Estate Planning Insights

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Karen S. Gerstner & Associates, P.C.

Attorneys At Law
5615 Kirby Drive, Suite 306
Houston, Texas 77005-2448
(713) 520-5205

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A TRUSTEE'S DUTIES–PART TWO

This newsletter (second in this series) will address some of the more important duties of a Trustee. When administering a Texas trust, a Trustee must follow the terms of the trust instrument and also Texas Trust law, as found primarily in the Texas Trust Code. In 2004, Texas adopted as part of its trust law the Uniform Prudent Investor Act and the Uniform Principal and Income Act (the "UPIA twins"). The UPIA twins affect all Texas trusts.

What is the Trustee's Duty? To state it as simply as possible, once a trust is created and "funded" (assets are placed in the trust), the Trustee must administer the trust in accordance with its terms and applicable law for the benefit of the beneficiaries of the trust.

Where Do the Trustee's Duties Come From? The Trustee's duties, powers and responsibilities are set out in the instrument that created the trust. Texas law allows the person creating a trust (the "Testator" of a Will or the "Trustor" of a trust document, hereafter referred to jointly as the "Settlor") to include any trust provisions the Settlor desires, except for those that are (1) illegal, (2) against public policy, or (3) disallowed by the Texas Trust Code. Thus, as long as the trust does not violate these restrictions, the provisions in the instrument creating the trust must be observed by the Trustee in "administering" (handling and carrying out the terms of) the trust. It does not matter what other trusts say or what the "default" terms of a trust are under Texas law–the instrument creating the trust is the primary document that must be followed. If the trust instrument is silent on a particular point, then applicable Texas trust law will "fill that gap" and provide the Trustee with guidance.

A Trustee's First Job: Review the Trust Instrument. As noted, the provisions of the instrument creating the trust control the administration of the trust. It is fundamental that, prior to beginning his job, the Trustee read the entire instrument that created the trust. The instrument creating the trust will either be a Will or a Trust document. A trust created in a Will is generically called a "testamentary" trust. A trust created during life is generically called an "inter vivos" trust. An inter vivos trust can either be irrevocable or revocable. The trust document will either be a "Trust Declaration" (a person declares herself to the be the initial Trustee of a trust she has created) or a "Trust Agreement" (a person appoints someone else to be the initial Trustee of a trust she has created).

Most instruments that create a trust have numerous provisions that relate to the administration of the trust besides the particular section that provides the specific rules for making distributions from the trust to the beneficiaries (although that part of the trust is of paramount importance and should be studied thoroughly). Most of the time, when a Trustee makes a mistake in handling a trust, it is because the Trustee does not know all of the terms of the trust and the effect of those terms. Thus, the first duty of the Trustee is to read and study the instrument creating the trust.

Gaps in the Trust Instrument: Look to Texas Trust Law. If the instrument creating a trust fails to address a particular issue, the Trustee must look to Texas trust law for guidance. Applicable Texas law includes the Texas Trust Code, the Texas Probate Code (if the trust in question is a trust created in a Will), and cases involving trusts decided by Texas courts.

Although many provisions in the Texas Trust Code governing the powers and duties of the Trustee can be altered by the Settlor in the instrument creating the trust, certain provisions in the Code are mandatory and cannot be altered. This is something that attorneys who draft trusts must take into account–most Trustees (especially individual Trustees) would not be aware of these restrictions, so they will not be discussed here.

What are the UPIA Twins? Texas adopted the Uniform Prudent Investor Act and the Uniform Principal and Income Act in 2004 by integrating them into the Texas Trust Code. The UPIA twins have imposed some new duties on Trustees of Texas trusts. Although these new laws took effect on January 1, 2004, they apply to all Texas trusts, even those established before 2004.

The Uniform Prudent Investor Act codified many of the Trustee's fundamental fiduciary duties under the common law, such as the duties of loyalty, impartiality, and competence. The Act also imposed some new duties regarding the handling of trust investments, such as the duty of every Trustee to create an appropriate investment plan for the trust and, in most cases, to diversify the trust's investment portfolio. The Act also encourages delegation of trust functions, in contrast to prior law. Every Trustee should familiarize herself with these changes in trust law and consider how they relate to the trust she is administering. The most important changes to the Trustee's duties will be discussed below.

The Uniform Principal and Income Act provides fiduciary "accounting rules" for trusts. Generally, trusts have two classes of beneficiaries in terms of distributions from the trust: those who have an interest in the "income" of the trust, known as income beneficiaries, and those who have an interest in the "principal" of the trust, known as principal beneficiaries. (The trust beneficiaries can also be divided into two classes based on *when* they are entitled to distributions from the trust: current beneficiaries and future beneficiaries.) When a trust receives something (interest, dividends, capital gains, royalties, etc.), the Trustee must categorize that receipt as being an income receipt or a principal receipt (or partly each). In the same manner, when a trust expense is paid, the Trustee must charge that expenditure to the income or principal of the trust (or partly to each). This allocation of trust receipts and disbursements can affect the interests of the beneficiaries of the trust, especially if certain beneficiaries are only entitled to distributions of income *or* principal, but not both. That is why there are so many rules that dictate how the Trustee should make these determinations. A Trustee who makes an improper allocation of receipts and disbursements could be breaching her fiduciary duties to some of the beneficiaries of the trust.

What are the Trustee's Fundamental Duties? A Trustee has a host of fundamental duties, including, but not limited to, those listed below.

I. The Duty to Administer the Trust in Accordance with its Terms and Purposes. The Trustee must administer the trust in good faith, according to the trust's terms and for the purposes expressed. Therefore, it is important that a Trustee regularly read the document creating the trust to ensure that his actions correspond with the trust's terms and the trust's overall purpose(s).

II. The Duty of Loyalty. The duty of loyalty means that the Trustee must at all times place the interests of the trust and its beneficiaries above his own personal interests. The duty of loyalty requires the Trustee to avoid conflicts of interest between himself (and his affiliates) and the trust (and its beneficiaries). The most egregious example of a Trustee having a conflict of interest would be the Trustee entering into a "self-dealing" transaction with the trust's assets.

If a Trustee buys an asset from the trust, sells an asset to the trust, or otherwise uses trust assets for his own personal benefit, the Trustee is engaging in self dealing. Unless self-dealing is *specifically* authorized in the trust instrument, the Trustee's action will be a breach of the duty of loyalty. Even if self-dealing is specifically authorized, the value the trust receives in the transaction must be "fair and reasonable", otherwise, despite authorization for the transaction, the Trustee will still be breaching his fiduciary duty. If a trust beneficiary complains about a self-dealing transaction, Texas law places the burden on the Trustee to prove that the transaction was fair to the trust (a difficult burden to meet in most cases). Therefore, the safest course is for a Trustee to avoid conflict of interest situations and *never* self deal with trust property (directly or indirectly).

III. The Duty of Fairness and Impartiality Toward the Beneficiaries of the Trust. All trusts have multiple beneficiaries–at least one current beneficiary and at least one future (remainder) beneficiary. Many trusts have multiple current beneficiaries and multiple future beneficiaries. The Trustee must act impartially when investing and managing the trust assets, when allocating receipts and disbursements, and when making distributions from the trust, taking into account the different interests of the trust's beneficiaries. Complying with this duty can be complicated, especially if the trust instrument does not indicate whether any particular beneficiaries are to be favored over other beneficiaries.

The above two rules do not mean that a person who is a beneficiary of a trust cannot also serve as the Trustee of the trust (and receive compensation for serving), it just means that such a person must be even more careful than an independent Trustee in carrying out his duties and meeting fiduciary standards.

IV. The Duty to Administer the Assets of the Trust as a Prudent Investor. The Uniform Prudent Investor Act provides a baseline set of rules and standards governing the Trustee's conduct relating to trust investments. These standards can be expanded, restricted, or eliminated by the trust instrument. The Trustee's duty to administer the assets of the trust as a prudent investor can be broken into several parts, some of which are discussed below.

A. Standard of Care. A Trustee has a duty to invest and manage trust assets *as a prudent investor would*, taking into account the purposes, terms, distribution requirements, and other circumstances of the particular trust. When performing these duties, the Trustee must exercise reasonable care, skill, and caution. Professional, corporate, or other trustees who possess special skills or expertise are generally held to a higher standard of care.

B. Prudence is Determined by the Overall Investment Strategy. A Trustee's investment decisions are evaluated by examining the entire portfolio of trust investments, as a whole, and determining whether the Trustee's overall investment strategy is appropriate for the particular trust (in view of its purposes and its beneficiaries). Therefore, an investment that might be imprudent standing alone can be deemed prudent if undertaken in sensible relation to other trust assets. The opposite is also true.

There are no categoric restrictions on the type of investments a trust can hold. Each investment must be viewed in the context of the entire trust portfolio. When managing the trust assets and making investment decisions, the Trustee should consider the purpose(s) of the trust, the general economic conditions, the possible effect of inflation or deflation, the expected tax consequences of the investment strategy, the "special value" of a particular trust asset, etc. This modern portfolio approach allows the Trustee to invest for "total return", which should meet the needs of both (current and future) income and principal beneficiaries of the trust.

C. Diversification. UPIA mandates that the Trustee diversify the trust's investments, unless the terms of the trust clearly override that duty. Diversifying the trust's assets distributes the risk of loss among several investments and reduces the impact that losses in any one investment could have on the trust as a whole. (Previously, diversifying the trust assets was expected from a prudent trustee, but not required.)

The duty to diversify can be overridden, but such a provision must be very clear in order for the Trustee to rely on it. For example, a trust may state that the primary purpose of the trust is to hold a family ranch indefinitely and that the purpose of the trust would be violated if the ranch were sold. A general provision to the effect that the Trustee need not diversify the trust's investments would probably not suffice, however.

D. Risk vs. Growth. The Trustee has a duty to analyze and make conscious decisions concerning the level of risk appropriate to the trust's purposes, distribution requirements, and other circumstances. The Trustee should tailor an investment strategy that incorporates risk and return objectives suited to the trust's purpose(s) and its beneficiaries. A Trustee may be asked to invest in speculative investments, which are risky and require specialized knowledge. On the other hand, a Trustee can be too conservative, making investments that do not keep up with inflation (which is also "risky"). Thus, the Trustee must balance the duty to invest in assets that will generate returns for the (current) beneficiaries with the duty to preserve the trust's assets for the (future) beneficiaries.

V. Duty Not to Delegate. Under prior law, the Trustee was obligated to administer the trust, personally, and could not delegate this obligation (or any part of it) to others. Even if a Trustee employed professionals to assist him, he was still liable for their actions. Conversely, the Prudent Investor Act takes a different approach, encouraging appropriate delegation and limiting the Trustee's liability in certain cases. The Trustee may delegate any investment or management task if a prudent Trustee of comparable skill would do likewise. The Trustee must use reasonable care, skill, and caution in selecting the agent and reviewing the agent's actions; however, if the Trustee meets this test, then the Trustee will not be held liable to the beneficiaries or the trust for the decisions or actions of the agent. An important exception is that a Trustee will be liable for the agent's malfeasance if the agent is an "affiliate" of the Trustee.

VI. The Duty to Keep Proper Books and Records and the Duty to Keep the Trust Beneficiaries Informed. The Trustee has a duty to keep trust beneficiaries reasonably informed about matters relating to the trust. This means that material information should be provided to the beneficiaries as necessary to protect their interests. If the beneficiaries so demand, the Trustee must also furnish a trust accounting, showing the nature and value of the trust assets, the receipts and disbursements of the trust, and other relevant information indicating the Trustee's management actions. Also, a Trustee should inform beneficiaries prior to engaging in any significant non-routine transaction on behalf of the trust, such as the sale of a major (or "special") trust asset.

The Trustee has a duty to keep detailed and accurate records of all trust activity. The Trustee should set up and maintain proper books of account as soon as possible after becoming the Trustee. In addition, the trust's records should show how receipts and disbursements have been allocated between principal and income.

Closing the Trust. The terms of the trust will determine when the trust terminates. When a trust terminates, the Trustee will have a reasonable period of time to "wind up" the affairs of the trust and make the final distributions to the beneficiaries per the terms of the trust.

CAVEAT: Individuals Without Expertise Serving As Trustee. A Trustee who is neither a professional Trustee nor an individual with trust, tax and investment expertise may not fully appreciate the scope of his duties. Because many individuals who serve as the Trustee of a trust do not possess the necessary expertise, such Trustees should consider hiring and/or consulting various professionals to assist the Trustee with his duties. The individual Trustee can hire an attorney (for legal advice), a CPA (for tax advice and to handle the trust's income tax matters), an investment advisor (for assistance with selecting and managing the investments of the trust), and/or a bank or private trust company (to serve as the individual Trustee's agent with respect to various trust administration matters–some trust instruments even allow an individual Trustee to appoint a corporate Trustee to serve as a Co-Trustee with him/her). In practice, very few individual Trustees hire an attorney to advise them regarding trust legal matters, either on a periodic or ongoing basis. Unfortunately, if the Trustee makes a mistake, the beneficiaries of the trust may hire a "trust litigation attorney" to represent them and their interests. If that happens, the Trustee will need to hire his own attorney. Trustees should consider consulting with an attorney (and other advisors) *before* trust problems arise, however. This newsletter is certainly no substitute for legal advice. For further information, *see also* "What Every Trustee Ought To Know" and "Trust Investments" on our website, www.gerstnerlaw.com.

Contact Us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown below.

You can also reach us by e-mail addressed to:

Karen S. Gerstner*	karen@gerstnerlaw.com
Kathryn Miller Connelly	kathryn@gerstnerlaw.com
Nan Darby	nan@gerstnerlaw.com
Biljana Salamunovic	biljana@gerstnerlaw.com
General delivery	gerstnerlaw@yahoo.com

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KAREN S. GERSTNER & ASSOCIATES, P.C.
A Professional Corporation
Attorneys At Law
5615 Kirby Drive, Suite 306
Houston, Texas 77005-2448

Telephone (713) 520-5205
Fax (713) 520-5235

www.gerstnerlaw.com