THE LAWYER AS TRUSTEE:
DUTY WITH RESPECT TO INCEPTION ASSETS

MAY 2002

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PREFACE

We examine certain issues surrounding trustee duty to formulate and implement, within a reasonable amount of time after accepting a trusteeship, strategies for the retention and disposition of assets. In discharging the duties of the office, the trustee looks primarily to the provisions of the trust instrument, and secondarily to applicable statutes and court precedents. Many trusts, however, have broadly drafted permissive language granting the trustee “absolute discretion” regarding the decision to sell or retain inception assets. Likewise, Maryland’s Prudent Investor Rule differs from the statutes adopted by other states as well as from the Uniform Prudent Investor Act in its guidelines for review of trustee investment decisions. Absent cases providing clear guidance for trustees electing “Prudent Investor” status with the Commissioner of Financial Regulation, we consider possible consequences of trustee decisions regarding inception assets lest the lawyer-trustee inadvertently fall victim to unforeseen litigation perils. Furthermore, having considered critical issues prior to accepting a co-trusteeship with either a family or commercial trustee, the lawyer is in a better position either to reject a nomination to assume trusteeship if he or she is uncomfortable with the proposed co-trustee’s policies; or, having accepted, to protect the interests of the beneficiaries.

Although courts will certainly wish to give effect to the language of trust instruments that combine broad discretionary powers with exculpatory clauses, it is not certain that they will do so by providing trustees with a blanket license for imprudent conduct with respect to inception assets. Indeed, the well-established principle of law stating that trust language is not dispositive (i.e., the trustor cannot waive certain fundamental duties of the trustee), should give pause to trustees who rely merely on boilerplate language to formulate guidelines for trust administration and asset management.

Management of inception assets is truly an undertaking in which the devil is in the details. Provisions of trust instruments, reflecting the law at the time of drafting, may require administration under current standards of prudence that differ greatly from those originally contemplated by the trust's creators. Original language, intended to thwart attempts to undermine strategies antithetical to the settlor's intentions, may, under the new legal environment, act as a straightjacket preventing trustee flexibility to adopt modern standards of asset management (or as a license permitting trustees to manage assets suboptimally). Additionally, affixing language reflecting new law to carryover boilerplate may create ambiguities that cloud a trustee's ability to interpret effectively trustor intentions.

Consider, for example, the following trust language:

> *"The trustee may acquire and retain investments that present a higher degree of risk than would normally be authorized by the applicable rules of fiduciary investment and conduct. No investment, no matter how risky or speculative, shall be absolutely prohibited, so long as prudent procedures are followed in selecting and retaining the investment and the investment constitutes a prudent percentage of the Trust. The Trustee may but need not favor retention of assets originally owned by me. The Trustee shall not be under any duty to diversify investments regardless of any rule of law requiring diversification…. The Trustee shall have absolute discretion in exercising these powers"*

What are the standards of prudence under which this trust should be administered? The trustee is given absolute discretion with respect to inception assets and is absolved from a duty to diversify the trust's investments. Is the required standard of prudence merely procedural (take title to property, account to beneficiaries, maintain impartiality, etc.)? Perhaps, but the language directing that the trustee employ prudent procedures in selecting and retaining investments, and that the trustee consider the prudence of under or over weighting investment positions, argues that prudence should also be substantive in order to promote a good decision making process. What construction should be put on trust provisions if the second sentence is removed? Does the grant of absolute discretion indicate trustor intent to negate trustee responsibility to the extent that there is no longer need to act in a fiduciary capacity with respect to investment decisions? Does the trustee need to evaluate the contribution of inception assets to the risk and return of the trust portfolio? Does the trustee need to articulate a rationale for asset concentration risk (i.e. retaining stock to continue a special relationship between the family and the company), or has the trustor written the trustee a blank check with respect to investment strategies so long as the trustee acts in good faith with respect to the administration of the trust estate? It is not clear, should this trust ever become the subject of a fiduciary breech proceeding for lack of diversification, whether a Maryland court would follow the logic of the Minnesota court affirming a surcharge against Norwest Bank and rejecting defense claims that trust provisions including exculpatory clauses absolved a diversification breach ["…failure of a professional to meet a minimum standard of care is not a mere error in judgment." Minn.

App. 1999) 591 N.W.2d at 748]; or whether a court would grant a trustee summary dismissal based solely on the language of the trust instrument.

Consider, further, the following language (which is currently the subject of fiduciary breach litigation against a commercial co-trustee):

> *"The Trustee is authorized in its fiduciary discretion (which shall be subject to the standard of reasonableness and good faith to all beneficiaries) with respect to the trust estate*
>
> - *to retain in the form received, without liability for loss, any property or investments of any kind, or any undivided interests therein, received from any source…regardless of any lack of diversification, risk or non-productivity, as long as the Trustee deems advisable, and to exchange any such security or property for other security or properties and to retain such items received in exchange, although said property represents a large percentage of the total property of the Trust Estate or even the entirety thereof.*
>
> - *to invest and reinvest all or any part of the trust estate … without being limited by any statute or rule of law concerning proper investments for the trustee."*

Again, the language is Janus-like. The trustee is given license to ignore issues of diversification, risk and lack of productivity; but may ignore them only for "as long as the Trustee deems advisable." Furthermore, the grant of discretion is not absolute but is qualified by the construction "fiduciary discretion (which shall be subject to the standard of reasonableness and good faith to all beneficiaries)…." Is the standard of prudence required for the trustee the community's standards as reflected by and codified in applicable Prudent Investor statutes? Or, should the provision allowing for trust administration "without being limited by any statute or rule of law concerning proper investments for the trustee" signify that the applicable fiduciary discretion is an ill-defined or subjective set of beliefs the reasonableness of which is determined by the commercial practices and profit imperatives of the trustee? If "fiduciary discretion" is given little force and effect, then one must agree that it was the trustor's intention to hire a steward for family wealth while simultaneously relieving the trustee of an obligation to use standards of care, skill and caution consistent with modern legal and investment principles. But such an agreement creates a transfer of property that may represent something other than a trust (i.e. an agency or a contract). Could any settlor prudently agree to execute a document that stripped the trust of any recourse against improper or substandard asset management? Trustee attempts to put such a construction on the trust may, itself, be prima facie evidence of negligence or reckless indifference to the needs of the beneficiaries and may constitute an argument for trustee removal. If the trustee maintains that the applicable standards of prudence should not be those currently ratified by the legislature, then do the trustee's proprietary standards meet the test of "reasonableness" (and, does such a defense shift the burden of proof in a fiduciary breach case from the plaintiff to the defendant)?

Code §15-114 enumerates the guidelines and standards for investment of assets under Maryland's Prudent Investor Rule. Section 15-114(b)(5) states that, in general, a fiduciary shall:

> *"Review fiduciary assets within a reasonable time after acceptance of the fiduciary appointment and make and implement decisions concerning the retention or disposition of investments existing prior to the appointment in order to conform with this section."*

Conformity with Section 15-114(b) reflects standards of care, skill, and caution that, in many respects, mirror the language of the Uniform Prudent Investor Act.

However, §15-114(c) creates unique standards for review of asset management decisions:

> *"The fiduciary may exercise reasonable business judgment regarding the anticipated effect on the portfolio of fiduciary assets as a whole under the facts and circumstances prevailing at the time of the decision or action.*
>
> *The fiduciary shall have no liability for continuing to hold fiduciary assets existing at the time the fiduciary appointment was accepted or subsequently added pursuant to proper authority if, and as long as, the fiduciary, in the exercise of good faith and reasonable prudence, considers the retention to be in the best interests of the beneficiaries or in the furtherance of the goals of the governing instrument."*

By contrast, §4 of the Uniform Prudent Investor Act, outlining duties at inception of trusteeship, simply refers, in the Reporter's Comments, to UPIA§2(a): "A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution." The language of §15-114(c), therefore, suggests that Maryland's legislature did not wish to hold trustees to the standard of the "prudent expert" which courts have applied to administration of employee benefit trusts under ERISA. Likewise, the absence of the language in UPIA §2(f) ["A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skill or expertise, has a duty to use those special skills or expertise."] suggests the possibility that Maryland commercial trustees providing investment management services may not be held to the UPIA objective standard of prudence which is to invest according to "an overall investment strategy having risk and return objectives reasonably suited to the trust." Indeed, this line of speculation receives some support in the language of §15-114(b)(3)'s directive that trustees should invest and manage "as part of an overall investment strategy that incorporates risk and return objectives reasonably suitable

under the terms of the governing instrument and *the nature of the fiduciary appointment*" [emphasis added].

The terminology of §15-114 may well evidence the fact that the nature of the fiduciary appointment in Maryland is fundamentally different from the appointment contemplated by the Uniform Prudent Investor Act. Use of terminology like "reasonable business judgment" implies that trustee decision making occurs within the context of the corporate officer or director investing corporate assets on behalf of his or her firm rather than on the standard of the prudent investor similarly situated. The trustee, with respect to inception assets, must evidence "the exercise of good faith and reasonable prudence." What is the relationship between "good faith and reasonable prudence," and "reasonable business judgment?" Reasonable business judgment is a standard that applies to a commercial marketplace (American corporations usually pursue profit by focusing on proprietary technologies and unique competitive advantages in an attempt to capture market share through concentration of resources rather than through diversification) rather than a standard that demands that trustee decision making rise above the morals of the marketplace. The difficulty for the lawyer-trustee (and for trustors and beneficiaries who must judge the merits of service packages offered by commercial fiduciaries) lies in the fact that not only do the statutes fail to provide a bright line standard of prudence (if such a monolithic standard would, in fact, be desirable); but also, they create puzzling ambiguities due to the idiosyncratic juxtapositions of terminology.

It is a well established principle of law that, although a beneficiary has only an equitable interest in trust property and personally has no enforceable rights against the trust, he or she has standing to sue for abuse of discretion should a trustee's dilatory or inefficient trust administration prove detrimental to this interest. In many states, trustee defenses based on a beneficiary's investment directives (or grantor investment directives during the period that the trust was revocable), beneficiary acquiescence to poorly understood strategies, boilerplate language granting broad scope discretion, exculpatory provisions, and so forth fail to avoid surcharges for breach of fiduciary duties. Although, at one time, a commercial trustee's mere opinion that blue-chip status for a security mitigates the duty to achieve reasonable diversification was sufficient to sway the members of the bench [Estate of Knipp, 414 A.2d 1007-10 (Pa. 1980) ruling in favor of a trustee that failed to diversify a portfolio 97% invested in Sears Roebuck & Co. stock: "Sears stock was, during the period in question, reasonably believed to be a sound, national, broad-based stock worthy of investment by a fiduciary."], currently, with blue-chip security prices rising and falling like yo-yos (and dot-com, telecommunications and internet stocks sinking like lead weights) such a post-Enron, post-Lucent Technologies defense is laughably irrelevant and ineffective in many jurisdictions [e.g. In re Estate of Rowe, 712N.Y.S.2d (S. Ct. 3d Div. Aug. 10, 2000 surcharging a commercial trustee for failure to diversify a charitable lead trust's concentrated position in IBM stock].

Irrespective of the language of the trust instrument (unless such language evidences the trustor's intent to ignore principles of modern financial economics in order to accomplish clearly specified objectives such as continuation of a special relationships between the family and the property in question) should a trustee retain property in the form received unless it is prudent to do so? This is a variation on the more general question of the difference between a power and a duty. A power, such as discretion regarding investment decisions, tells a trustee that he or she has the ability to act or not act on any investment strategy; a duty, however, imposes an obligation on the trustee. Thus, in most jurisdictions, courts have ruled that discretionary powers (including grants of "absolute discretion") must be exercised under the constraints imposed by the duty of prudence. For trusts administered in Maryland, are the force and effect of the discretionary powers and exculpatory provisions embedded in the trust instrument to be evaluated in terms of the "reasonable prudence" of the trustee's investment decisions? The judicial answer to this question will determine the extent to which trustees will be procedurally prudent caretakers of assets or, will be substantively prudent caretakers of investment policy suited to the purposes, terms, distribution requirements and other circumstances of the trust. If the provider of commercial trust and investment services, under Maryland law, does not have the duty to employ professional skills with respect to inception assets that are self-evidently under diversified or inappropriate to the needs of the beneficiaries (either because they are under productive, cannot produce adequate income for current beneficiaries, etc.), it may be difficult to prevail in a breach of duty action.

In the world of modern trust administration, what should a beneficiary (and legal counsel / co-trustee) expect from a commercial fiduciary? Consider a fact pattern where a bank or trust company, pitches its services to a grantor; or, having been nominated as trustee in the governing instrument, provides beneficiaries with information on its depth of expertise and resources, its track record for proprietary investment programs, its brokerage services for

trust customers, etc. Suppose further that the welcome-to-the-trust-department material identifies or references trust department personnel that are members of the Association for Investment Management and Research (AIMR) and that hold a Chartered Financial Analysts (CFA) designation. AIMR is "the primary professional organization for securities analysts, investment managers, and others related to the investment decision-making process…," and it promulgates a Code of Ethics and Standards of Professional Conduct in the AIMR *Standards of Practice Handbook*: At the heart of AIMR's "best practice" standards is the recognition that investment decisions should be based on academically sound principles using generally acceptable standards of quantitative and statistical analysis ("The risk of many investment strategies can and should be analyzed and quantified in advance"). Specifically, with respect to the suitability of inception assets to the ongoing purposes, terms, distribution requirements and other circumstances of the trust, the *Handbook* notes:

> *"The investment profession has long recognized that the combination of several different investments is likely to provide a more acceptable level of risk exposure than having all funds in a single investment. The unique characteristics (or risks) of an individual investment may become partially or entirely neutralized when combined with other individual investments within a portfolio. Some reasonable amount of diversification is thus the norm for many portfolios, especially those managed by individuals or institutions that have some degree of fiduciary responsibility…. Understanding the basic characteristics of the investment is of great importance in judging the suitability of each investment on a stand-along basis, but it is especially important in determining the impact each investment will have on the characteristics of the portfolio. For instance, although the risk and return characteristics of shares of a stock seem to be the same for any investor if the stock is viewed in isolation, the implications of such an investment vary greatly depending on the other investments held."*

The existence of AIMR standards for investment management may be critically important in the litigation arena. Commercial trustees boasting that the trust department is populated with CFAs run the risk that, if they fail to conduct and document adequate analysis of inception assets (capital gains tax liabilities vs. opportunity costs of maintaining concentrated asset positions; risk-adjusted return expectations of alternative strategies, etc.) according to best practice standards, they may also fail to demonstrate "reasonable prudence" or fail to demonstrate that a course of action remained "advisable." Certainly, evidence that an investment review committee periodically evaluates each security in isolation to determine if it is a "safe" or "good" or "undervalued" security merely documents a process that is wholly inadequate in terms of best practice standards for portfolio management. Although, Plaintiff may not prevail in a fiduciary breach suit; nevertheless, the question of deceptive trade practices remains on the table. Consumer fraud statutes allow for methods of calculating damages that, in some cases, may result in very high awards (fiduciary breach actions do not ordinarily provide for punitive damages). If the fiduciary held itself out as an organization with investment expertise by virtue of its employment of individuals clearly identified by the CFA designation, then courts may find that beneficiaries have a reasonable expectation that the CFA best practice standards will be employed in the administration of the trust portfolio.

The *Handbook* details procedures for compliance and directs that AIMR members should create a written investment policy statement for each client. Interestingly, this parallels the American College of Trust and Estate Counsel's recommendation that ACTEC fellows acting as trustees should design and implement a written investment policy statement in a document separate from the trust instrument; and, the AIMR requirements also compliment the American law Institute – American Bar Association's recommendation in their Fiduciary Accounting Guide (Chapter 10) regarding performance accounting according to AIMR standards.

Lawyers, accepting positions as co-trustees, may have duty to represent the interests of their clients by reviewing the policies and procedures of a commercial fiduciary's investment management services. This is especially the case where a commercial fiduciary intends to treat inception assets either as fodder for rollover to proprietary investment programs; or, because of boilerplate trust provisions, as a source of supplementary fee income generated through a strategy of benign neglect. The growing propensity of litigators to advance both consumer fraud arguments and fiduciary breach arguments suggests that employment of best practice standards is the preferred method for offloading liability.