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## With Great Power Comes Great Responsibility: A Trustee's Practical Guide to Investing Trust Assets

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For an individual, being asked to serve as the trustee of a trust is typically an indication of the settlor's absolute trust. For a corporate trustee, being asked to serve as trustee is typically an indication of the settlor's common sense. A corporate trustee's experience and sophistication with trust administration will often outweigh its purportedly greater cost relative to individuals.<sup>1</sup> Nonetheless, even professionals can end up embroiled in trust litigation over trust investments if those investments produce results that fail to live up to a beneficiary's expectations.<sup>2</sup>

### STATE LAW

#### General Fiduciary Duties

State law, both statutory and common law, sets forth the fiduciary duties imposed on a trustee when

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<sup>1</sup> Corporate trustees may actually be less expensive than individuals, considering that a corporate trustee's fee generally includes all services provided, including investment management services. On the other hand, individual trustees, even if serving without compensation, will often need to employ professionals at significant cost or else risk mistakes that will lead to even greater expense to fix, or worse yet, litigation.

<sup>2</sup> For a more detailed analysis of fiduciary duties of and risk management for fiduciaries, see 857 T.M., *Managing Litigation Risks of Fiduciaries*.

investing trust assets. Even though the Uniform Trust Code (UTC), now enacted in the majority of jurisdictions,<sup>3</sup> has brought greater uniformity to the fiduciary duties of trustees, there are still 51 variations thereof in the United States. Accordingly, a trustee must identify the relevant state law and either review directly or request summary from legal counsel of key provisions of the governing instrument. Regardless of which jurisdiction's law applies to a trust, there are two core duties that apply to all trustees and from which all duties are derived, namely: (i) the duty of loyalty and (ii) the duty of care.

#### Duty of Loyalty

In the context of investments, the duty of loyalty requires a trustee to invest and manage the trust funds solely in the best interests of the beneficiary and refrain from placing his or her own or a third party's interests above those of the beneficiary.<sup>4</sup> As a conceptual matter, any transaction in which the trustee has an actual or potential interest (i.e., a "self-dealing transaction"), whether direct or indirect, violates the duty of loyalty regardless of whether the transaction would also be beneficial to the beneficiaries. As a general rule, if a trustee breaches his or her duty of loyalty by engaging in a self-dealing transaction, the transaction is voidable by the beneficiaries regardless of the objective fairness of the transaction terms.<sup>5</sup> Accordingly, trustees should avoid investing in any entity in which the trustee has any ownership and/or management interest, whether directly or indirectly, unless expressly permitted by the provisions in the governing instrument and/or after consultation with legal counsel.

#### Duty of Care

In the context of investments, the duty of care requires a trustee to exercise reasonable care and skill

<sup>3</sup> See <http://www.uniformlaws.org/Act.aspx?title=Trust%20Code> for a current list of states that have adopted the Uniform Trust Code (UTC).

<sup>4</sup> See, e.g., UTC §802; Uniform Prudent Investor Act (UPIA) §5.

<sup>5</sup> See, e.g., UTC §802(b).

in investing and managing the trust assets.<sup>6</sup> The standard used to measure a trustee's level of care is generally that which a prudent person would utilize in the context of the terms of the trust.<sup>7</sup> While a settlor may generally modify the standard of care, state law limits the modification to ensure a basic level of care is required.<sup>8</sup>

Notwithstanding the general standard, "[a] trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, shall use those special skills or expertise."<sup>9</sup> Accordingly, a corporate trustee or individual trustee with special investment skills will be required to act as a prudent person with comparable skills and, thus, is held to a higher level of care. A trustee with special skills or expertise in investment would be well-advised to document additional diligence that is undertaken in making investment decisions.

## Specific Provisions Regarding Investments

In addition to the more general fiduciary duties, investments by trustees are also subject to rules targeted specifically to trust investments. While these provisions are derived from the general fiduciary duties, they impose certain specific requirements on trustees when investing trust assets. Like the UTC provisions, these provisions are default rules and may generally be modified by the terms of the governing instrument itself.

The majority of jurisdictions have adopted the UPIA,<sup>10</sup> which requires trustees to utilize the "Modern Portfolio Theory" in investing trust assets. The Modern Portfolio Theory judges prudence in trust investment not on the success or failure of individual trust investments but rather in the context of the prudence of the investment in light of the overall portfolio of assets.<sup>11</sup> Additionally, the Modern Portfolio

Theory as adopted under the UPIA imposes an express duty to diversify in most circumstances.<sup>12</sup>

Some of the jurisdictions that have not yet adopted the UPIA still utilize a form of the "Prudent Man Rule." Additionally, the Prudent Man Rule is still relevant to older trusts in other jurisdictions when reviewing trust investments prior to the adoption of the UPIA. Under the Prudent Man Rule the prudence of each investment is analyzed individually. Because there is no obligation to review the investments in context of the whole portfolio, there is no implicit duty to diversify under this standard. However, because there is potential liability for each individual investment, it encourages trustees to invest in perceived "safe" investments, such as government bonds and money market accounts, often to the detriment of both income production and appreciation of capital.

## GOVERNING INSTRUMENT AND BEYOND

In many instances, the provisions of a particular Last Will and Testament, in the case of a testamentary trust, or a trust agreement, in the case of an inter vivos trust, will expand or reduce the fiduciary duties of a trustee with respect to trust investments. Therefore, it is imperative for trustees to carefully review the governing instrument's investment and distribution standards. However, in a high-profile case in New York, the court found that a settlor's direction regarding concentration of a trust's investment must still be viewed in light of an overall reasonable investment policy for the trust.<sup>13</sup> Accordingly, the provisions of the particular governing instrument should not be viewed as absolute and the trustee should also consider any proposed investment in light of applicable state law standards. Moreover, trustees should consider seeking advice from legal counsel regarding any provisions that are unclear.

Further, a trustee should take into consideration family dynamics and investment philosophies, which

<sup>6</sup> See, e.g., UTC §804.

<sup>7</sup> See, e.g., UTC §804.

<sup>8</sup> See, e.g., UTC §1008 (prohibiting a settlor from exculpating a trustee from liability for any "breach of trust committed in bad faith or with reckless indifference to the purposes of the trust or to the interests of the beneficiaries."). See UTC §804 (comment).

<sup>9</sup> See, e.g., UTC §806.

<sup>10</sup> See <http://www.uniformlaws.org/Act.aspx?title=Prudent%20Investor%20Act> for a current list of states that have adopted the UPIA.

<sup>11</sup> See, e.g., UPIA §2(b) ("A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.")

<sup>12</sup> See, e.g., UPIA §3 ("A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.")

<sup>13</sup> See *Matter of Chase Manhattan Bank*, 791 N.Y.S.2d 868 (Surr. Ct. 2004), *rev'd*, 809 N.Y.S.2d 360 (N.Y. App. Div. 2006) (trustee should have diversified despite language in will governing testamentary trust that permitted corporate trustee to retain Kodak stock as its sole asset). While the appellate court reversed the surrogate court by holding that the date assigned for selling the Kodak stock was premature, the appellate court stated, "[i]t is well established that a Surrogate may select a date within the entire period during which an investment was held when divestiture of an imprudently held investment should have occurred." (citation omitted).

often cannot be easily intuited from a governing instrument. Non-family member trustees, such as corporate trustees, should consider meeting with the settlor, if living, or, if not, a trusted advisor of the settlor, and ask questions about the beneficiary's needs and expect-

tations. Having this information prior to making major investment decisions will allow the trustee to tailor investment decisions more effectively. After all, sometimes the best defense is a good offense.