would violate a no-contest clause, except if the trust also permitted principal invasions.

  - But if a principal invasion was permissible, exercise of the adjustment power would be unnecessary.

- Query the Court’s analysis of “impairing” the trust if the adjusted income payout is not considered a principal distribution, but rather is the mechanism by which the trustee determines to administer the trust impartially.
Other Recent Power to Adjust Litigation

- **Estate of Morse**, Index No. 83862 (Sur. Ct., Dutchess Cty. 2006)
  - A testamentary trust was established for the benefit of a surviving spouse, the remainder persons being the decedent’s children from a prior marriage.
  - When the trustee exercised the power to adjust, the remainder beneficiaries objected, claiming the trustee was favoring the interests of the income beneficiary to their detriment. They brought suit to block the adjustment.
  - The trustee filed a petition for advice and direction with the Surrogate.
    - The Surrogate found the adjustment to be appropriate.
      - The remainder beneficiaries failed to show any abuse of discretion, bias, or arbitrary action.
      - The Surrogate further cited the statutory language of EPTL §11-2.3A.
        - A Court shall not change a fiduciary’s decision to exercise or not exercise an adjustment power unless it determines that the decision was an abuse of the fiduciary’s discretion.

E. Identification of Clients – Multiple Representation Conflicts

  - The District of Columbia and 49 other states have professional conduct rules adopted or modified from the ABA Model Rules.
    - California is the only state that has not adopted some form of the Model Rules.
  - All references to the “Rule” or “Rules” herein, refer to the New York Rules of Professional Conduct.
    - Unless otherwise noted, the New York Rules discussed are substantially similar to the Model Rules.
There are a number of situations in which lawyers representing grantors, trustees and beneficiaries may potentially violate the RPC.

- May a lawyer for a grantor also represent the trustee?
  - Rule 1.7(a)(1) provides that a lawyer may not represent a client “if the representation will involve the lawyer in representing differing interests”.
  - The Model Rule prohibits concurrent representation if “the representation of one client will be directly adverse to another client.”
  - Do grantors and trustees have differing or directly adverse interests?
  - A lawyer may be able to cure a potential violation with informed consent. Rule 1.7(b) allows a lawyer to represent clients with differing interests if:
    1. the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
    2. the representation is not prohibited by law;
    3. the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
    4. each affected client gives informed consent in writing.
  - Informed consent is defined in Rule 1.0(j):
    “Informed consent” denotes the agreement by a person to a proposed course of conduct after the lawyer has communicated information adequate for the person to make an informed decision, and after the lawyer has adequately explained to the person the material risks of the proposed course of conduct and reasonably available alternatives.
  - Informed consent under the Model Rule 1.0(e) is defined as:
    …the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct.
- May the grantor’s lawyer also represent the beneficiaries?
Conflicting interests between grantors and beneficiaries may arise. The grantor’s wishes may not necessarily be in the best interests of the beneficiaries.

- For example, a grantor may wish to invest trust assets in a manner which involves more risk than the beneficiaries can tolerate (a concentrated stock position, for instance), or to prohibit principal invasions, or to distribute principal for limited purposes, only.

Is it possible for a lawyer to cure these conflicts pursuant to Rule 1.7(b)?

- Assuming that the lawyer feels that he or she can provide diligent representation to both the grantor and the beneficiaries, can the beneficiaries give informed consent?
  - Will the beneficiaries understand that the lawyer may not be drafting the document in what they consider to be their best interests?
  - If informed consent is not possible, the lawyer may not represent both clients without violating Rule 1.7.

May a lawyer represent the interests of the trustee and the beneficiaries?

- Asset allocation, discretionary distributions, accountings, exercise of trustee powers – these are only some of the matters rife with potential conflict between trustees and beneficiaries. Can a lawyer properly advocate for these different, and potentially conflicting, interests?

- Stock concentration cases like In re Charles G. Dumont, Wood v. U.S. Bank and Fifth Third Bank v. Firstar Bank, NA, discussed infra, provide examples of situations in which the interests of the trustee and income beneficiary are not aligned.

What Rules are potentially violated by this dual representation?

- Under Rule 1.1(c)(1), a lawyer may not intentionally fail to seek the objectives of the client through reasonably available means (Pursuant to Model Rule 1.1, a lawyer must “provide competent representation”). Rule 1.2(a) requires a lawyer to abide by a client’s decision regarding the objectives of representation.
Do these Rules create a potential violation for lawyers representing trustees and beneficiaries with competing interests?

- Is Rule 1.7(b)(1) violated by such representation?

- May a lawyer represent both the income beneficiaries and the remainderpersons?

  - Trust litigation case law highlights many of the conflicts that can arise between income beneficiaries and remainder persons. However, are these conflicts so pervasive that a lawyer can never represent both interests under Rule 1.7?

  - In a second marriage situation, it is understandable that a lawyer may find it difficult to represent the interests of both the second wife income beneficiary and the children from the first marriage remainder persons. See Matter of Heller, supra.

  - As a practical matter, a lawyer may find it difficult to obtain informed consent from both parties.

  - What about a family trust in which the remainder persons are the children of the income beneficiaries?

- May the drafting lawyer name himself as trustee?

  - Rule 1.8(c) prohibits a lawyer from soliciting gifts or drafting instruments giving himself or his family gifts.

  - Rule 1.7(a)(2) prohibits an attorney from representing a client if the lawyer concludes that “there is a significant risk that the lawyer’s professional judgment on behalf of a client will be adversely affected by the lawyer’s own financial, business, property or other personal interests.” The Model Rule prohibits a lawyer acting if there “is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.”

  - Is a fiduciary position considered a gift in violation of Rule 1.8(c)?

    - The Comments to the Model Rules provide that Rule 1.8(c) does not prohibit a lawyer from seeking to have himself or an associated lawyer
appointed to a “potentially lucrative” fiduciary position in the client’s estate.

- The Comments provide that such appointments are subject to the general conflict of interest provision of Rule 1.7 where “there is significant risk that the lawyer’s interest in obtaining the appointment will materially limit the lawyer’s independent professional judgment in advising the client concerning the choice of an executor or other fiduciary.”
  - If the lawyer seeks to obtain the informed consent of the client to cure the Rule 1.7 conflict, the lawyer should advise the client as to the nature and extent of the lawyer’s financial interest in the fiduciary appointment and the availability of alternative candidates for the same appointment.

- Although not all states have adopted the Comments (New York, for example, has not), they may provide useful guidance.

- New York’s Surrogate Court Procedure Act (“SCPA”) §2307-a provides that an attorney (or affiliated attorney or employee) who drafts a will appointing himself as executor is limited to one-half the commissions to which he would otherwise be entitled unless he informs the client, prior to the execution of the will that:
  
  (a) subject to limited statutory exceptions, any person, including the testator’s spouse, child, friend or associate, or an attorney, is eligible to serve as an executor;
  
  (b) absent an agreement to the contrary, any person, including an attorney, who serves as an executor is entitled to receive an executor’s statutory commissions;
  
  (c) absent execution of a disclosure acknowledgement, the attorney who prepares the will, a then affiliated attorney, or an employee of such attorney or a then affiliated attorney, who serves as an executor shall be entitled to one-half the commissions he or she would otherwise be entitled to receive; and
  
  (d) if such attorney or an affiliated attorney renders legal services in connection with the executor’s official duties, such attorney or a then affiliated attorney is entitled to receive just and reasonable compensation for such legal services, in addition to the executor’s statutory commissions.
The acknowledgement of disclosure must be in writing and must be witnessed by at least one witness other than the attorney.

- In Matter of Moss, 863 N.Y.S.2d 588 (2008), the Surrogate held that an acknowledgement of disclosure witnessed by the attorney-executor’s partner was invalid for purposes of SCPA §2307-a.
  
  Under the express terms of section 2307-a, a nominated executor is identified with the draftsman if the two are “affiliated”. In view of the affiliation between the nominated executor and the Partner, the…disclosure statement may reasonably be deemed to have been “witnessed” not simply by the partner, but, in effect and contrary to the purpose of the statute, by the nominee.

- Following the reasoning of the Surrogate, can any employee of the attorney-executor ever be considered an unaffiliated witness? Even an administrative salaried employee who does not share in the firm’s profits?

- Consider the practical difficulties this presents: If the client signs his or her will at the law firm of the attorney-executor, who can witness the acknowledgement of disclosure?

- May the grantor’s lawyer serve as successor trustee?
  
  - What if the grantor’s lawyer, who was not named in the instrument as a successor trustee, is nonetheless appointed successor trustee pursuant to the designation provisions of the governing instrument?

What if the lawyer representing two clients develops a conflict that cannot be cured?

- Rule 1.16(b)(1)/Model Rule 1.16(a)(1) requires a lawyer to withdraw from representation of a client when the lawyer knows that the representation will result in a violation of the RPC.
  
  - Which client must be dropped? Both?

Note that, if a lawyer is serving in a fiduciary capacity only, and is not performing legal services, the lawyer may still be subject to the RPC.

- Pursuant to Rule 5.7(a)(2), a lawyer who provides nonlegal services which are distinct from legal services (such as acting as trustee), is subject to the Rules
with respect to the nonlegal services “if the person receiving the services would reasonably believe that the nonlegal services are the subject to a client-lawyer relationship”.

- Will a beneficiary understand that a person who is a lawyer is not acting in that capacity with regard to his/her trust?
  
  - Fiduciaries who are lawyers should be careful to fully explain their role. They should avoid sending correspondence on firm letterhead or otherwise holding themselves out to be acting in their capacity as lawyers.
  
  - Should the fiduciary advise the beneficiary to seek separate representation?

- Under the Model Rule 5.7(a)(2), the lawyer must take “reasonable measures to assure that a person obtaining the law-related services knows that the services are not legal services and that the protections of the client-lawyer relationship do not exist” - otherwise, he is subject to the Rules with respect to the nonlegal services.

1. Consider Diversification Issues and Retention Clauses:

- What if there is a conflict between the provisions of the document and the realities of the market or needs/wishes of the beneficiaries? Will a family trustee appreciate that s/he will not necessarily be permitted to rely on the terms of the dispositive instrument?


  - A trust created under Mr. Dumont’s will was funded almost entirety with Eastman Kodak stock.

  - An action was brought against JP Morgan Chase (as successor to a former trustee) for breach of fiduciary duty following significant declines in the stock’s value.

  - The Bank had maintained a near-exclusive concentration of the Kodak stock from 1958 until 2002.
- During this time, the Bank had no meaningful investment review process in place and failed to document the investment strategy, performance of Kodak stock and reasons for maintaining the concentration.

- The Bank rarely communicated with the beneficiaries and never addressed their concerns regarding the concentration of Kodak stock.

- The will contained the following retention clause:

  It is my desire and hope that said stock will be held by my said executors and by my said trustee to be distributed to the ultimate beneficiaries under this will, and neither my executors nor my said trustee shall dispose of such stock for the purpose of diversification of investment and neither they nor it shall be held liable for any diminution in the value of such stock.

- The will also provided that:

  The foregoing shall not prevent my said executors or my said trustee from disposing of all or part of the stock of Kodak in case there shall be some compelling reason other than diversification of investment for doing so.

- Surrogate’s Court:

  ▪ The retention language was “clearly precatory”.

  ▪ The Surrogate noted that the Prudent Investor Act statutorily requires a trustee to “diversify assets unless…it is in the interests of the beneficiaries not to diversify, taking into account the purposes and terms and provisions of the governing instrument.”

  ▪ The Surrogate opined that there are three voices to which the trustee must listen: the settlor (his/her intent and strength of wording); the beneficiaries (regarding their economic situation and expressed desires); and the market (realities of financial world and composition of trust corpus).

  ▪ The Surrogate held that, where prudence dictates sale, a retention clause is superseded: “…a retention clause does not exculpate [a fiduciary] from poor judgment and laziness, but instead…a retention clause almost requires a greater level of diligence and work…”

  ▪ After scathing criticism of the Bank’s “on-going self-perpetuating atmosphere of neglect”, the Surrogate surcharged the trustee $24 million.
- The Surrogate held that the Bank’s “complete lack of documentation alone is itself a breach of trust”.

- Appellate Division:
  - The Appellate Court reversed the Surrogate – but on technical grounds, holding that the Surrogate erred by finding that a compelling reason existed to sell the stock on a date that was not pled and, further, that the Surrogate’s determination was based impermissibly on hindsight.
  - The Appellate Court did not address the Surrogate’s determination that a retention clause is superseded where prudence dictates sale. This casts doubt on the ability of a grantor to ever exonerate a fiduciary from the duty to diversify.

- Court of Appeals:
  - Denied motions for leave to appeal.

Mary and Emanuel Rosenfeld Foundation Trust, 2006 Phila. Ct. Com. Pl. LEXIS 394

- Emanuel Rosenfeld, the founder of Pep Boys, established a charitable trust funded entirely with Pep Boys stock in 1952. He named three individuals co-trustees: Mr. Rosenfeld’s son Lester, his daughter Rita, and Lester’s son Robert. Wachovia Bank was the corporate trustee.
  - Lester had worked for Pep Boys all his life. After his retirement in 1980, he continued to serve as a consultant and board member.
  - Beginning in 1997, Rita and Wachovia both urged diversification of the trust assets. Lester and Robert both opposed diversification, and both ignored the bank’s attempt at communication regarding the issue. The trustees were deadlocked. The Court found that:
    - Lester’s obdurate refusal to diversify stemmed from his position with the company, the interests of which the Court found he put above those of the charitable beneficiaries.
    - Robert abdicated any responsibility as trustee by inattention, his supine submission to his father’s presumed inside knowledge and his fear of the personal financial repercussions of failing to follow his father’s lead.
In 2001, Lester and Robert agreed to sell some of the Pep Boy stock. By this time, however, the stock had declined significantly in value.

In 2002, Rita sued Lester, Robert, and Wachovia for breach of their fiduciary duty, based on the failure to diversify. Summary judgment was later granted for Wachovia.

The Court noted that Wachovia (along with Rita) raised “contemporaneous and vigorous” objections to Lester and Robert’s actions, actively monitored and reviewed the trust investments and sent multiple letters to the co-trustees urging diversification.

The Court noted that neither Lester nor Robert appreciated the responsibilities of being a trustee.

The following excerpts from Lester’s disposition graphically illustrate this point:

Q: Do you consider yourself a trustee of the foundation to have any duties to beneficiaries of the foundation, and by beneficiaries, I mean the charities that will be receiving...

A: No.

Q: …distribution?

A: No.

Q: You have no duty to the beneficiaries?

A: No. I have no commitment to them, they’re very appreciative of what we give them and I’m grateful for the fact that we’re able to do it.

Q: Now, I understand from your testimony that it didn’t matter what the bank was recommending as to putting the proceeds into, you were against diversification per se, correct?

A: Yes.

The Court surcharged Robert and Lester almost $600,000 for trust losses, calculated from the date Rita and Wachovia objected to the concentration in Pep Boys stock, and over $425,000 in legal fees.

- In 1989, a charitable lead trust was funded entirely with IBM stock.

- A few months after the trust’s funding, the corporate trustee’s Trust Committee met to review the management of the trust. Although the trustee had a written diversification policy, the Committee felt it would be imprudent to diversify the IBM stock immediately because the value of the stock had dropped since the funding of the trust. It agreed to diversify “at a later time when the stock reached a higher price” (a tactic the beneficiaries’ expert witness described as “wishful thinking”).

- Following an intermediate accounting, the remainder persons filed objections and brought suit for failure to diversify. At the time of the accounting, the trust had diversified only a third of the IBM stock and the value of the trust assets had dropped from $3.5 million to $1.8 million.

- The Surrogate’s Court found that the trustee had been negligent, that it violated its own policies, and that it should have diversified most of the trust assets soon after funding.

- The Appellate Division agreed with the findings of the Surrogate:

  In addition…to testimony describing petitioner’s decision to delay diversification as unwise and unreasonably risky…petitioner failed to follow its own internal protocol during the administration of the trust…failed to conduct more than routine reviews of the IBM stock…[and gave] no particular consideration to the unique needs of this particular trust…Neither adverse tax consequences nor any provision of the trust instrument restricted petitioner’s freedom to sell the IBM stock and diversify the trust’s investments.


- John Wood created a trust valued at over $8 million, naming Firstar as successor trustee after his death and his wife as beneficiary.

- Nearly 80% of the trust was funded with Firstar stock.

- The trust instrument authorized the trustee:
to retain any securities in the same form as when received, including shares of a corporate trustee, even though all of such securities are not of the class of investments a trustee may be permitted by law to make and to hold cash uninvested as they deem advisable or proper.

- Shortly after John’s death, Firstar decided to sell only ten percent of the Firstar stock to pay the nearly $4 million in debts owed by the estate. Sales of other stock generated the balance of the funds required.

- After paying the debts, 86% of the trust portfolio was composed of Firstar stock.

- Despite requests by John’s wife to diversify, Firstar did not diversify the concentration.

- Firstar stock plummeted and John’s wife sued the Bank for failure to diversify.

- The jury returned a verdict in favor of Firstar, but the Court of Appeals overturned the jury verdict and remanded the case for a new trial.

- Court of Appeals:
  - To abrogate the duty to diversify, the trust must contain specific language directing the trustee to retain in a specific investment a larger percentage of trust assets than would normally be prudent.

  - Even if a trust authorizes a trustee to “retain” assets that would not normally be suitable, the duty to diversify remains absent special circumstances. The duty to diversify may be expanded, eliminated or otherwise altered only if the trust instrument clearly indicates an intention to abrogate the duty to diversify.

    - The retention clause contained within the trust agreement merely circumvented the duty of undivided loyalty and did not affect the duty to diversify.

    - The clause smacked of boilerplate language.


- This case involved a single stock portfolio, which was sold within one year.

- Elizabeth Gamble Reagan, a descendant of one of the founders of Procter and Gamble, established a charitable remainder unitrust (“CRUT”) with $2 million
of Procter and Gamble stock. One of the purposes of the trust was to diversify out of the Proctor & Gamble stock.

- The trust agreement contained the following retention clause:

  Trustees shall have the…[right to] retain, without liability for loss or depreciation resulting from such retention, original property, real or personal, received from Grantor or from any other source although it may represent a disproportionate part of the trust.

- Under the terms of the CRUT, Reagan was to receive an 8 percent unitrust payout, with the remainder to be distributed to three charities upon her death.

- U.S. Bank (Firstar Bank) was appointed trustee and gradually began to reduce the concentration of Procter & Gamble stock, but by the end of the year, the value of the CRUT had dropped by 50 percent.

- Reagan then replaced U.S. Bank with Fifth Third and filed suit against U.S. Bank for breach of fiduciary duty.

- U.S. Bank contended that the language of the CRUT both relieved it from the duty to diversify and exculpated it from liability for losses.

- The trial court awarded over $1 million in damages to Reagan.

- Court of Appeals affirmed, holding:

  - The duty to diversify attaches to all investments, even those already held in trust, absent special circumstances or explicit authorization not to diversify.

  - The language contained in the trust agreement did not clearly indicate the intention to abrogate the duty to diversify.

  - A permissive provision or a mere authorization to hold a trust asset is not sufficient to insulate a trustee from liability.

Night Watchman?

- According to the Court in Saxton (discussed below):

  A fiduciary must be as a watchman in the night, ever vigilant and always dedicated to the best interest of the cestui que trust.
- Will a family member trustee appreciate that s/he has agreed to be a “night watchman”?

Americans for the Arts v. Ruth Lilly Charitable Remainder Annuity Trust #1, 855 N.E.2d 592 (Ind. Ct. App. 2006)

- Ruth Lilly was a descendant of Eli Lilly, founder of Eli Lilly and Co.
- In 1981, the Probate Court appointed National City to be conservator of Ruth’s estate.
- In 2001, National City petitioned the Probate Court to permit certain changes to the estate plan. The plan was to streamline and simplify Ruth’s estate in order to avoid unnecessary taxes and litigation relating to her disposition of more than $1 billion.
- The plan involved the creation of two Charitable Remainder Annuity Trusts (“CRATs”).
- All interested parties, including three charitable remainder beneficiaries, were given notice of the changes and copies of the proposed plan, and each had an opportunity to raise objections. While many objections were raised and changes were made, there were no objections to the retention clause, which provided:

  To retain indefinitely any property received by the trustee and...any investment made or retained by the trustee in good faith shall be proper despite any resulting risk or lack of diversification or marketability and although not of a kind considered by law suitable for trust investments.

- In January 2002, the CRATs were funded as planned, entirely with shares of Lilly stock.
- By March, National City had developed an investment policy for the CRATs.
- In July, National City had sold significant portions of the Lilly stock.
- By October, most of the Lilly stock had been sold.
- However, the value of the Lilly stock had declined considerably during this time frame.
- In November, National City sought court approval of its diversification of the CRATs. Two of the charities objected, citing violations of the Prudent Investor Act, and sought to surcharge National City for the losses.
- Probate Court:
  - The Probate Court granted summary judgment in favor of National City. The Court concluded the exculpatory clause was valid and binding upon the parties, and that the investments made or retained by the trustee during the accounting period were made or retained in good faith and were proper.

- Court of Appeals:
  - The Court affirmed the granting of summary judgment.
  - The Court cited the level of sophistication of the attorneys involved and the fact that no objections were raised to the retention clause despite the 400 hours they spent reviewing the proposed plan and the $250,000 incurred in legal fees.
  - Since the charities were given the opportunity to object to the retention/exculpatory clause and did not, they could not “turn back the clock” and claim the provision was unenforceable.
  - The Court found no evidence of self-dealing by National City.
  - The Court found no evidence that National City benefited from the failure to diversify.
  - The Court found no evidence that National City abused its fiduciary relationship.
  - The general retention clause, combined with the clause explicitly lessening the trustee’s duty to diversify, was sufficient to exempt National City from its duty to diversify.
    - The Court relied on Wood v. U.S. Bank, which held that the trust instrument could have eliminated the duty to diversify, had it included the requisite authorizing language.
  - The exculpatory clause was held enforceable.
    - Absent a finding of self-dealing, breach of fiduciary duty or abuse of a confidential relationship with the settlor, the Court could not conclude that the exculpatory clause was invalid.
National City Bank v. Noble, 2005 Ohio 6484 (Ct. App.)

- In 1965, the son of the founder of the J.M. Smucker Company established a trust for the benefit of his two children, funded with life insurance policies and shares of J.M. Smucker Company stock.

- The trust agreement contained the following clause:

  The Trustees are expressly empowered to retain an investment, without liability for depreciation in value, any and all securities issues by The J.M. Smucker Company, however and whenever acquired, irrespective of the proportion of the trust properly invested therein.

- In 1980, a request was made to diversify the Smucker Company stock, which at that time constituted 87% of the trust’s assets. In 1983 and 1985, the trustees began to diversify and by 2001, Smucker Company stock constituted 25% of the total value of trust’s equities.

- In 2002, the trust was terminated and its assets were distributed. In the judicial accounting proceedings, the trust beneficiaries objected, citing breaches of fiduciary duty, including for failure to diversify and for conflict of interest.

  - The individual trustee was a member of Smucker Company’s board of directors.

- The Probate Court denied summary judgment to the beneficiaries.

- The Court of Appeals affirmed.

- The Court noted (1) the clear retention language and (2) additional language providing that the corporate trustee had no duty to review or make recommendations without the specific request of the individual trustee and (3) the overall increase in the trust assets over the life of the trust.

- The Court of Appeals distinguished Wood, noting that in Wood concentrated position was in the corporate trustee’s stock. Further:

  There is no allegation that Welker Smucker’s Trust contained an inordinate amount of [corporate trustee] stock. While the trust certainly contained a large amount of stock in the family company, it is unquestionable that the value of the trust increased since its inception – providing both for the retention of Smucker stock and for the benefit of the beneficiaries.
John Ervin established a testamentary trust for the benefit of his daughter and four grandchildren.

In 2001, one of the beneficiaries objected to an accounting, claiming that the corporate trustee breached its fiduciary duty on multiple counts, including breach of the duty to diversify the trust’s holdings.

- The primary asset of the trust was stock in Ervin Industries, a family-owned corporation. However, it is unclear from the decision what percentage of the trust assets were invested in that stock.

- The Court of Appeals held that the trustee was “exempt” from the prudent investor rule.

- The Michigan prudent investor rule provides that a trustee must act as a prudent person would, “except as otherwise provided by the terms of the trust”.

  - In this instance, the trust agreement authorized the trustee “to invest and reinvest…in income-producing assets in accordance with its judgment, not being limited by any present or future investment laws...” (emphasis added)

- The Court found that this language alone made the prudent investor rule inapplicable to any evaluation of the trustee’s management of trust assets.

- Furthermore, the trust agreement contained a retention clause permitting the trustee to retain Ervin Industries’ stock “without liability for any loss that may be incurred, and without regard to the proportion that it may bear to the whole…until any substantial amount of it shall be or become unproductive of income.”

- In response to this language, the Court noted:

  Certainly, the Ervin Industries’ stock held by the Trust is not currently ‘unproductive of income’ and [the beneficiary] does not assert otherwise. Therefore, [the trustee] has had no duty to diversify the Trust’s holding at any time, and there is no basis for [the beneficiary] to complain that [the trustee] has failed to do so.
Query whether a drafting lawyer may, without violating the RPC, represent a beneficiary wanting to diversify trust assets if the grantor expressed an intent not to diversify.

- The prudent investor rules are typically default regimes. What if Firm A, at the direction of the grantor, drafts a document which purports to obviate the duty to diversify. A former attorney at Firm A who has no knowledge or involvement with the drafting of the instrument later becomes employed by Firm B, the firm representing the trust beneficiaries in an action to compel diversification. Is Firm B precluded from representing the beneficiaries?

  ▪ Rule 1.9(b) provides that, absent the former client’s written informed consent, a lawyer is prohibited from knowingly representing another client in the same or substantially related matter in which the lawyer’s former firm has previously represented the former client (1) whose interests are materially adverse to the prospective client and (2) about whom the lawyer had acquired confidential information that is material to the matter.

  • Although the lawyer was previously employed by Firm A, if he had no knowledge of the transaction and gained no confidential information material to the action to compel diversification, it appears Firm B would not be precluded from representing the beneficiaries.

  • The Comments to the Model Rules provide that the duty of loyalty to the former client must be weighed against the ability of current clients to have a reasonable choice of legal counsel and the ability of lawyers to form new associations.

- What if the grantor’s lawyer working at Firm A drafts a document which purports to obviate the duty to diversify. The grantor’s lawyer later becomes employed by Firm B, the firm representing the trust beneficiaries in an action to compel diversification. Is Firm B precluded from representing the beneficiaries?

  ▪ In this situation, the lawyer was directly involved with the matter and the former client’s representation. However, would the lawyer have gained confidential information that is material to the diversification issue?

- There is a stricter standard for a lawyer with direct involvement in the specific transaction.
- Rule 1.9(a) provides a *one-prong test* with respect to a lawyer who had direct involvement in the specific transaction.

  - Rule 1.9(a) prohibits a lawyer who has formerly represented a client from representing another client in the same or substantially related matter in which the prospective client’s interests are “materially adverse” to the interests of the former client.

- Rule 1.9(b) provides a *two-prong test* for disqualification with respect to a lawyer who did not have direct involvement in the specific transaction, but whose former firm was involved.

  - In order to disqualify a lawyer because his prior firm represented a client in the same or substantially related matter, it must be shown that (1) the prospective client and former client’s matters are materially adverse *and* (2) the lawyer acquired confidential information during his association with his former law firm.

    - Rule 1.9(a) does not require that the lawyer have privileged information material to the current matter to preclude him from representing the current client.

- Rule 1.9(a) and Rule 1.9(b) provide that the conflict between a former client and a prospective client may be resolved by the former client’s informed consent.

  - What if the former client is deceased?

    - Note that Rule 1.10 imputes conflicts of interest from lawyers to their firms.

2. **Communication is Key**

   - An integral part of a lawyer’s representation of a trustee is ensuring that the trustee understand his or her fiduciary duties to the beneficiaries. If the lawyer fails to inform the trustee of the need to communicate with the beneficiaries, is the lawyer violating the RPC?

    - Rule 1.1(a) requires a lawyer to provide competent representation to a client.

    - Rule 1.3(a) requires a lawyer to act with reasonable diligence in representing the client.

    - Rule 1.4(a)(2) requires a lawyer to reasonably consult with his client regarding the means to achieve the client’s objectives.

- Settlor created a revocable trust in 1991, which provided she was to be consulted by the trustee as to any purchase or sale and that the trustee had to abide by her decision.

- The trust was funded with Enron stock and other assets.

- Seven months later, she signed a letter directing Bank of America, as trustee, to retain the Enron stock. The letter exonerated and indemnified the Bank for all losses as a result of the retention and relieved the Bank from responsibility for analyzing and monitoring the stock. By the end of 2000, Enron stock comprised 77% of the trust assets.

- After Enron stock plummeted in 2001, the settlor brought suit against Bank of America for the lost value of the stock, claiming Bank of America failed to comply with the prudent investor rule.

- The Court rejected the arguments of the settlor.
  - Kansas statutory law *specifically provides* that a trustee who follows the written directions of a settlor of a revocable trust is deemed to have complied with the prudent investor rule and is authorized to follow such written instructions.
  - In rejecting the settlor’s claims, the Court also relied on the retention of investment powers by the settlor and the letter to the Bank.
  - However, the Court did note that the better practice of Bank of America would have been to communicate the effects of the letter and to have notified the settlor of the significant decreases in the value of the Enron stock.


- Francis Margesson was the sole income beneficiary of a trust, founded predominately with large concentrations of four stocks. Bank of New York had been a co-trustee since 1989 and became sole trustee in 1996.

- Because sale of the highly appreciated stocks would result in substantial tax liability, there was a long-standing understanding that the trust would be managed to avoid unnecessary sale of these stocks. Francis was 74 years old when Bank of New York became sole trustee.
- In 1997, the Bank of New York sought to diversify the trust assets. Without communicating with the trust’s administrative officer or Francis, the trust’s investment officer sold a portion of the stock holdings. The sale resulted in Francis being personally liable for over $22,000 in capital gains. Francis then sued the Bank of New York for breach of fiduciary duty.

- The bank claimed it was merely complying with the prudent investor rule and the sale was made for the purpose of diversifying the trust’s investments.

- The Appellate Division overturned a lower court’s grant of summary judgment, finding that, although the bank complied with the prudent investor rule, a triable issue of fact existed as to whether it breached its fiduciary duty by failing to communicate:

  “She [the administrative officer] had no conversation with [the investment officer] regarding this sale or the plaintiff’s needs as income beneficiary. [The investment officer] has a responsibility to communicate with [the administrative officer]…to ensure his understanding of the investment objectives.”

**Rollins v. Branch Bank and Trust Co. of Virginia, 56 Va. Cir. 147 (2001)**

- In 1977, trusts were established for the benefit of the grantors’ children and grandchildren. The trusts were funded predominately with stock of one company.

- The trust agreement contained the following language:

  Investment decisions as to the retention, sale, or purchase of any asset of the Trust fund shall likewise be decided by such living children or beneficiaries, as the case may be.

- At the time of the trust’s inception, the Bank obtained written approval to over-concentrate the trust. This concentration was held until 1997, when the trustee sold the stock at the direction of the beneficiaries. By that time, however, the stock had plummeted to one-twelfth of its highest value. The beneficiaries sued the Bank for breach of duty for the failure to diversify assets and the failure to communicate with the beneficiaries.

- The Bank claimed that the language of the trust agreement insulated it from liability, as the investment responsibility rested exclusively with others. Additionally, the Bank relied on Virginia statutory law:
Whenever the instrument under which a fiduciary or fiduciaries are acting vests in any other person including a co-fiduciary to the exclusion of one or more of the fiduciaries, authority to direct the making or retention of investments the excluded fiduciary or co-fiduciary shall not be liable as fiduciary or co-fiduciary for any loss resulting from the making or retention of any investment pursuant to such authorized directions.

- The Court agreed that the language of the trust agreement and the statute protected the trustees from liability for failure to diversify.

- However, the Court held, the trustee has a duty to (1) keep informed as to the conditions of the trust and (2) fully inform beneficiaries of all facts relevant to the subject matter of the trust and which are material for the beneficiary to know for the protection of his interests. A trustee cannot rid himself of this “duty to warn”.

- Although the conduct of the beneficiary in requesting retention of the stock prohibited them from complaining about that decision, the prohibition on recovery does not excuse a trustee from liability for failing to participate in the administration of the trust, which can include the duty to communicate.

- The Court overruled the demurrer regarding breach of fiduciary duty, except as it related to failure to diversify.

**Hartman v. Walker, 73 Va. Cir. 245 (2007)**

- Separate testamentary trusts were established for the benefit of each of the testator’s two children. Upon the death of one, the trust assets would pour over to the surviving sibling’s trust. The remainder persons of both trusts were the testator’s grandchildren. The testator’s son Leonard, daughter Barbara, Barbara’s child, and a bank were named as co-trustees of Leonard’s trust.

- Each trust was funded with equal shares of two family entities, a limited partnership and a corporation, each holding unimproved real estate. Barbara was the general and controlling partner of the partnership. The trusts were valued at $14.5 million, but Leonard’s trust distributed to him only minimal income. In 2005, after receiving only $19,000 in income, Leonard brought suit against his co-trustees for lack of impartiality and failure to diversify trust assets. He sought to remove the trustees and $800,000 by way of a surcharge.

  - Leonard claimed that the co-trustees breached their fiduciary duties by failing to approve measures to increase his income payments, failing to disclose
offers to purchase partnership assets, and developing partnership land at partnership expense without his knowledge or consent. He alleged all actions were taken to deprive him of income in order to benefit the remainder persons of his trust – his sister’s children. Leonard had no children.

- The Court rejected the argument that the Will relieved the trustees from complying with the Prudent Investor Act and permitted the trustees to maintain trust assets for the remainder persons at Leonard’s expense.

  In order to circumvent the diversification requirements of the Prudent Investor Act, held the Court, the testator’s intent must be clear: “This intent could be demonstrated in a variety of ways, though reliance on ‘a general authorization in a will or trust authorizing a fiduciary to invest in such assets as the fiduciary, in his sole discretion may deem best’ will not suffice…The mere fact that she [the testator] permitted Trustees the ability to maintain undiversified investments…would not have had the effect of waiving application of the [Prudent Investor] Act.”

- The Court also concluded that while neither the Prudent Investor nor Principal and Income Acts “specifically demand that a beneficiary be paid ‘reasonable income’, they do contemplate that the beneficiaries will be impartially favored and that trusts will be managed so as to fulfill the intent of the testator, which may in fact require that a reasonable ‘net income’ be provided.”

- The Court noted that, as a co-trustee and beneficiary, Leonard must be provided with adequate information to enforce his rights or prevent or redress a breach of trust. Interestingly, the Court found that it was in failing to properly provide information concerning offers made for partnership property that the trustees may have breached their fiduciary duty to Leonard (by preventing a full determination of whether the trust was better served by maintaining unproductive property).


- Decedent established an inter vivos trust in 1976. In 2000, the trust was amended to make her husband a trustee and purportedly a co-settlor of the trust. The decedent died in 2003, leaving her husband as sole trustee.

- In 2003, after the decedent died, the husband’s attorney sent Patricia Welch a check for $50,000 from the trust funds. The accompanying letter explained that he was the trustee, Patricia was a contingent beneficiary and the check...
represented an “advance payment” of her legacy under the trust, which he would continue to make annually until her legacy was satisfied.

- Shortly thereafter, Patricia sought a copy of the trust agreement. After her request was denied, she brought a petition for an accounting of the trust, a copy of the trust agreement, the removal of the husband as trustee, and sanctions against the husband as trustee. The Probate Court denied her request.

- The Court of Appeals found that Patricia was entitled to an accounting and a copy of the trust agreement. The Court found that Patricia was an interested trust beneficiary, who was entitled to relevant information about the trust and an accounting under Michigan law.

- The Court of Appeals also ordered the Probate Court, on remand, to remove the husband as trustee, finding he breached his fiduciary duty by failing to provide Patricia with an accounting and other relevant information.

3. The Duty to Diversify is not Absolute


- Settlor established a revocable trust pursuant to the terms of which marital and family trusts were created for the benefit of her husband after her death.

- The corporate trustee was a wholly owned subsidiary of Sky Financial Group, a publicly traded company and the trust contained a large holding of Sky Financial stock, which paid a generous dividend.

- After the death of the settlor in 1999, without ever inquiring as to the health or financial circumstances of the husband, Sky Trust began to diversify the assets of the trust, decreasing the income yield, instituting a more equity-weighted investment goal and lengthening the investment time horizon.

- In fact, the health of the elderly husband rapidly deteriorated after his wife’s death and he moved into a nursing home where he died in December 2000.

- Remaindermen filed objections to the trustee’s accounting. The trial court found the trustee liable for gross negligence.

- On appeal, the Superior Court affirmed:
The trust became irrevocable prior to the enactment of the Uniform Principal and Income Act in Pennsylvania and the Court concluded the diversification requirements under the Act did not apply.

The Court found the trustee guilty of gross negligence in diversifying the stock.

The Court held that “diversification cannot become a goal in and of itself. Rather, diversification is a tool that can provide the means to effectuate a settlor’s goals of a trust, if used properly and prudently with due regard to the specific facts and circumstances that exist in a particular case”.

A trustee’s hypothetical good strategy does not satisfy its fiduciary duty.


- Testator’s will contained the following language:

  I note that the bulk of my income-producing assets at the time of my death will probably consist of securities of TRW, Inc…and I note that I am particularly desirous that my TRW, Inc. securities be retained by my Executrix and by my Trustee unless compelling reasons arise for the disposal thereof. (emphasis added)

- Within two months of the delivery of the securities, and over the objection of the testator’s widow, the trustee sold approximately half of the shares.

- The widow brought suit against the trustee for breach of trust and to require the trustee to repurchase the shares.

- The trustee argued that the will authorized it to sell the stock, and that it did so in the interest of diversification.

- The Surrogate rejected the argument of the trustee and ordered the trustee to repurchase the shares and pay the widow’s attorneys fees and expenses.

- Appellate Division affirmed:

  - The Court found that diversification was not a compelling reason to sell and that the trustee breached its fiduciary duty when it sold the securities over the objections of the widow.

- Decedent established a testamentary trust. The purpose of the trust was to provide suitable income to the decedent’s daughter. The remainder was to be paid outright to the daughter’s son.

- The trust was initially funded with a concentration of stock of the trustee bank, along with stock in 18 other corporations. Eventually, the trustee liquidated all of the stock and invested the proceeds in its common stock funds.

- After the death of his mother, the son filed objections to the trustee’s final accounting. He claimed that the trustee breached its fiduciary duty by diversifying the trust assets.

- The son relied on a clause in the trust agreement permitting the trust to retain the stock of the trustee bank.

- The Court rejected the claims of the son, noting that, just as a trustee cannot rely on the terms of a retention clause to justify a failure to diversify assets, neither may a beneficiary claim such clause supersedes the requirements of the Prudent Investor Act:

  Since a fiduciary’s maintenance of an undue concentration of a particular stock...has been found to constitute a violation of the ‘prudent person rule’, petitioner can hardly be faulted for selling the National Commercial Bank stock and thereby insuring proper portfolio diversification...Neither the trust language permitting retention of the stock nor the preference of the trust beneficiaries would have insulated petitioner from a claim that it breached its fiduciary duty had it failed to achieve appropriate diversification.


- Charlotte Hyde and Nell Cunningham were the daughters of Samuel Pruyn, founder of Finch, Pruyn & Company, Inc., a closely-held family corporation. At her death, Charlotte established testamentary trusts, and Nell established an inter vivos trust in 1935. Two of Charlotte’s trusts and Nell’s trust were the subject of accounting proceedings.

- Each trust was funded with large concentrations of Finch Pryun common stock. Each trust agreement granted the trustees absolute discretion in managing trust
assets, but contained no directions concerning the disposition of the Finch Pruyn stock.

- In addition to being closely-held, Finch Pruyn had an unusual capital structure in which Class A shareholders held all voting rights and therefore controlled the decision to liquidate, but were entitled to virtually no proceeds upon liquidation. Class B shareholders held no voting rights and therefore no power to effect a liquidation, but received almost all proceeds upon liquidation.

- Beneficiaries alleged breach of fiduciary duty for failure to diversify by the corporate fiduciaries (no objections were filed against the individual trustees). The Surrogate’s Court dismissed all objections. Upon appeal, each accounting was addressed individually.

- As to one of the Hyde trusts, the Appellate Division held that the corporate fiduciary “made a reasonable determination that it was in the best interests of the beneficiaries not to diversify”. The corporate trustee examined the liquidity of the stock, the fact that the company was closely-held with an unusual corporate structure, its lack of marketability, the general economic situation of the trust assets, the expected tax consequences of different investment decisions, the needs of the beneficiaries, and the intent of the settlor.

  - The Bank met with various investment bankers and brokerage houses prior to making a determination as to the liquidity and marketability of the stock, as well as regularly reviewing the financial condition of the trust assets.

  - The Court also noted the Bank’s conclusion that the needs of the beneficiaries militated against diversification. The stock paid considerable dividends such that a discounted sale for the sake of diversification may have been imprudent. Additionally, the Court noted that the intent of the settlor for the stock to remain in the family was a “material consideration” in determining whether to diversify.

- As to the other Hyde trust, the Appellate Division affirmed the Surrogate Court’s dismissal of the claims against the trustee. Although the corporate trustee was appointed in 1995, it was not informed of its appointment until 2004, and could not be surcharged for failure to exercise a fiduciary duty of which it was unaware. The Court also held that, even if the trustee had known about the appointment, it would have concluded, as it did with respect to the other Hyde trust, that diversification was unnecessary.
Similarly, the Court upheld the Surrogate’s decision regarding the Cunningham trust

- One of the factors in the corporate fiduciary’s decision not to diversify was a letter received from a Pruyn family member stating that the corporation was willing to repurchase the shares at a heavily discounted price. The Court found that the Bank reasonably determined that it was not in the best interests of the beneficiaries to sell the stock at a heavily discounted price merely for the sake of diversification.

- The Court found that the trustee was cognizant of the lack of liquidity of the stock, its lack of marketability and its unusual capital structure. Even so, the Court noted, the Bank regularly explored the market for the stock and kept well informed of the company’s financial condition.

**In re Wege Trust, 2008 Mich. App. LEXIS 1259 (Ct. App.)**

- Decedent died in 1947, establishing a trust under his will that was funded predominately with shares in his company.

- When the company went public in 1998, the trust sold 10% of its holdings in the company for approximately $52,000,000. The trust sold additional shares in 2000 and 2001, but still maintained a concentration of over 40%.

- The Will expressed the decedent’s desire that his trustees retain the stock and provided:

  [The trustees may] hold and retain bonds or shares of stock or other securities or other properties held or owned by me at my death, if in their discretion they shall deem it prudent and for the best interest of my estate so to do, notwithstanding the fact that the retention of such investments might, except for this express direction, be in violation of the laws of this State governing investments.

- In 2006, one income beneficiary brought suit against the corporate trustee for failure to diversify and sought removal.

- The Probate Court found that the language of the Will provided a “safe harbor” protecting the trustee “from the diversification requirement that ordinarily would be deemed prudent”.

- The Court of Appeals upheld the decision of the lower court and reiterated that the language of the Will expressly exempted the trustees from compliance with
the prudent investor rule, allowing them to retain the stock if they in their subjective discretion deemed it prudent and in the best interest of the beneficiary, notwithstanding the objective standards of prudence that might otherwise be imposed under the statute.

- The Court noted that the beneficiary presented no evidence that the trustee acted other than as it deemed prudent and in the best interest of the beneficiary.

- The Court also noted that deposition testimony expressed the difficulties inherent in diversifying this particular stock and that the beneficiary disavowed an interest in diversifying when she found the price of the stock to be too low.

- The Court of Appeals did affirm the lower court’s removal of the trustee, based upon an inappropriate principal place of administration.


- Beneficiary’s uncle was named successor individual trustee of a trust. Under the terms of trust, the principal was to be fully distributed to the nephew upon his 40th birthday in 2001.

- The uncle delegated investment duties to Merrill Lynch in 1999, who invested heavily in high-tech stocks.

- After the technology market crash in 2000, the value of the trust fell significantly. When the final principal distribution was made, the value of the trust was 10% of the value when the uncle delegated investment responsibility to Merrill Lynch.

- The beneficiary brought suit against the uncle under the Prudent Investor Act for breach of his fiduciary duty in delegating the management of trust assets. The uncle brought and won a motion for summary judgment, which the nephew appealed.

- The Court noted that “[P]ursuant to the Ohio Uniform Prudent Investor Act, a trustee ‘may delegate the following investment and management functions, using reasonable care, skill and caution: 1) selecting an agent; 2) establishing the scope and terms of the delegation consistent with the purpose and terms of the trust; [and] 3) periodically reviewing the agent’s actions in order to monitor the agent’s performance with the terms of the delegation.”
The Court of Appeals affirmed the lower court’s ruling, holding that a trustee need not be heavily involved in the duties delegated in order to comply with the Prudent Investor Act.

- The uncle periodically met with Merrill Lynch, reviewed performance reports, statement and confirmations of trades, and reviewed (but did not scrutinize) the regular account statements. The uncle admitted he never questioned the investment strategy. For the Court, it was sufficient that the uncle did not “fall asleep at the wheel”.

- The Court also took note that losses in high-tech stocks were very common for the time period and that a common investment strategy was to stay the course in that particular market.

Interestingly, the Court faulted the nephew for the losses. It was revealed that he and the Merrill Lynch account officer collaborated in determining to make all of the high-tech stock trades.


- New York Estates, Powers and Trusts Law §11–1.7(a) provides:

  The attempted grant to an executor or testamentary trustee, or the successor of either, of any of the following enumerated powers or immunities is contrary to public policy

  (1) The exoneration of such fiduciary from liability for failure to exercise reasonable care, diligence and prudence.

  See Estate of Allister, 545 N.Y.S.2d 483 (1989)

- Connecticut Fiduciary Powers Act (Conn. Gen. Stat. §45a-234(38)) provides that the following exculpatory clause may be incorporated by reference:

  The fiduciary is hereby exonerated from any liability resulting from its retention, sale or operation, whether due to losses, depreciation in value or actions taken or omitted to be taken with respect to any business, farm or real estate interests held in an estate or trust, nor shall the fiduciary be liable for any loss to or depreciation of any other estate or trust property, so long as it is acting in good faith in the management thereof and exercising reasonable care and diligence, but the fiduciary is not exonerated from his own bad faith, willful misconduct or gross negligence.

- Fla. Stat. §736.1011 provides:
(1) A term of a trust relieving a trustee of liability to a beneficiary for breach of
trust is unenforceable to the extent that the term:
   (a) Relieves the trustee of liability for breach of trust committed in bad faith
       or with reckless indifference to the purposes of the trust or the interests of
       interested persons; or
   (b) Was inserted into the trust instrument as the result of an abuse by the
       trustee of a fiduciary or confidential relationship with the settlor.
(2) An exculpatory term drafted or caused to be drafted by trustee is invalid as an
   abuse of a fiduciary or confidential relationship unless:
   (a) The trustee proves that the exculpatory term is fair under the
       circumstances.
   (b) The term’s existence and contents were adequately communicated
       directly to the settlor or to the independent attorney of the settlor. This paragraph
       applies to trusts created on or after July 1, 2007.

- Fla. Stat. §733.620 applies this same language to personal representatives

DC Code § 19-1310.08; Va. Code Ann. § 55-550.08

- Term of trust relieving a trustee for breach of trust is unenforceable to the extent
  it relieves liability for acts of bad faith or reckless indifference

- Such term is invalid as an abuse of the fiduciary relationship unless trustee
  proves the existence and contents of the term were adequately communicated to
  the settlor


- An exculpatory clause that excuses self-dealing or attempts to limit liability for
  breaches of duty committed in bad faith, intentionally, or with reckless
  indifference to the interest of the beneficiary, is generally considered to be
  against public policy


- Remanded to determine whether there was gross negligence, which was excused
  under the exculpatory clause

If attorney includes an exoneration clause, is the attorney guilty of violating the
Code of Professional Responsibility?

- Rule 3.1(a) prohibits an attorney from advancing a claim unless there is a basis
  in law or fact for doing so that is not frivolous.
Rule 3.1(b) provides that a claim is frivolous if the lawyer knowingly advances a claim or defense that is unwarranted under existing law.

- This language is similar to the former Disciplinary Rules of the Code of Professional Responsibility (“DR”) §7-102(a)(2), which was under consideration in Estate of Edwin Lubin.

- In Estate of Edwin Lubin, 539 N.Y.S.2d 695 (1989), the Surrogate said of the testamentary exculpatory clause under consideration:

  This provision purports to relieve the executor from liability “for any loss or injury to the property…except…as may result from fraud, misconduct or gross negligence.” This clause, which attempts to exonerate petitioner from liability for his failure to use reasonable care, diligence and prudence, is contrary to public policy and void (EPTL 11-1.7). Clearly, counsel has an obligation to advise his client that such an exoneration clause is a toothless tiger if the beneficiaries of the estate are aware of the provisions of EPTL 11-1.7. If a client who has been so advised nevertheless prevails upon counsel to include the exoneration clause, either to lull the nominated fiduciary into a false sense of security so that he will undertake the fiduciary responsibilities or to deceive the beneficiaries into believing that they do not have a remedy against a negligent fiduciary, is counsel guilty in violation of DR 7-102 of the Code of Professional Responsibility of having become a coconspirator in an act declared to be against public policy?

- See also In re Kornrich, 2008 N.Y. Misc. LEXIS 2049 (noting an attorney’s attempt to draft a trust agreement holding herself unaccountable “strongly suggests a violation of professional ethics on her part”).

- Greater protection from liability was previously available in the inter vivos context. In New York, exculpatory clauses in inter vivos trusts have been upheld [Carey v. Cunningham, 595 N.Y.S.2d 185 (1993); Bauer v. Bauernschmidt, 589 N.Y.S.2d 582 (1992)] but that may be changing:

  - In re Kornrich, supra, the Surrogate held:

    This public policy against exonerating testamentary fiduciaries from any and all accountability is equally applicable with respect to inter vivos trusts where there is no one in a position to protect the beneficiaries’ interests during the existence of the trust. Although some decisions might appear to hold that the references to testamentary fiduciaries in EPTL 11-1.7 signify that exoneration clauses in inter vivos trusts are not similarly forbidden…such a conclusion is not supportable.
- In any event, exculpatory provisions are strictly construed: Will a family trustee appreciate that s/he will not necessarily be permitted to rely on an exculpation clause?

- Note that a lawyer who drafts a document limiting that lawyer’s own liability for malpractice violates Rule 1.8(h)(1).

  ▪ If the lawyer drafts a document with an exculpatory clause and the lawyer is named as trustee, would this violate the Rule?

    • The Rule provides that a lawyer may not limit his own liability for “malpractice”. Does this Rule also extend to limiting his liability for acting as a fiduciary?

    • What if the drafting lawyer is not named in the document, but is later appointed successor trustee? Must the lawyer decline the appointment to avoid violating the Rule?

  ▪ Note, the Model Rule allows the attorney to draft his own exculpatory clause for professional malpractice if the client has his own independent representation in connection with the agreement.

    • Under the Model Rules, can a lawyer limit his liability for acting in a fiduciary capacity under the terms of the document if the client has independent representation?


  - The Court reiterated the rule that indemnification clauses are subject to strict scrutiny.

  - Maria Williams, a Brazilian citizen, was the income beneficiary of an inter vivos trust and J.P. Morgan acted as trustee.

  - Williams became concerned that a proposed treaty between the U.S. and Brazil (providing for an information exchange between the tax authorities) would lead to severe consequences for Williams and her family for having failed to report the trust assets to the Brazilian authorities.
To avoid the possible penalties, a plan was developed by Williams’ attorneys for the trust assets to be reinvested solely in tax-exempt bonds so that the assets would no longer be reported for tax purposes in the U.S.

Williams authorized J.P. Morgan to liquidate the trust’s tax-generating investments in a letter which explained the nature of the proposed treaty, including the fact that the treaty was only in the negotiation stage, although the letter opined that ratification was likely.

The letter contained the following language:

I hereby release and discharge you from any liability to me for making such sales and causing the trust to incur a net current decrease an account of capital gain taxes. I hereby agree to indemnify you against any claims made by other beneficiaries of the trust arising out of my requested action.

(Jemphasis added)

J.P. Morgan requested and received an opinion letter from Williams’ attorneys, a prominent New York law firm, endorsing the strategy authorized by Williams.

U.S. and Brazil never entered the proposed treaty and Williams’s son Luiz filed suit against J.P. Morgan for breach of fiduciary duty for failure to appropriately reinvest the assets of the trust.

J.P. Morgan impleaded Maria Williams, asserting the right to contractual indemnification based on the letter.

The Court held that, because of the strict scrutiny given to indemnification clauses, the surrounding facts and circumstances must be considered in order to find an “unmistakable and unequivocal intent” to indemnify the negligent party.

The Court found that the indemnification provision in the letter only indemnified J.P. Morgan for the original reinvestment decision and not for J.P. Morgan’s alleged failure to monitor the propriety of the trust investments in subsequent years.

The Court held that J.P. Morgan could not “shirk its responsibilities to act as trustee and fiduciary”.

In re Trusteeship of Williams, 591 N.W.2d 743 (Minn. Ct. App. 1999), affirmed
631 N.W.2d 398 (Minn. Ct. App. 2001)

- A decedent created a testamentary trust, funded almost exclusively with stock from his closely-held dairy farm. In 1980, Borden, Inc. acquired the dairy farm and the trust’s stock was exchanged for Borden stock.

- That same year, the two individual trustees (also beneficiaries) and one corporate trustee began to diversify the trust assets. By the end of 1989, Borden stock accounted for 40% of the trust assets. Over the next several years, the value of Borden stock steadily declined and several attempts at further diversification were attempted, but the corporate trustee voted to hold the stock until the price recovered. When the stock was finally disposed of, the price of Borden stock had fallen from $36.36 per share to $14.25 per share. One of the individual trustees objected to the 1990-1995 accounting, and sought to surcharge the corporate trustee for the losses.

- The corporate trustee claimed that the trust agreement’s exculpatory clause protected it from liability. It read:

  No trustee shall be liable for the default or doing of any other Trustee, whether the act be one of misfeasance or nonfeasance, nor shall he be held liable for any loss by reason of any mistake or errors in judgment made by him in good faith in the execution of the trust.

- The Court of Appeals recognized the validity of an exculpatory clause, but held that the clause could not protect the corporate trustee from an act of negligence.

  - The Court found that the first section of the clause protected trustees from the acts of other trustees, not themselves; and the second section protected only against “mistakes or errors of judgment”, not negligence.

  - The Court remanded the matter to the District Court to consider the surcharge claim.

- The District Court concluded that as part of its duty to diversify, the corporate trustee also had a duty to educate or convince the individual trustees about the need to diversify the assets. If unable to do so, the corporate trustee should have sought instruction from the court or petitioned to withdraw.

- The Court concluded that, by deferring the sale of Borden stock and attempting to time the market, the corporate trustee breached its duty to diversify assets and was surcharged $4 million.
Possible solution:

- Investment Direction Agreement ("IDA")
    - The beneficiaries filed objections to a trustee’s final accounting based on the trustee’s failure to diversify a high concentration of IBM stock over a 30-year period.
    - An investment direction agreement had been signed by the life tenant and two remainder persons in 1960. The IDA directed the trustees to hold the IBM stock and released them from liability due to decreases in value.
    - Beginning in 1984, two of the three beneficiaries repudiated the IDA and urged diversification, but the trust officer maintained that the IDA prevented him from taking any action, despite the Bank’s own policy of diversification and careful scrutinization of concentrated holdings.
    - The trustee also failed to communicate with the beneficiaries on tax considerations, investment planning and market changes, never comprehensively evaluated the IBM stock and never considered alternative investment choices over the 30-year period.
    - By 1987, the trust had lost over $4 million.
    - The Surrogate held that “the bank breached its fiduciary duty…in such a degree that no court of equity or law can permit it to shield itself behind an IDA executed by two beneficiaries, then in their 20’s and 30’s, which they subsequently repudiated time and time again.”
    - However, in dictum, the Court did say that a fiduciary should be entitled to rely on an IDA in appropriate circumstances:
      - A fiduciary should be entitled to rely on an investment directive from the beneficiaries in contravention of the normal policy of the bank for a reasonable amount of time, or until such time that there is demonstrated disagreement among the beneficiaries, provided however that the bank does not completely abdicate its fiduciary responsibility to periodically advise the beneficiaries of time-tested formulas for protecting their investments from the inroads of a fluctuating market...What is a reasonable time that a corporate fiduciary should be required to seek reaffirmation of an IDA can only be set forth in this decision as dictum,
since there is no precedent for establishing such a benchmark, and it
would be unfair to hold a trustee to an ex post facto standard in this
proceeding. It seems to this court, however, that with the record-keeping
and computer systems available to the modern corporate fiduciary an IDA
should be reaffirmed at least every four years, or within 30 days upon any
indicated repudiation or disagreement among the beneficiaries.

Perfect solution?

■ Create a Directed Trust under Delaware Law

- Under Delaware law, a settlor can name either an individual or institution to
direct the trustee on the investments.

- This arrangement may be particularly attractive where the settlor owns a block
of stock, closely held family business or other asset which the settlor wants to
ensure remains in the family indefinitely.

- Using a Delaware directed trust, the settlor can use his or her own outside
manager to make trust investment decisions, leaving the administrative duties in
the hands of the trustee.

- Should the settlor want to retain investment control, he or she may serve as the
adviser without jeopardizing any potential estate planning benefits.

- In Delaware, a settlor can authorize individual co-trustees, protectors or advisers
to direct the trustee to make distributions to beneficiaries.

- Except in cases of willful misconduct, a trustee will not be held liable for any
loss resulting from complying with an investment direction or distribution
decision given or made by an authorized person. Del. Code Ann. tit 12, §3313.

- Ancillary benefits of using Delaware law:
  ▪ Delaware allows trusts to continue indefinitely.

  ▪ Delaware law provides that, as long as there are no Delaware beneficiaries,
there will be no Delaware income tax imposed on the trust income and
capital gains realized in the trust.
5. **Derivative Strategies**

  
  David Levy opened an investment management account with Bessemer Trust, funded with a large concentration of Corning, Inc. stock which he acquired shortly before the account was opened. The stock certificate prohibited trading of the shares for a period of one year.

  The investment management account constituted a large percentage of David’s net worth, and he informed Bessemer Trust that it was important to protect the account from any possible downward movement in the price of Corning stock. Bessemer Trust repeatedly informed him that, given the restrictions, it was not possible to gain immediate protection.

  At some later point, David consulted with an advisor outside of Bessemer Trust who informed him that there were various hedging strategies he could employ to protect against falling stock prices, including the purchase of a “European options collar”.

  David eventually purchased a European options collar through Merrill Lynch, but not before the value of the stock dropped. He then brought suit against Bessemer Trust for a variety of claims, including gross negligence and breach of fiduciary duty for failing to inform him about the availability of collars.

  The Court held that David’s suit survived summary judgment, but no ruling was ever issued.

  This case did not involve a trust or the application of the Prudent Investor Act and David had specifically required Bessemer Trust to provide him with diversification strategies. Nevertheless, it might be useful for a trustee to consider a hedging strategy when dealing with a concentrated position if diversification is not possible or is inappropriate.

-F. **Self-Dealing by Fiduciaries**

- **Estate of Hester v. United States,** 2007 U.S. Dist. LEXIS 14834 (W.D.Va.)
  
  Testator established a trust naming her widower as income beneficiary and trustee, with their two children as remainder persons. At the time of the testator’s death, the trust was valued at $3.2 million.
- In February 1998, the widower transferred all of the trust’s liquid assets into his own brokerage account and co-mingled the funds. Over the next several months, the widower lost $2 million from day-trading, withdrew over $450,000 in cash, and collected $280,000 on a promissory note held by the trust.

- When the widower died in October 1998, the funds had become so co-mingled, it was impossible to distinguish trust funds from the individual brokerage funds.

- The estate tax return for the widower included the misappropriated funds in his gross estate, and over $2.7 million was paid in estate taxes. The children did not assert a claim against the father’s estate, nor did the executors claim a deduction for possible claims, probably because the same individuals were beneficiaries of both estates.

- The estate later claimed an estate tax refund on two alternative grounds: (1) as the widower had possessed no interest in the misappropriated assets, he was merely holding the assets in a constructive trust for the benefit of the remainder persons and the misappropriated funds were not includable in the decedent’s gross estate, and alternatively (2) if the misappropriated assets were includable in the estate, the estate should be awarded an offsetting deduction for claims against the estate (under IRC §2053(a)(4)) or for indebtedness (with respect to property includable in the estate under IRC §2053(a)(4)). When the IRS refused the refund, the children brought suit.

- District Court:
  - As to the first claim, the Court found that since the decedent “exercised dominion and control over the assets as though they were his own without an express or implied recognition of an obligation to repay”, the misappropriated funds were properly includable in the gross estate.
  - The Court rejected the second argument, as the remainder persons had never asserted a claim against the estate and the statute of limitations for asserting such a claim had expired. The Court also held that misappropriation of trust assets did not create an indebtedness.

- Be mindful of Rule 1.15(a): A lawyer cannot commingle or misappropriate client funds or property.
Estate of Robert Atkins (Settled)

- In April 2003, diet guru Robert Atkins died leaving an estate valued at $400 million. 90% of the estate assets poured over to a martial trust. The remaining assets passed to a foundation established to continue Dr. Atkins’ diet research. Dr. Atkins’ widow, Veronica, and two individuals were named trustees under the will. The income from the marital trust was reported to range between $14 million and $25 million per year.

- Veronica reportedly suffered severe depression following the death of her husband. Shortly after his death, Veronica received a phone call from a self-described entrepreneur who offered to help her with her finances. He introduced her to two of his acquaintances, an accountant and an attorney from Connecticut. By the end of 2003, the three men succeeded the two original trustees and became officers in the foundation.

- The trustees were each paid $1.2 million a year in commissions. Two of the trustees were paid by Veronica personally, as the combined payments exceeded the statutory limitations on trustee commissions. Veronica also agreed to a ten-year employment agreement between the men and the foundation with automatic time renewals, effectively employing the three men with the foundation for their entire lives. The men also purchased and made themselves beneficiaries of $15 million in life insurance on Veronica.

- The relationship began to break down in 2006 when Veronica met a man she later married. Veronica eventually stopped paying the $1.2 million personally, and sought to terminate the employment agreement. The men sued Veronica for breach of contract and sought $8.7 million in damages, representing back pay and fees to which they claimed they were entitled under the contract.

- In April 2007, Veronica brought suit in New York Surrogate’s Court to remove the three men as co-trustees of the marital trust, to surcharge them for unreasonable compensation charged, and to appoint a corporate fiduciary.

Estate of Brooke Astor (Pending)

- Socialite Brooke Astor died in August 2007 at the age of 105, leaving an estate valued at approximately $130 million.

- In 2002, Mrs. Astor executed a will under which her son, Anthony Marshall, received significantly more assets outright than under her prior will, which was executed in 1997. Mr. Marshall was appointed sole executor and trustee.
- In July 2006, Phillip Marshall filed a petition in State Supreme Court accusing his father Anthony Marshall of neglecting Mrs. Astor’s care while enriching himself with her fortune.

- JP Morgan Chase, one of the court-appointed guardians, challenged the 2003 transfer to Anthony Marshall of Mrs. Astor’s home in Maine and $5 million. In fact, JP Morgan Chase filed amended tax returns for Mrs. Astor, characterizing the items as taxable income rather than gifts. This could result in Mr. Marshall owing millions of dollars of income tax payments.

- In 2006, Mr. Marshall was removed as his mother’s guardian. He and his wife Charlene also agreed to relinquish their appointment as co-executors of his mother’s will. It was agreed that the Surrogate would name an administrator following Mrs. Astor’s death.

- After her death, the court-appointed guardians petitioned the Court for appointment as temporary co-administrators. They also argued that the 2002 will was invalid, claiming Mrs. Astor was either not competent or was unduly influenced when she signed it.

- Mr. Marshall opposed the petition.
  - Mr. Marshall claimed that his mother was neither incompetent nor unduly influenced when she signed the 2002 will. Mr. Marshall also opposed the appointment of the administrators, claiming that the individual administrator would use the appointment to further her own interests, contrary to his mother’s wishes, and that the corporate administrator is biased against him.

- On October 26, 2007, J.P. Morgan Chase and retired State Appeals Court Judge Howard Levine were named temporary administrators.

- In November 2007, Anthony Marshall was indicted on multiple criminal charges stemming from his handling of Mrs. Astor’s finances while she was still living.
  - The charges include grand larceny, falsifying business records, offering a false instrument for filing, and criminal possession of stolen property.
  - Mr. Marshall’s former attorney, Francis Morrissey, Jr. was also indicted.

- The Westchester Surrogate’s Court has agreed to stay its proceedings until the Manhattan District Attorney pursues its criminal charges against Mr. Marshall.
- Mr. Marshall’s criminal trial date set for February 23, 2009, has been postponed.

- Be mindful of other Rules of Professional Conduct:

- **Rule 4.1: Truthfulness in Statements to Others**

  In the course of representing a client, a lawyer shall not knowingly make a false statement of fact or law to a third party.

  - Presumably, the falsification of business records would fall under this Rule.

- **Rule 8.4: Misconduct**

  A lawyer or firm shall not:

  ...

  (b) engage in illegal conduct that adversely reflects on the lawyer’s honesty, trustworthiness or fitness as a lawyer;

  (c) engage in conduct involving dishonesty, fraud, deceit or misrepresentation;

  (d) engage in conduct that is prejudicial to the administration of justice;

  ...

  (h) engage in any other conduct that adversely reflects on the lawyer’s fitness as a lawyer. [not in Model Rule]

- What is the proof necessary to find a violation of Rule 8.4?


- Note, pursuant to Rule 1.14(b), when a lawyer reasonably believes that his client has diminished capacity, the lawyer *may, but is not required to*, take reasonably necessary action to protect the client. Such action will not trigger a violation of
the attorney-client privilege, provided information is revealed only to the extent reasonably necessary to protect the client’s interest.


- A testator established a testamentary trust for the benefit of his granddaughter. The trust authorized income and principal distributions for her support, education, maintenance and general welfare until age 30, at which time the balance of the funds would be distributed to the granddaughter outright.

- The granddaughter’s divorced father was named trustee.
  - Under the terms of the divorce settlement, the father was obligated to pay his daughter’s educational and medical expenses.

- After the testator’s death in 1997, the father began to make payments from the trust for his daughter’s private school expenses, medical expenses, and personal allowance.

- In August 2000, a court relieved the father from child support obligations and ordered that his daughter’s further “normal and customary” college expenses be paid from the trust.

- In March 2003, the daughter objected to the trustee’s accounting, claiming that the divorce decree required the father to personally pay her educational expenses, rather than using trust funds.

- Surrogate’s Court:
  - The Court found that the father’s personal obligation to support the beneficiary could “not be avoided by him by the simple expedient of using trust funds to pay for what he was otherwise lawfully required to expend for her support” and ordered the father to reimburse the trust for expenditures related to the daughter’s secondary education, medical expenses, and personal allowance.

  - The Court did not require the father to reimburse the trust for expenditures for her college education, finding that the August 2000 Supreme Court order controlled.

- Appellate Division:
The Appellate Division held that the father did not engage in self-dealing, as he used the trust funds “precisely in the manner authorized by the testator in the will provision establishing the trust”.

- The Court also took note that the testator was aware of the father’s support obligation.

- Court of Appeals:
  - The Court agreed that the expenses in question were within the expenditures authorized by the trust, but noted that the father did not seek court approval for the use of trust funds to fulfill his personal obligation regarding the secondary school expenses.
  - The Court remitted the matter to the Surrogate’s Court to determine if the father made the expenditures of trust funds in good faith and if those expenditures furthered his daughter’s interests.

G. Attorney-Client Privilege

Pursuant to Rule 1.6, a lawyer is prohibited from revealing confidential information, absent informed consent of the client or in other limited circumstances.

Confidential information is defined as:

…information gained during or relating to the representation of a client, whatever its source, that is (a) protected by the attorney-client privilege, (b) likely to be embarrassing or detrimental to the client if disclosed, or (c) information that the client has requested be kept confidential. “Confidential information” does not ordinarily include (i) lawyer’s legal knowledge or legal research or (ii) information that is generally known in the legal community or in the trade, field or profession to which the information relates.

Model Rule 1.6 prohibits a lawyer from revealing information related to the representation of a client, absent informed consent.

Under New York law, for example, the attorney-client privilege extends to fiduciary relationships.

- Civil Practice Law and Rules (“CPLR”) §4503(2) provides that a beneficiary is not entitled to access privileged communications made between a personal representative and the personal representative’s attorney, solely by virtue of his/her position as a beneficiary.
However, a “fiduciary exception” to the privilege may apply.

- The privilege is not absolute and a showing of “good cause” may trump the privilege.

  - The controlling feature for the applicability of the fiduciary exception is whether the advice sought was for the benefit of the beneficiary, as a result of the fiduciary relationship. Stenovich v. Wachtell, Lipton, Rosen & Katz, 756 N.Y.S. 2d 367 (2003)

  - Factors to be considered are: (1) whether the beneficiaries may have been directly affected by a decision the fiduciary made on the attorney’s advice, (2) if the communications are the only evidence available regarding whether the fiduciary’s actions furthered the interests of the beneficiaries, (3) whether the communications relate to prospective actions and not advice on past actions, and (4) whether the communications sought are highly relevant and specific. Hoopes v. Carota, 531 N.Y.S.2d 407 (1988), affirmed by, 543 N.E.2d 73 (Ct. App. 1989)

Note, however, that inter vivos trusts are excluded from CPLR §4503(2) and communications with counsel may be accessible by beneficiaries of inter vivos trusts.

In Florida, for example, a lawyer retained by the trust generally represents the trustee, not the beneficiary and the beneficiary would have to prove the existence of some exception to overcome the privilege. Jacob v. Barton, 877 So. 2d 935 (2004)

- However, the beneficiary may be considered the “real client” if the beneficiary will ultimately benefit from the work the trustee has instructed the attorney to perform, such as a legal memoranda regarding the trust’s tax issues.

  - See also Barnett Banks Trust Company v. Compson, 629 So. 2d 849 (Fla. 2nd DCA 1993)(finding that a trustee’s duty to provide beneficiaries with relevant information regarding the assets and administration of a trust is not sufficient to compel the production of documents when the litigant-beneficiary is not bringing suit to protect her interests as a beneficiary of the trust).

- Note, however, that that the law is clear regarding personal representatives and estates: “In Florida, the personal representative is the client rather than the estate or the beneficiaries.” Rules Regulating the Florida Bar, 4-1.7.
V. Minimizing Fiduciary Risk

Recent litigation offers fiduciaries some guidelines for minimizing risk:

- Carefully examine the circumstances
  - The specific terms of a trust and the particular circumstances of the beneficiaries will drive the choices a fiduciary must make; including whether to exercise the power to adjust or opt-in to a unitrust regime and whether it might be permissible to deviate from the duty to diversify assets.

- Do not blindly rely on the language of the trust agreement
  - Trustees who blindly rely on the terms of a trust agreement leave themselves open to liability. Retention and exculpatory clauses are strictly construed.
  - Boilerplate language is not sufficient to obviate the duty to diversify.
  - If the settlor’s intent is for a concentrated holding to be maintained, insure that is documented in the trust instrument.
  - No matter what the language of an instrument provides, trustees must be vigilant not to abdicate their fiduciary duties.

- Maintain communications with the beneficiaries
  - Communication is key. A trustee should always maintain regular communication with beneficiaries and keep them informed.

- Maintain business records
  - A trustee should always document decisions made regarding the trust. Indeed, in the Dumont case, the Surrogate found that the lack of documentation itself constituted a breach of trust.
  - It is critical to establish and implement procedures to enable a trustee to comply with his fiduciary responsibilities, and document having done so.

- Consider an IDA or creating a trust in/moving a trust to Delaware
  - Courts are strongly disposed to find a duty to diversify. These are effective risk reduction strategies.
Consider the use of derivative instruments

- If diversification is not advisable for any reason, consider whether the use of derivative instruments is appropriate.

Consider appointment of a corporate fiduciary

- The appointment of a corporate fiduciary can alleviate the pressure on a family member trustee, circumvent intra-family suspicion and prevent perceived or actual impropriety.

- Many individual trustees, particularly family members who may be acting as a favor, do not appreciate the full extent of the responsibilities, and potential liabilities, to which they are subject. A professional trustee can provide expertise and guidance to insure compliance with the law.
A model Uniform Prudent Investor Act (UPIA) was promulgated by the National Conference of Commissioners on Uniform State Laws in 1994 and recommended for enactment by the states. The UPIA allows trustees and similar fiduciaries to employ modern portfolio theory to guide investment decisions, and evaluates a fiduciary’s conduct based on a strategy for the total portfolio, rather than on the selection of individual assets. In addition, the UPIA makes the following alterations in the former criteria for fiduciary investment: a) the tradeoff between risk and return is identified as the fiduciary’s central investment consideration; b) categoric restrictions on types of investments have been abrogated; c) the concept that fiduciaries should diversify portfolio investments has been integrated into the definition of prudence; d) the much criticized rule of trust law forbidding the trustee to delegate investment and management functions has been reversed (some jurisdictions impose notice requirements not mandated by the UPIA); and e) the trustee may be relieved from liability from acts of the agent, if certain requirements are met.

It should be noted that charitable foundations and private trusts are subject to similar investment rules. The UPIA is applicable to foundations organized in trust form. Charitable corporations, on the other hand, are governed in many jurisdictions by the Uniform Prudent Management of Institutional Funds Act (UPMIFA).

The UPMIFA, promulgated in 2006 and modeled after the UPIA, replaces the former Uniform Management of Institutional Funds Act of 1972.
This chart shows the states that have adopted the UPIA, or substantial portions thereof, as of publication. Additionally, other states are identified that require a total portfolio approach to investment management, but which do not otherwise have provisions resembling the UPIA.

If a state has no total portfolio statute, the chart makes no representation regarding whether that state’s laws contain any other provision resembling the UPIA.

The far right column of the chart indicates whether a state has adopted the UPMIFA.

| State             | Uniform Prudent Investor Act (or similar UPMIFA provisions) Effective Date | Total Portfolio Statutes (or UPMIFA provisions) Effective Date | Authority | | Risk/Return Liabilities Emphasized | | Unrestricted Investment Types Authorized | | Diversification of Prudent Funds as Emphasized | | Delegation of Investment Management Authorized | | Trustee/Agent Liability Severed | | Notice of Delegations Required | | Uniform Prudent Management of Institutional Funds Act (UPMIFA) |
|------------------|---------------------------------------------------------------------------|-----------------------------------------------------------------|-----------|-------------------------------|---------------------------------|--------------------------------|-------------------------------|--------------------------------|---------------------------|--------------------------------|--------------------------------|--------------------------------|
| Alabama          | 1/1/07                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Alaska           | 5/23/98                                                                   |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Arizona          | 7/20/95                                                                   |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Arkansas         | 9/1/05                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| California       | 1/1/96                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Colorado         | 7/20/95                                                                   |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Connecticut      | 10/1/97                                                                   |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | Yes                            | Yes                            | No                             |
| Delaware         | 7/19/96                                                                   |                                                                                 |           | No                            | No                              | No                             | No                            | No                            | No                        | No                             | No                             | No                             |
| District of Columbia | 3/1/04                     |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | Yes                       | No                             | No                             | No                             |
| Florida          | 10/1/93                                                                   |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Georgia          | 1/1/98; 7/1/02                                                            |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Hawaii           | 4/14/97                                                                   |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Idaho            | 7/1/97                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Illinois         | 1/1/92                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Indiana          | 6/30/99                                                                   |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Iowa             | 7/1/00                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Kansas           | 7/1/00                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Kentucky         | 7/1/96                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Louisiana        | 8/15/01                                                                   |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Maine            | 7/1/05                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Maryland         | 10/1/94                                                                   |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Massachusetts    | 3/4/99                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Michigan         | 4/1/00                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Minnesota        | 1/1/97                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Mississippi      | 7/1/06                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Missouri         | 8/28/96                                                                   |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Montana          | 1/1/03                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Nebraska         | 1/1/05                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Nevada           | 10/1/10                                                                   |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| New Hampshire     | 10/1/04                                                                   |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| New Jersey       | 7/30/05                                                                   |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| New Mexico       | 7/1/95                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| New York         | 1/1/95                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| North Carolina   | 1/1/00                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| North Dakota     | 8/1/07                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Ohio             | 1/1/07                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Oklahoma         | 11/1/95                                                                   |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Oregon           | 1/1/06                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Pennsylvania     | 12/25/99                                                                  |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Rhode Island     | 8/6/06                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| South Carolina   | 10/1/06                                                                   |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| South Dakota     | 7/1/05                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Tennessee        | 7/1/02                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Texas            | 1/1/04                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Utah             | 1/1/07                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Vermont          | 7/1/08                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Virginia         | 1/1/00                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Washington       | 1/1/85; 7/3/95                                                           |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| West Virginia    | 7/1/96                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Wisconsin        | 4/9/04                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |
| Wyoming          | 4/1/03                                                                    |                                                                                 |           | Yes                           | Yes                             | Yes                            | Yes                           | Yes                           | No                        | No                             | No                             | No                             |

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Fiduciary Trust’s investment management services extended to foundations and endowments during the 1930s. In the early 1960s, Fiduciary Trust began investing internationally, making it one of the first American firms to develop global investment capabilities. Fiduciary Trust offers the following services to clients throughout the world:

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A state-by-state analysis of legislation
to define trust income

The Uniform Principal and Income Act (“UPAIA”), issued by the National Conference of Commissioners on Uniform State Laws, has the basic purpose of providing guidelines for trustees in defining principal and income. The Act, which was originally promulgated in 1931, was substantially revised in 1962 and 1997.

The UPAIA of 1997 is a companion to the Uniform Prudent Investor Act of 1994, and provides the means to implement an investment regime embodied in the prudent investor rule—investment for total return under modern portfolio theory. The shift to a total return approach intensified the competing interests between the current and remainder beneficiaries of a trust, placing the trustee in a dilemma between investing for growth of capital and providing fair distributions to current beneficiaries who are entitled to trust income. The UPAIA of 1997 revolutionized the administration of trusts by providing potential solutions to the dilemma, permitting trustees discretionary power to adjust allocations between income and principal to meet income needs of current beneficiaries and preserve principal for future beneficiaries. This new approach is found in Section 104 of the UPAIA. Another widely-used approach is the unitrust option, permitting a trustee to convert a conventional income trust to a total return trust, under which the payout to the income beneficiary is a fixed percentage of the trust’s market value. The UPAIA does not provide for a unitrust approach.

As of June 2008, 47 states and the District of Columbia have adopted the UPAIA, or substantial portions thereof. Although North Dakota has adopted the UPAIA, it has not yet drafted legislation. Illinois has not adopted the UPAIA, but it has enacted a form of total return legislation. Mississippi and Vermont have adopted neither the UPAIA nor any other form of total return legislation.

Included in this guide is information on the key aspects of total return legislation including: a) a default rule of either the power to adjust approach, as found in UPAIA Section 104, or traditional income allocation principles; b) the unitrust approach as an opt-in provision with a statutory distribution percentage; c) mandatory court approval to opt into or opt out of a unitrust approach, or both; d) safeguards to protect the trustee from liability for the good faith exercise or non-exercise of these important new powers; and e) an abuse of discretion standard that protects a trustee from liability for a good faith decision to exercise or not exercise the power to adjust.
The chart makes no representation as to those states that have neither adopted the UPAIA nor any other form of total return legislation. The chart shows the states that have adopted a method for defining income under either or both the power to adjust or unitrust approach, and describes the other key aspects of each state’s law.

**The effective date for conversion may not be less than 60 days after the notice of conversion.**

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Trustee Safeguards:

1. Notice to beneficiaries of proposed adjustment is optional, but if trustee provides notice and no beneficiary objects, the trustee may not be held liable for the adjustment.
2. No duty to adjust. A trustee is not liable for not considering whether to make an adjustment, or choosing not to make an adjustment.
3. In an abuse of discretion proceeding regarding the trustee's power to adjust, New York, Ohio and Washington added language that the court may not require the trustee personally to pay damages unless the trustee acted in bad faith and dishonestly.
4. A decision to adjust the distribution to the income beneficiary to an amount not less than 3% nor more than 5% shall be presumed fair and reasonable to all beneficiaries.
5. Trustee may make a safe harbor adjustment up to and including an amount equal to 4%.
6. In an abuse of discretion proceeding regarding the trustee's power to adjust, the sole remedy shall be to seek an order from the court to instruct the trustee to direct, deny, or revise the adjustment.
7. If a trustee reasonably and in good faith takes or omits to take any action under a unitrust section, and a person interested in the trust opposes the act or omission, the person's exclusive remedy shall be to seek an order from the court to direct the trustee to convert, recover, or change the payout percentage.
8. Unless a court determines that a trustee abused its discretion regarding the adjustment power, a trustee shall be reimbursed for all costs and attorney's fees incurred in defending an abuse of discretion action.
9. Breach of fiduciary duty claims are barred two years from when the trustee sent notice of proposed action(s) to beneficiaries.
10. No duty to convert or reconvert to or from a unitrust.

FN 1 (California) 4% is the default. Percentage may be 3%–5% if all beneficiaries consent in writing.

FN 2 (Florida) Trusts that exist on 1/1/03: The default rule is traditional income allocation, and the trustee may opt into the power to adjust or the unitrust. Trusts that are created after 12/31/02: The default rule is the power to adjust, and the trustee may opt into the unitrust.

FN 3 (Kentucky) The default rule for an individual acting as trustee is the traditional income allocation rule, but a corporate trustee's default rule is the power to adjust. An individual trustee may opt into the power to adjust, but only with court approval. Any trustee may opt out of the power to adjust with court approval.

FN 4 (Louisiana) Effective date for trusts created before 1/1/02 is 1/1/04, unless all current beneficiaries or the trust instrument designates an earlier effective date. 1/1/02 effective date for trusts created on or after 1/1/02.

FN 5 (Maryland) Use of the power to adjust is contingent on a determination that a unitrust conversion is not appropriate. A trustee may not make an adjustment without court approval if the adjustment results in a distribution other than 4%. Trustee is required to give notice to all beneficiaries of a proposed decision regarding the exercise or non-exercise of the power to adjust.

FN 6 (New York) For trusts that existed as of 1/1/02, court approval was not required to adopt a unitrust approach if election was made by 12/31/03. For trusts established after 1/1/02, court approval is not required if election is made before the last day of the second full year of the trust.

FN 7 (North Dakota) Power to adjust section reserved but not yet drafted.

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AN ACT to amend the estates, powers and trusts law, in relation to trust accounting income and the optional unitrust and to repeal section 11-A-4.11 of the estates, powers and trusts law relating to the allocation of trustee accounts for receipts from an interest in minerals, water, and other natural resources

THE PEOPLE OF THE STATE OF NEW YORK, REPRESENTED IN SENATE AND ASSEMBLY, DO ENACT AS FOLLOWS:

1 Section 1. Clauses (A), (C) and (D) of subparagraph 5 of paragraph (b) of chapter 243 of the laws of 2001, as added by the rules in article 11-A apply to a trust and the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust’s income, the prudent investor standard also authorizes the trustee to adjust between principal and income to the extent the trustee considers advisable to enable the trustee to make appropriate present and future distributions in accordance with clause (b)(3)(A) if the trustee determines, IN LIGHT OF ITS INVESTMENT DECISIONS, THE CONSIDERATION FACTORS INCORPORATED IN CLAUSE (B)(5)(B), AND THE ACCOUNTING INCOME EXPECTED TO BE PRODUCED BY applying the rules in article 11-A, that such an adjustment would be fair and reasonable to all of the beneficiaries, so that current beneficiaries may be given such use of the trust property as is consistent with preservation of its value.

(C) A trustee may not make an adjustment:

(i) {that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction is claimed} WITH RESPECT TO A CHARITABLE REMAINDER UNITRUST DESCRIBED IN SECTION 664 OF THE UNITED STATES INTERNAL REVENUE CODE OF 1986;

EXPLANATION--Matter in ITALICS (underscored) is new; matter in brackets { } is old law to be omitted.
(ii) {that reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion;}

(iii)

(iv)

(v)

(vi)

(vii)

(D) AN ADJUSTMENT OTHERWISE PROHIBITED BY ITEMS (B)(5)(C)(I) THROUGH (VIII) MAY BE MADE IF THE TERMS OF THE TRUST, BY EXPRESS REFERENCE TO THIS SECTION, PROVIDE OTHERWISE. IF ITEM (B)(5)(C){(v), (vi), (vii), or (viii)} (IV), (V), (VI) OR (VII) APPLIES TO A TRUSTEE AND THERE IS MORE THAN ONE TRUSTEE, (A CO-TRUSTEE) THE TRUSTEES TO WHOM THE PROVISION DOES NOT APPLY MAY MAKE THE ADJUSTMENT UNLESS THE EXERCISE OF THE POWER BY THE REMAINING TRUSTEES IS PROHIBITED BY THE TERMS OF THE TRUST. IF THERE IS NO TRUSTEE QUALIFIED TO MAKE THE ADJUSTMENT, IT MAY BE MADE IF SO DIRECTED BY THE COURT UPON APPLICATION OF THE TRUSTEE OR OF AN INTERESTED PARTY.

S 2. Paragraph (b) of section 11-2.4 of the estates, powers and trusts law, as added by chapter 243 of the laws of 2001, is amended to read as follows:

(b) Unitrust amount.

(1) For the first three years year of the trust AS A UNITRUST, INCLUDING A SHORT YEAR IF APPLICABLE, the "unitrust amount" for (a current valuation) THE year (of the trust) shall mean an amount equal to four percent of the net fair market values of the assets held in the trust (on) AT THE BEGINNING OF the first business day of the current valuation year.

(2) Commencing with) FOR the fourth second year of a trust AS A UNITRUST, INCLUDING A FIRST SHORT YEAR IF APPLICABLE, the "unitrust amount" for (a current valuation) THE year (of the trust) shall mean an amount equal to four percent multiplied by a fraction, the numerator of
which shall be the sum of (A) the net fair market values of the assets held in the trust (on) AT THE BEGINNING OF the first business day of the current valuation year and (B) the net fair market values of the assets held in the trust (on) AT THE BEGINNING OF the first business day of (each) THE prior valuation year, and the denominator of which shall be (three) TWO.


(4) The unitrust amount for the current valuation year as computed in accordance with subparagraph (b)(1) (or), (2) OR (3), AS ADJUSTED IN ACCORDANCE WITH THIS SUBPARAGRAPH, shall be proportionately reduced for any CORPUS distributions to beneficiaries mandated by the terms of the trust, in whole or in part (other than distributions of the unitrust amount), and shall be proportionately increased for the receipt, other than a receipt that represents a return on investment, of any additional CORPUS into the trust within a current valuation year.

{(4)} (5) For purposes of clause (b)(2)(B), the {combined} net fair market values of the assets held in the trust (on) AT THE BEGINNING OF the first business day of a prior valuation year shall be adjusted to reflect any reduction (in the case of a mandated distribution) or increase (in the case of a receipt) in the unitrust amount for such prior valuation year pursuant to subparagraph (b)(3) DISTRIBUTIONS TO BENEFICIARIES MANDATED BY THE TERMS OF THE TRUST, IN WHOLE OR IN PART (OTHER THAN DISTRIBUTIONS OF THE UNITRUST AMOUNT), OR RECEIPTS (OTHER THAN RECEIPTS THAT REPRESENT A RETURN ON INVESTMENT) OF ANY ADDITIONAL PRINCIPAL INTO THE TRUST, WHICH HAVE OCCURRED AFTER THE FIRST DAY OF SUCH PRIOR VALUATION YEAR AND BY THE CLOSE OF THE FIRST DAY OF THE CURRENT VALUATION YEAR, as if the distribution or receipt had occurred on the first day of such prior valuation year.

{(5)} (6) In the case of a short year, the trustee shall prorate the unitrust amount on a daily basis. THE TRUSTEE SHALL PRORATE ANY ADJUSTMENT UNDER SUBPARAGRAPH (B) (4) ON A DAILY BASIS.

{(6) The assets "held in the trust" for purposes of computing the unitrust amount shall not include assets while held in an estate. If this section applies to a trust by reason of an election pursuant to clause (e)(1)(B) and if such election is not expressly made effective prospectively as permitted under clause (e)(4)(A),} (7) IN THE CASE WHERE THE UNITRUST AMOUNT HAS BEEN INCORRECTLY DETERMINED EITHER IN A CURRENT VALUATION YEAR OR IN A PRIOR VALUATION YEAR, THEN WITHIN A REASONABLE TIME (NOT TO EXCEED EIGHTEEN MONTHS) AFTER THE {election} ERROR WAS MADE, the trustee shall {determine the unitrust amount properly payable for any preceding and current valuation year of the trust. The trustee shall} MAKE ANY NON-MATERIAL ADJUSTMENTS AND pay to the {current} UNDERPAID beneficiary (in case of NON-MATERIAL underpayment) or shall recover from the {current} OVERPAID beneficiary (in case of NON-MATERIAL overpayment) an amount equal to the difference between the unitrust amount properly payable and any amount actually paid for any completed valuation year of the trust AND SHALL PROPERLY ADJUST THE UNITRUST AMOUNT FOR THE CURRENT VALUATION YEAR IF AFFECTED NON-MATERIAL-
1. By prior incorrect determination of a unitrust amount. A material
2. correction shall require approval of the surrogate if applied for by the
3. trustee or an interested party.
4. (7) In the case where the net fair market value of an asset held in
5. the trust has been incorrectly determined either in a current valuation
6. year or in a prior valuation year, the unitrust amount shall be
7. increased (in the case of an undervaluation) or be decreased (in the
8. case of an overvaluation) by an amount equal to the difference between
9. the unitrust amount as determined based on the correct valuation of the
10. asset and the unitrust amount as originally determined.

S 3. Subparagraphs 5, 6, 7 and 9 of paragraph (c) of section 11-2.4 of
the estates, powers and trusts law, as added by chapter 243 of the laws
of 2001, are amended to read as follows:
(5) "Net fair market value" shall mean the fair market value of each
asset comprising the trust reduced by the fair market value of any
outstanding interest-bearing obligations of the trust, whether allocable
or otherwise. Fair market value of an asset may be
determined by any appropriate technique adopted and consistently applied
by the trustee, and such techniques may include, but are not limited to,
use of the asset’s value at the close of business on the previous busi-
ness day, and notwithstanding that such day may be in a prior year or be
a day on which the trust was not subject to this section.
(6) In determining the sum of the net fair market values of the assets
held in the trust for purposes of subparagraphs (b)(1) and, (2) and
(3), and in determining whether an adjustment is required in accordance
with subparagraph (b)(4) or (5), there shall not be included taken
into account the value:
(A) of any residential property or any tangible personal property
that, as of the beginning of the first business day of the current valu-
ation year, one or more current beneficiaries of the trust have or had
the right to occupy, or have or had the right to possess or control
(other than in his or her capacity as a trustee of the trust), and
instead the right of occupancy or the right to possession or control
shall be deemed to be the unitrust amount with respect to such residen-
tial property or such tangible personal property; provided, however,
that the unitrust amount shall be adjusted in accordance with subpara-
graph (b)(3) for partial distributions from or receipt into the trust of such residential property or tangible
personal property during the current valuation year.
(B) of any asset specifically given to a beneficiary and the return on
investment on such property, which return on investment shall be
distributable to such beneficiary.
(C) of any assets while held in a testator’s estate.
(D) of (I) amounts paid or distributed to the trust by a decedent’s
estate, another trust or another payor, as income pursuant to Article
11-A attributable to an asset or amount due to the trust for a period
prior to its payment or distribution to the trust, unless and except to
the extent that the unitrust trustee, having the power to accumulate
income, shall have determined to accumulate and add such income to prin-
cipal, and such unaccumulated net income shall be distributable to the
beneficiaries of the trust; or (II) any amount paid or distributed by
such decedent’s estate, other trust or other payor, directly to benefi-
ciaries of the trust in satisfaction of their ultimate entitlement to
such income.
(7) In determining the net fair market value of each asset held in the
trust pursuant to subparagraphs (b)(1) and, (2) and (3), the trustee
shall, not less often than annually, determine the fair market value of
each asset of the trust that consists primarily of real property or
other property that is not traded on a regular basis in an active
market, and all such determinations shall, if made reasonably and in
good faith, be conclusive on all persons interested in the trust. Such
determination shall be conclusively presumed to have been made reason-
ably and in good faith unless proven otherwise in a proceeding commenced
by or on behalf of a person interested in the trust within three years
after the close of the year in which the determination is made.

(9) The term "trust" does not include an estate (or any trust pursuant
to the terms of which any amount is permanently set aside for charitable
purposes unless the income therefrom is also permanently devoted to
charitable purposes).

S 4. The opening paragraph of subparagraph 1 of paragraph (d) of
section 11-2.4 of the estates, powers and trusts law, as added by chap-
ter 243 of the laws of 2001, is amended to read as follows:
The interest of a current beneficiary or class of current benefici-
aries in the unitrust amount begins on the date (specified in the
governing instrument, on the date specified in an election to have this
section apply pursuant to clause (e)(1)(B), on the date specified by the
court pursuant to clause (e)(2)(B) or, if no date is specified, on) ON
WHICH THIS SECTION BECOMES APPLICABLE TO THE TRUST PURSUANT TO CLAUSE
(E)(4)(A), OR IF LATER the date assets first become subject to the
trust. An asset becomes subject to a trust:

S 5. Subparagraph 2 of paragraph (d) of section 11-2.4 of the estates,
powers and trusts law, as added by chapter 243 of the laws of 2001, is
amended to read as follows:
(2) A trust which continues in existence for the benefit of one or
more new current beneficiaries or class of current beneficiaries upon
the termination of the interests of all prior current beneficiaries or
classes of prior current beneficiaries, shall be deemed to be a new
trust, and, for purposes of (clause) CLAUSES (e)(1)(B) AND (E)(4)(A) AND
SUBPARAGRAPH (D)(1), assets shall be deemed to first become subject to
the trust on (the first day of the first year that follows) the date of
the termination of such interests.

S 6. Clause (B) of subparagraph 1 of paragraph (e) of section 11-2.4
of the estates, powers and trusts law, as added by chapter 243 of the
laws of 2001, is amended to read as follows:
(B) ((I)) (I) with respect to a trust in existence prior to January
first, two thousand two, on or before December thirty-first, two thou-
sand five, the trustee, with the consent by or on behalf of all persons
interested in the trust or in his, her or its discretion, elects to have
this section apply to such trust, or
((II)) (II) with respect to a trust not in existence prior to January
first, two thousand two, on or before the last day of the second full
year of the trust beginning after assets first become subject to the
trust, the trustee, with the consent by or on behalf of all persons
interested in the trust or in his, her or its discretion, elects to have
this section apply to such trust.
((III)) (III) An election in accordance with this subparagraph shall
be made by an instrument, executed and acknowledged, and delivered to
the creator of the trust, if he or she is then living, to all persons
interested in the trust or to their representatives and to the court, if
any, having jurisdiction over the trust.
S 7. Clause (A) of subparagraph 4 of paragraph (e) of section 11-2.4 of the estates, powers and trusts law, as added by chapter 243 of the laws of 2001, is amended to read as follows:

(A) This section shall apply to a trust with respect to which there is:

(I) a direction in the governing instrument in accordance with clause (e)(1)(A), AS OF THE DATE PROVIDED FOR IN SUCH GOVERNING INSTRUMENT, OR IF THERE IS NO PROVISION THEN AS OF THE DAY ON WHICH ASSETS FIRST BECOME SUBJECT TO THE TRUST;

(II) an election in accordance with clause (e)(1)(B), AS OF THE DATE SPECIFIED IN THE ELECTION, WHICH MAY BE ANY DAY WITHIN THE YEAR IN WHICH THE ELECTION IS MADE OR THE FIRST DAY OF THE YEAR COMMENCING AFTER THE ELECTION IS MADE; or a

(III) court decision rendered in accordance with clause (e)(2)(B) as of the (first year of the trust in which assets first become subject to the trust, unless the governing instrument or) DATE SPECIFIED BY the court in its decision (provides otherwise, or unless the election in accordance with clause (e)(1)(B) is expressly made effective as of the first day of the first year of the trust commencing after the election is made.);

PROVIDED, HOWEVER, THAT IF LATER THAN ANY DATE SET BY THIS CLAUSE, THIS SECTION SHALL NOT APPLY TO THE TRUST UNTIL JANUARY FIRST, TWO THOUSAND TWO.

S 8. Section 11-2.4 of the estates, powers and trusts law is amended by adding a new paragraph (f) to read as follows:

(F) TRUSTS TO WHICH THIS SECTION SHALL NOT APPLY. THIS SECTION SHALL NOT APPLY TO A TRUST IF:

(1) THE GOVERNING INSTRUMENT PROVIDES IN SUBSTANCE THAT THIS SECTION SHALL NOT APPLY;

(2) THE TRUST IS A POOLED INCOME FUND DESCRIBED IN SECTION 642(C)(5) OF THE UNITED STATES INTERNAL REVENUE CODE OF 1986;

(3) THE TRUST IS A CHARITABLE REMAINDER ANNUITY TRUST OR A CHARITABLE REMAINDER UNITRUST DESCRIBED IN SECTION 664 OF THE UNITED STATES INTERNAL REVENUE CODE OF 1986; OR

(4) THE TRUST IS AN IRREVOCABLE LIFETIME TRUST WHICH PROVIDES FOR INCOME TO BE PAID FOR THE LIFE OF A GRANTOR, AND POSSESSING OR EXERCISING THE POWER TO MAKE THIS SECTION APPLY WOULD CAUSE ANY PUBLIC BENEFIT PROGRAM TO CONSIDER ADDITIONAL AMOUNTS OF PRINCIPAL OR INCOME TO BE AN AVAILABLE RESOURCE OR AVAILABLE INCOME, AND THE PRINCIPAL OR INCOME OR BOTH WOULD IN EACH CASE NOT BE CONSIDERED AN AVAILABLE RESOURCE OR INCOME, IF THERE WAS NO POWER TO MAKE THIS SECTION APPLY, IF, BASED UPON THE FACTS AND CIRCUMSTANCES SURROUNDING THE FORMATION OF SUCH TRUST, IT CAN REASONABLY BE CONCLUDED THAT THE PRIMARY PURPOSE FOR THE ESTABLISHMENT OF THE TRUST WAS TO ENSURE THAT THE TRUST PRINCIPAL WOULD NOT BE TREATED AS AN AVAILABLE RESOURCE FOR THE PURPOSES OF A GOVERNMENTAL ASSISTANCE PROGRAM.

S 9. Subparagraph (B) of paragraph 2 of section 11-A-2.1 of the estates, powers and trusts law, as added by chapter 243 of the laws of 2001, is amended to read as follows:

(B) paying from income or principal, in the fiduciary's discretion, fees of attorneys, accountants, and fiduciaries; court costs and other expenses of administration; and interest on death taxes, but the fiduciary may pay those expenses from income (and) OF property passing to a trust for which the fiduciary claims an estate tax marital or charitable deduction only to the extent that the payment of those expenses from income will not cause the reduction or loss of the deduction; and
Section 11-A-2.2 of the estates, powers and trusts law is amended by adding a new paragraph (e) to read as follows:

(E) THE PORTION OF A BENEFICIARY DETERMINED UNDER PARAGRAPH (A) IS SUBJECT TO THE FIDUCIARY’S FURTHER POWER OF ADJUSTMENT UNDER SUBPARAGRAPH 11-2.3(B)(5), WHICH ADJUSTMENT IF MADE SHALL BE MADE TO OR FROM THE PRINCIPAL OF SUCH BENEFICIARY’S SHARE. THE FIDUCIARY SHALL MAINTAIN APPROPRIATE RECORDS SHOWING THE PRINCIPAL INTEREST OF EACH BENEFICIARY, AS ADJUSTED.

Paragraph (a) of section 11-A-3.3 of the estates, powers and trusts law, as added by chapter 243 of the laws of 2001, is amended to read as follows:

(a) In this section, "undistributed income" means net income received ON OR before the date on which an income interest ends. The term does not include an item of income or expense that is due or accrued or net income that has been added or is required to be added to principal under the terms of the trust.

Section 11-A-4.11 of the estates, powers and trusts law is REPEALED and a new section 11-A-4.11 is added to read as follows:

(A) TO THE EXTENT THAT A TRUSTEE ACCOUNTS FOR RECEIPTS FROM AN INTEREST IN MINERALS OR OTHER NATURAL RESOURCES PURSUANT TO THIS SECTION, THE TRUSTEE SHALL ALLOCATE THEM AS FOLLOWS:

(1) IF RECEIVED AS A BONUS, DELAY RENTAL OR ANNUAL RENT ON A LEASE, A RECEIPT OF LESS THAN ONE THOUSAND DOLLARS MUST BE ALLOCATED TO INCOME AND A RECEIPT OF ONE THOUSAND DOLLARS OR MORE MUST BE ALLOCATED FIFTEEN PERCENT TO PRINCIPAL AND EIGHTY-FIVE PERCENT TO INCOME;

(2) IF RECEIVED FROM A PRODUCTION PAYMENT, A RECEIPT MUST BE ALLOCATED TO INCOME IF AND TO THE EXTENT THAT THE AGREEMENT CREATING THE PRODUCTION PAYMENT PROVIDES A FACTOR FOR INTEREST OR ITS EQUIVALENT. THE BALANCE MUST BE ALLOCATED TO PRINCIPAL;

(3) IF RECEIVED AS A ROYALTY, SHUT-IN-WELL PAYMENT, OR TAKE-OR-PAY PAYMENT, A RECEIPT MUST BE ALLOCATED FIFTEEN PERCENT TO PRINCIPAL AND EIGHTY-FIVE PERCENT TO INCOME;

(4) IF AN AMOUNT IS RECEIVED FROM A WORKING INTEREST OR ANY OTHER INTEREST NOT PROVIDED FOR IN SUBPARAGRAPH (A)(1), (2), OR (3), A RECEIPT MUST BE ALLOCATED FIFTY PERCENT TO PRINCIPAL AND FIFTY PERCENT TO INCOME.

(B) AN AMOUNT RECEIVED ON ACCOUNT OF AN INTEREST IN WATER THAT IS RENEWABLE MUST BE ALLOCATED TO INCOME. IF THE WATER IS NOT RENEWABLE, NINETY PERCENT OF THE AMOUNT MUST BE ALLOCATED TO PRINCIPAL AND THE BALANCE TO INCOME.

(C) THIS ARTICLE APPLIES WHETHER OR NOT A DECEDENT OR DONOR WAS EXTRACTING MINERALS, WATER, OR OTHER NATURAL RESOURCES BEFORE THE INTEREST BECAME SUBJECT TO THE TRUST.

(D) IF A TRUST EXISTS ON THE EFFECTIVE DATE OF THIS SECTION, THE TRUSTEE MAY ALLOCATE RECEIPTS FROM AN INTEREST IN MINERALS, WATER, OR OTHER NATURAL RESOURCES AS PROVIDED IN THIS SECTION OR IN THE MANNER USED BY THE TRUSTEE BEFORE THE EFFECTIVE DATE OF THIS SECTION. FOR EVERY TRUST CREATED AFTER THE EFFECTIVE DATE OF THIS SECTION, THE TRUSTEE SHALL ALLOCATE RECEIPTS FROM AN INTEREST IN MINERALS, WATER, OR OTHER NATURAL RESOURCES AS PROVIDED IN THIS SECTION. IF AND TO THE EXTENT THAT THE TERMS OF A TRUST EXPRESSLY PROVIDE FOR A DIFFERENT ALLOCATION OF RECEIPTS OR GRANTS THE TRUSTEE DISCRETIONARY AUTHORITY TO DETERMINE THE AMOUNT OF THE ALLOCATION, THIS SECTION SHALL NOT APPLY TO THOSE RECEIPTS.
S 13. Section 11-A-6.4 of the estates, powers and trusts law, as added by chapter 243 of the laws of 2001, is amended to read as follows:

S 11-A-6.4 Application of article

Except as specifically provided in the trust instrument, the will, or in this article, this article shall apply to any receipt or expense received or incurred on or after its effective date by any trust or decedent's estate established before, on or after its effective date and whether the asset involved was acquired by the trustee before, ON or after its effective date, EXCEPT THAT THIS ARTICLE SHALL NOT APPLY TO A TRUST WHILE ANY CURRENT BENEFICIARY IS INTERESTED IN A UNITRUST AMOUNT PURSUANT TO SUBPARAGRAPH 11-2.4(B)(1); BUT IT DOES APPLY WITH RESPECT TO ASSETS TO WHICH SUCH A UNITRUST MAY BECOME ENTITLED BUT PRIOR TO THEIR ACTUAL RECEIPT INTO THE UNITRUST. (This article shall also apply to any trust or decedent's estate established on or after its effective date except to the extent that the trust instrument or the will provides otherwise, or unless an election or court decision is made pursuant to 11-2.4 to make this article not apply to such trust.)

S 14. This act shall take effect immediately.
New Dilemmas

Once a trustee has opted for a power-to-adjust or unitrust regime, big questions remain: How to allocate the portfolio and the capital gains tax?

Traditionally, there has been tremendous tension between the competing interests of a trust’s income and remainder beneficiaries. Investing pursuant to the Uniform Prudent Investor Act of 1994 (UPIA), which allows fiduciaries to invest for total return under modern portfolio theory, actually intensified this inherent conflict. Under the UPIA, trustees are permitted to invest in a manner that produces the best overall return, without distinguishing between principal and income. However, trustees were faced with the dilemma of whether they should invest for principal growth, which ultimately inures to the benefit of the remainder beneficiaries, or invest in a manner that produces a fair income payout to the current beneficiaries. The Uniform Principal and Income Act of 1997 (UPAIA) seemed to relieve this pressure when it revolutionized trust investing by giving trustees the ability to adjust allocations between principal and income to satisfy the needs of the current beneficiaries while preserving the principal for future beneficiaries.

Some states adopted a unitrust approach instead of, or in addition to, the power-to-adjust. Under a unitrust regime, trustees are permitted to convert a conventional income trust into a total return trust, under which the income beneficiary receives an amount equal to a fixed percentage of the trust’s market value.
As of January, 45 states had adopted (or have pending) the UPAIA, or substantial portions of the Act, or some form of total return legislation. Only five states have adopted neither the UPAIA nor any other form of total return legislation.

The result is that fiduciaries are now very focused on determining whether to use their power to adjust or to implement a unitrust regime or, in states where there's a choice between the two, whether to select one or the other. They also pay considerable attention to the amount of the adjustment or unitrust payout. These are all important decisions. But, query: If the trustee making these determinations fails to consider the bottom-line impact to all beneficiaries, current and remaindermen, has he discharged his duty of impartiality?

There is statutory guidance for trustees in determining whether to make an adjustment or opt into a unitrust regime. The various state statutes typically set forth a number of factors for trustees to consider; some additionally provide a permissible adjustment/unitrust percentage amount or range. In many states, there are also explicit safeguards to protect trustees from liability for the good faith exercise or non-exercise of these new powers and often an abuse of discretion standard by which trustees are judged. But there is neither statutory direction nor any explicit safeguards to protect trustees with respect to how they invest the trust funds or allocate taxes. And, beware; these decisions are fraught with deep conflicts between current and future beneficiaries. Trustees should therefore try to retain as much flexibility as they can so they might act as fairly as possible towards all beneficiaries.

INVESTMENT ISSUES
Consider the quintessentially acrimonious trust situation: A decedent created a trust for the benefit of his second wife, Dorothea, for her lifetime with the remainder to go to the children from his first marriage. Assume that the trustee has decided to adjust the income payout to Dorothea to an amount equivalent to 4 percent of the trust's value or has opted into New York's fixed 4 percent unitrust regime. In other words, Dorothea will receive a 4 percent payout that will be comprised of traditional accounting income, to the extent available, and the balance of the 4 percent will actually be a principal payout, that is to say it will be "redefined" as income.

How the trust is invested can make a big difference to Dorothea. If the fixed income portion of the portfolio is invested in tax-exempt municipal bonds, the yield will be lower than if it was invested in taxable bonds; but, as the income beneficiary, Dorothea will get the tax break. In addition, to the extent those lower yielding bonds (and whatever other income and dividends are generated in the trust) produce less than the 4 percent payout Dorothea is to receive, the difference will be made up with a tax-free distribution from the principal of the trust.

If the fixed income portion of the trust is instead invested in taxable bonds, the yield will be higher, but all of it will be taxable to Dorothea as the income beneficiary. Also, if the income yield is higher, less will have to be paid to Dorothea (income tax free) from the trust's principal.

Clearly, Dorothea would prefer to see tax-exempt bonds in the fixed income portfolio and the children from the first marriage would prefer to see taxable bonds.

WHAT'S A TRUSTEE TO DO?
Consider how the investments would play out. Assume the trust is worth $10 million and is invested 60 percent in fixed income and 40 percent in equities. Now imagine it is invested two ways. First, there's a mix we can call Dorothea's Dismay: If the fixed income portfolio is invested 80 percent in taxable bonds and 20 percent in municipal bonds, the value of the portfolio at the end of 20 years will be $18.973 million. By contrast, there's Dorothea's Delight: If the fixed income portfolio is invested 20 percent in taxable bonds and 80 percent in municipal bonds, the value of the trust portfolio at the end of 20 years will be
$17,084 million. (See "Change the Mix, Change the Result").

The reason Dorothea much prefers the latter mix is because of the completely opposite impact the taxable/tax exempt mix has on her net distributions from the trust. If the fixed income portfolio is invested 80 percent in taxable bonds and 20 percent in municipal bonds, Dorothea will have received $7,979 million in net distributions at the end of 20 years. If the fixed income portfolio is invested 20 percent in taxable bonds and 80 percent in municipal bonds, she'll have received $9,621 million in net distributions at the end of 20 years. (See “Dorothea’s Delight”). The difference to Dorothea is even more dramatic if she invests each of the distributions she receives. If she earns a 5.8 percent after-tax rate of return, the $7,979 million in net distributions will have grown to $13,536 million after 20 years. But the $9,621 million in net distributions will have grown to $16,480 million in that same time.

**CAPITAL GAINS**

Another issue with which trustees must grapple is the allocation of capital gains. The final Treasury Regulations under Internal Revenue Code Section 643 (effective as of Jan. 2, 2004) restate the general rule that capital gains are ordinarily excluded from a trust’s distributable net income (DNI). That is, gains are ordinarily taxed to the trust and not passed out to the income beneficiary. Under the final regulations, capital gains can be included in DNI if, pursuant to a reasonable and impartial exercise of discretion by the fiduciary, gains are:
- allocated to income;
- allocated to the corpus but treated by the trustee as distributed to a beneficiary; or
- allocated to the corpus but actually distributed to a beneficiary or utilized by the fiduciary in determining the recipient’s distribution amount.

**CHANGE THE MIX, CHANGE THE RESULT**

A fixed income portfolio invested 80 percent in taxable bonds, 20 percent in municipal bonds, leaves more in the trust after 20 years than a portfolio with the opposite mix.

*Assumes an asset allocation of 60 percent fixed income, 40 percent equity; 4 percent payout to income beneficiary; bonds held until maturity; capital gains taxed to the trust at a blended long-term/short-term rate of 30 percent; and a 35 percent turnover in account.

**REMAINDEERMEN’S BEST CASE SCENARIO**

Trust distributions—with capital gains taxed to the income beneficiary—from a fixed income portfolio with 80 percent in taxable bonds, 20 percent in municipal bonds.

*Assumes an asset allocation of 60 percent fixed income, 40 percent equity; 4 percent payout to income beneficiary; bonds held until maturity; and a 35 percent turnover in account.

—Sharon L. Klein

Sharon L. Klein thanks John Ravalli, Donal Bishnoi, and Jennifer Barry for their assistance with the charts accompanying this article.
If a trustee is using a unitrust regime, the discretion to allocate gains must be exercised consistently. Before the final regulations were issued, the proposed regulations imposed the consistency requirement with respect to both the power to adjust and unitrust regimes. But the final regulations changed the language regarding the exercise of discretion in a power-to-adjust situation. The proposed regs stated: “Gains... are included in distributable net income to the extent they are... pursuant to a reasonable and consistent exercise of discretion.” That was replaced in the final regs with “pursuant to a reasonable and impartial exercise of discretion” (emphasis added in both quotes). Although the Internal Revenue Service declined to give examples regarding the inclusion of capital gains in DNI when the trustee exercises a power to adjust between income and principal under applicable local law, the preamble to the final regs states that “the IRS and the Treasury Department agree that the (discretionary power to allocate capital gains to income does not have to be exercised consistently, as long as it is exercised reasonably and impartially.”

Accordingly, when acting under the unitrust regime, trustees appear to be locked into allocating capital gains the same way that the allocation was made in the first year. But when acting under the power to adjust, trustees appear to have more flexibility in allocating gains.

How does this work for Dorothea and her stepchildren? If their trustee is locked into one method of capital gains tax treatment for the duration of the trust, you can be sure Dorothea will want capital gains taxed to the trust and you can be sure that the children will want capital gains included in DNI and taxed to Dorothea.

If the trust is not saddled with the capital gains taxes and the fixed income portfolio is invested 80 percent taxable bonds/20 percent municipal bonds, it will be valued at $19,151 million at the end of 20 years. Keep it free of capital gains taxes but reverse that mix, with 20 percent in taxable bonds and 80 percent in municipal bonds; the result: at the end of 20 years the portfolio is worth $17,797 million. (See “Remaindermen’s Best Case Scenario”)

Consider again the completely opposite impact the taxable/tax exempt mix has on Dorothea’s net distributions from the trust. If Dorothea is paying the capital gains taxes and the portfolio has the mix of 80 percent taxable bonds/20 percent municipal bonds (Dorothea’s Double Dismay), she will have received $7,886 million in net distributions at the end of 20 years. The picture is better if Dorothea is paying the capital gains taxes and the portfolio mix is reversed (20 percent taxable bonds/80 percent municipal bonds): She will have received $9,268 million in net distributions at the end of 20 years. (See “Dorothea’s Dismay”). Again, because of the compounding effect of investing over time, the difference to Dorothea would be much more dramatic if she invests each of the distributions she receives. Assuming she earns a 5.8 percent after-tax rate of return, the $7,886 million in net distributions would grow to $13,365 million in that time; the $9,268 million would become $15,814 million.

**BOTTOM LINE**

Obviously, the best scenario for Dorothea is 80 percent municipal bond/20 percent taxable bond mix in the fixed income portfolio with capital gains taxed to the trust. But the best scenario for her stepchildren is 80 percent taxable bond/20 percent municipal bond mix in the fixed income portfolio and capital gains taxed to Dorothea. In “Dorothea’s Delight,” she receives $9,621 million in total net distributions over the course of 20 years (which, if she invests all distributions, becomes a handsome $64,80 million). Of course, the trust value at the end of the 20-year period is $17,084 million. In “Dorothea’s Dismay,” she receives just $7,886 million in distributions (which becomes $13,365 million if she invests all distributions) but the ending trust’s value is an attractive $19,151 million.

Clearly the tension between trusts’ income and remainder beneficiaries is very much alive. And the trustee is caught right in the middle.

**A TRUSTEE’S OPTIONS**

So, how should the trustee be investing the trust funds and to whom should the gains be allocated? At first blush, one might have thought that a fixed unitrust regime such as the one in New York presents a panacea for the trustee and all the beneficiaries: The amount to be paid to the income beneficiary is a strict mathematical formula; the allocation of receipts and disbursements does not affect that formula; and if the assets increase in value, supposedly everyone is happy regardless of whether the source of the increase is yield or growth. Indeed, perceived simplicity of administration is perhaps an attractive draw for some trustees in determining to opt into such a unitrust regime. It’s almost counterintuitive to think that the application of a strict mathematical formula to determine a payout could still leave a trustee fraught with conflict. Ah, but that’s just what happens.

If the trustee is operating in a unitrust regime such as New York’s where the unitrust amount is a fixed 4 percent, there’s not much room for maneuver. Come hell or high water, the income beneficiary will receive an amount equal to 4 percent of the value of the trust and the trustee will have to make a determination regarding the tax character of the 4 percent put into the income beneficiary’s hands.
Whoever is saddled with the capital gains tax burden will be saddled with it for the duration of the trust. With respect to both the investment strategy and the allocation of capital gains, it will be very important for the trustee to have all beneficiaries on the same page. If the trustee is able to obtain a written agreement among the beneficiaries, particularly regarding the treatment of capital gains, that would certainly be prudent. In an acrimonious situation, of course, that may not be possible. A trustee should at least be able to demonstrate that he was cognizant of these issues and made a determination that he considered fair and impartial under the circumstances. In some states, a trustee is permitted or required to send to the beneficiaries notice of his election to adjust or opt into the unitrust regime. Prudence dictates that a trustee should consider memorializing the proposed capital gains tax treatment in the notice documents (or court papers if court approval is sought).  

Trustees have far more options if they're operating in a power-to-adjust regime or a unitrust regime where the unitrust amount is flexible. They're able to examine the character of the distributions flowing to the income beneficiary, see on whom the burden of the capital gains taxes lies and adjust the payout to the income beneficiary accordingly.

For example, assume that the trustee determines to tax gains to the trust. Assume also that the trust has incurred a large capital gain resulting from the sale of a position and that sale was made in order to make the adjusted income payout to the income beneficiary. Because the trust will be burdened with the capital gains taxes, perhaps it would be equitable to adjust downwards the amount of the adjusted income payout. If the fixed income portion of the trust's portfolio is invested in taxable bonds in order to achieve a higher yield and the tax burden.

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**DOROTHEA'S DISMAY**

An income beneficiary—like our hypothetical Dorothea—ends up with the least amount if she has to pay capital gains taxes on distributions from a fixed income portfolio of 80 percent in taxable bonds, 20 percent in municipal bonds:

*Assumes Dorothea's asset allocation is 80 percent fixed income, 40 percent equity; total after tax return 5.8 percent; and reflects current year distribution added to the trust total.

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**DOROTHEA'S DELIGHT**

The best case scenario for an income beneficiary like our hypothetical Dorothea is trust distribution—with capital gains taxed to the trust—from a fixed income portfolio with 20 percent in taxable bonds, 80 percent in municipal bonds:

*Assumes Dorothea's asset allocation is 60 percent fixed income, 40 percent equity; total after tax return 5.8 percent; and reflects current year distribution added to the trust total.

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—Sharon L. Klein

Sharon L. Klein thanks John Pavalli, Donoi Bishnoi, and Jennifer Barry for their assistance with the charts accompanying this article.
den on the income beneficiary is accordingly increased, perhaps it would be equitable to adjust upward the amount of the adjusted income payout. Fixed formulas might seem appealing, but clearly it's better for trustees to have the latitude to consider all facts and circumstances when deciding on a fair and reasonable payout.

MINIMIZING CONFLICT

Trustees would certainly have more flexibility if states like New York, which have a fixed unitrust regime, moved to a flexible unitrust approach, like Delaware. The more tools a trustee has at his disposal in administering trusts, the more likely it will be that conflicts between the income beneficiary and remainder persons will be minimized—the very reason for the introduction of the UPAIA. Getting Dorothea and her stepchildren to spend Thanksgiving together may not be in the cards, but having them dream of carving up the turkey, rather than each other, may be.

Endnotes
1. The Uniform Principal and Income Act (UPAIA), issued by the National Conference of Commissioners on Uniform State Laws, provides guidelines for trustees in defining principal and income. The act, originally promulgated in 1931, underwent substantial revisions in 1962 and 1997. The UPAIA of 1997 works in tandem with the Uniform Prudent Investor Act of (UPIA) 1994. The UPAIA provides the means to implement the total return investment regime embodied in the UPIA.
2. The power-to-adjust approach is located in UPAIA Section 104.
3. For example, California, Colorado, Illinois, New York, Pennsylvania, Texas and Washington.
4. In New York, for example, see Estates, Powers & Trusts Law (EPTL) Section 11-2.3(b)(5) (power to adjust) and Section 11-2.4(b) and (e)(c) (unitrust).
5. For example, in New York, even if abuse of discretion is established, a trustee has to dip into his own pockets only if it is not possible to restore the beneficiaries from the trust funds and the court finds that the trustee was dishonest or arbitrary and capricious. EPTL Section 11-2.3 A(c)
6. This is assuming capital gains are not included in the distributable net income of the trust, which is usually the case.
7. This assumes an asset allocation of 40 percent equities and 60 percent fixed income.
8. Distributable net income (DNI) determines the character of the income that is taxable to the beneficiaries and limits the amount taxable to the beneficiaries by limiting the amount of the trust's allowable distribution deduction.
9. Treasury Regulations Section 1.643(a)-3(b).
10. Treas. Regs. Sections 1.643(a)-3(b)(i) and 1.643(a)-3(e), Examples 12-14.
11. Some state statutes contain ordering provisions regarding the types of income used in satisfying distributions (Delaware's unitrust statute, for example, provides for ordinary income first, short-term capital gain second and long-term capital gain third). There is also no specific guidance in the Regulations regarding the inclusion of capital gains in DNI where the trustee is utilizing ordering provisions, but see Treas. Regs. Section 1.643(a)-3(e), Example 11.
12. In the recently enacted California unitrust statute, the characterization of the unitrust payout for income tax reporting purposes is a discretionary decision that must be included in the written notice to the beneficiaries. Cal. Prob. Code Section 16336.4(f)(6). In New York, court approval is required if the trust was established after Jan. 1, 2002, and an election to opt into unitrust is not made before the last day of the second full year of the trust. EPTL 11-2.4(c).

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