ACTEC 2014 Fall Meeting Musings

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This summary reflects the individual observations of Steve Akers from the seminars at the 2014 Fall Meeting and does not purport to represent the views of ACTEC as to any particular issues.

Steve R. Akers

Senior Fiduciary Counsel — Southwest Region, Bessemer Trust
300 Crescent Court, Suite 800
Dallas, TX 75201
214-981-9407
akers@bessemer.com
www.bessemer.com

BESSEMER TRUST

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1. History of Trusts in Louisiana

   Louisiana historically resisted the recognition of trusts on two principles. (1) Louisiana civil law prohibited the principle of fedei commissa (before the French revolution, this permitted a grantor to transfer property to a grantee with the condition that the grantee would transfer the property to a third person upon the happening of a certain condition). (2) The Civil War tradition opposed deferring the vesting of interests in trusts. The Louisiana legislature did not authorize private trusts until 1920. It further liberalized the recognition of trusts in stages; eventually the Louisiana Trust Code was codified in 1964.

2. Unique Characteristics of Louisiana Trusts

   a. ***Vesting of Principal Beneficiaries.*** The principal of a Louisiana trust must generally be "vested" in one or more beneficiaries who are in being and ascertainable when the trust is formed. This may cause traditional common law dispositions to fail. For example, naming "my issue, then living" as remainder beneficiaries following the surviving spouse's life may cause the property to pass by intestacy because the principal beneficiaries are not properly vested. (There are exceptions, discussed below.)

   b. ***Permitted "Substitutions" On Death of Principal Beneficiary.*** Upon a principal beneficiary's death, other substitute principal beneficiaries may be permitted. If the beneficiary dies without descendants, the instrument may name other substitute beneficiaries (but if the principal beneficiary's trust interest represents his portion as a forced heir, this shift can occur only if the principal beneficiary also dies intestate).

      Substitute beneficiaries must meet the "in being and ascertainable" vesting requirement. Substitute beneficiaries who are descendants of the settlor only need to be in being and ascertainable on the death of the principal beneficiary. Otherwise, substitute beneficiaries must be in being and ascertainable at the creation of the trust.

   c. ***Class Trusts.*** The principal and income may be vested in a defined "class" which may include some or all of the settlor's children, grandchildren, great grandchildren, nieces, nephews, grandnieces, grandnephews, great grandnieces, or great grandnephews. The class can include members not in being at the time of the creation of the trust as long as at least one member is alive at the trust creation. At the death of a class member, the assets may vest in other members of the class. If a class member dies with descendants, the trust may provide that the interest of the deceased beneficiary vests in his heirs.

   d. ***Limitations on Distributions to Income Beneficiaries Who Are Not Principal Beneficiaries.*** Distributions to an income beneficiary who is not also the principal beneficiary must be limited by an ascertainable standard (even if the trustee is not the beneficiary). There are exceptions to accommodate annual exclusion withdrawals, annuity trusts, and unitrusts.

e. ***No Powers of Appointment; Limited Ability to Modify Trusts.*** Traditionally, Louisiana has not recognized limited powers of appointment. Principal beneficiaries may have testamentary general powers of appointment. This restriction on powers of appointment has been loosened somewhat by a recent modification to the Louisiana Trust Code, which allows "a person other than the settlor to modify the provisions of the trust agreement in order to add or remove beneficiaries, or to modify their rights, if all of the affected beneficiaries are descendants of the person who is given the right to modify."

f. ***Trust Term.*** Louisiana trusts cannot last forever, but Louisiana does not recognize the common law rule against perpetuities. Section 1831 provides limitations on the length of the stipulated term of the trust. For many trusts, the limit is the death of the last surviving income beneficiary (or for a class trust, the death of the last surviving class member) or the expiration of 20 years from the death of the last settlor to die, whichever occurs first. (Because the class can include great grandchildren, even if they are not born on the date of the creation of the trust, the trust can last a very long time.)

g. ***Form Requirements.*** A Louisiana inter vivos trust must be exercised either (i) by "authentic act" passed before a notary and two witnesses, or (ii) by "private" form executed before two witnesses and duly acknowledged (in either event, requiring two witnesses). A testamentary trust must be in a valid will.

   If the form is invalid, the trust will fail and property purportedly transferred to the trust will remain with the settlor and pass under the settlor's will at death.

h. ***Destructibility.*** Consent termination upon the agreement of all parties is not permitted; a court proceeding is required. (A court will allow the termination of the trust for good reasons.)

i. ***Community Property Application to Persons Moving to Louisiana.*** A person moving to Louisiana has one year to opt out of the community property regime without requiring court approval.

j. ***Forced Heirship.*** Forced heirship generally does not apply to persons who live outside Louisiana, except it does apply to immovable property if the decedent has a forced heir domiciled in Louisiana at the time of his death. Forced heirs are defined in Louisiana Civil Code Article 1493. Forced heirs are children who are 23 years of age or younger at the decedent's death or are permanently incapable of taking care of themselves due to mental incapacity or physical infirmity. If a child predeceases the decedent, his children are forced heirs only if the child would have been 23 years of age or younger at the decedent's death (but if a child of the predeceased child is permanently incapable of taking care of himself due to mental incapacity or physical infirmity, he is a forced heir regardless of the age of the deceased child).

The portion that must pass to forced heirs (the "forced portion") is one-fourth if the donor has one forced heir and one-half if he has two or more forced heirs. The forced portion is sometimes called the "legitime" (or legitimate portion).

A surviving spouse may have an income interest in a trust that holds the forced portion or may have the usufruct over the forced portion.

A transfer of the forced portion in trust must give the forced heir certain rights. For example, a successor beneficiary is allowed following the forced heir's death only if the forced heir dies both intestate and without descendants. There can be no other beneficiary except the decedent's surviving spouse. If there is not a surviving spouse who is a trust beneficiary, the forced heir must receive income distributions for health, education, maintenance and support if the beneficiary does not have other resources.

3. Usufructs in Louisiana

A usufruct is somewhat like a life estate, but the usufruct owner (the "usufructuary") has even more rights than the holder of a life estate. For nonconsumables (such as lands, houses, shares of stock, animals, furniture, and vehicles) the usufructuary receives all income. For consumables, the usufructuary has the possession and use of things and may consume, alienate, or encumber them, subject to the obligation to repay later the "naked owner" of the value of the things at the beginning of the usufruct. A donor may give the usufructuary the authority to dispose of nonconsumables and hold the proceeds as if they were consumables.

The instrument creating the usufruct may grant a power of sale; otherwise naked owners must consent to a sale of assets in the usufruct.

There is a considerable difference of opinion among Louisiana practitioners regarding the pros and cons of whether to use a usufruct for life or an income interest in trust for a surviving spouse to qualify for the marital deduction. The usufruct is closer to full ownership, subject to certain rights of the naked owners to be repaid if consumables are consumed or disposed of. The usufruct may be simpler (for example no separate trust income tax return is required).

The QTIP election may be made on an asset-by-asset basis for usufruct assets.

4. Other Trust Substitutes in Louisiana

Other trust substitutes in Louisiana include the "right of habitation" and the "right of use." These rights cannot be transferred and cannot be seized by creditors of the holder of the right.

5. Practical Considerations for Non-Louisiana Residents

Avoid contributing Louisiana immovable property into non-Non-Louisiana trusts. Instead, consider using a limited liability company to hold Louisiana real estate. Alternatively, establish a Louisiana Trust (either inter vivos or testamentary) to hold Louisiana immovables (using a Louisiana attorney).

The "Law Institute" is attempting to conform the Louisiana Trust Code more closely to other states. That is still a work in progress; many Louisiana practitioners think that Louisiana should stick to the Napoleonic tradition as much as possible, but others desire more consistency with other states' trust laws.

6. Civil Law Alternatives to Trusts

   a. ***Usufruct.*** The usufruct is similar to a life estate (and is described above based on the civil law of Louisiana). It is common in civil law jurisdictions.

   b. ***Stiftungs***. This is a statutory creation that is viewed as an entity. It is a foundation that has most of the characteristics of trusts. There is a body that manages the assets for beneficiaries. They are recognized by statute in Switzerland (and there are variants in Germany and Austria) for charitable purposes. They are recognized in Lichtenstein for charitable or personal purposes.

   c. ***Anstalt***. Anstalts exist only in Lichtenstein. They are created by statute. The settlor retains "founder's rights," and they are therefore somewhat similar to revocable trusts. They have beneficiaries rather than shareholders. Unlike Stiftungs, they may conduct business, and are generally used as holding companies in conjunction with trusts, not as a trust substitute.

   d. ***Treuhand***. A treuhand is essentially a contractual relationship by which the settlor transfers property to the fiduciary with instructions about management and beneficiaries. It is enforceable between the settlor and the fiduciary, at least for damages for breach of trust, but is not enforceable *vis a vis* third parties (they view the fiduciary that holds the title as the absolute owner). They are recognized in Germany, Austria, and Switzerland among other countries.

   e. **Fideicommissum**. The fideicommissum has some of the attributes of a trust. (In some countries this is known as a fideicomiso.) It is recognized in Roman law countries such as Italy, France, Spain and Latin American countries that trace their law to Spain. While it is similar to a trust, all of the interests in property are contractual, not a fiduciary relationship for which someone who holds equitable title. It is not a creature of statute (except in Columbia) and is not enforceable at law. The "fiducie" is somewhat like a trustee but his creditors can attach the trust assets and in many ways the relationship is more akin to an agency under contract law.

7. Trusts in Mixed Law Jurisdictions and Some Civil Law Jurisdictions

   Various jurisdictions recognize trusts by statute, such as Quebec, Scotland, and South Africa. Columbia and Lichtenstein are civil law (not mixed law) countries that recognize trusts by statute. In Lichtenstein they are used more as what we refer to as Massachusetts Business Trusts; the anstalt is more commonly used in Lichtenstein for purposes that we think of for using trusts. Columbia, on the other hand, has real trusts by statute. They are often used to hold escrow funds in real estate transactions. There must be a corporate trustee, and are used more for commercial than private trust reasons.

8. Recognition of Common Law Trusts by Civil Law Countries

   As an example of issues that arise, can an English trust with an English settlor, beneficiaries and trustee buy real estate in France? Trusts are not recognized in France (so typically a corporation would acquire the real estate and the trust would own the corporation). However, French courts have, on occasion, recognized the trust's existence by enforcing the trust as a matter of contract law to leave the assets to the trust beneficiaries.

   Another example is when French persons are beneficiaries of trusts from other countries. In one case, the French tax department tried to impose a wealth tax on a French beneficiary with respect to trust property, but the court recognized that the beneficiary did not own the property but was just a beneficiary. The court held that France could impose an income tax when the beneficiary received trust assets but not a wealth tax on the trust interest.

9. FATCA Treatment of Foreign Trusts

   FATCA is now grappling with how to deal with foreign trusts, and whether they are treated as foreign entities. Generally, foreign discretionary trusts did not have to report the identity of beneficiaries until they actually receive distributions, and Italy has passed a law requiring the reporting of foreign assets in foreign trusts for Italian residents.

10. Hague Convention

    The Hague Convention on the Law Applicable to Trusts and on Their Recognition is a multilateral treaty aimed at ensuring the international recognition of common law trusts and equivalent civil law instruments. It provides generally that a civil law country must recognize a trust that is valid in the country where it was created. Twelve nations have ratified the Hague Convention (but not the United States-due largely to opposition from Louisiana).

    Article 13 provides that a country does not have to recognize a trust even though it purports to be a valid trust if it has a closer connection to a civil law jurisdiction that does not recognize trusts than to the country under which the trust is purportedly valid (for example, if the only connection to such country is the choice of law, place of administration and residence of the trustee—but not the residence of the settlor or the beneficiary, or the place where the assets are located).

Items 11-19 are observations from a panel by Ryan M. Harding and Suzanne L. Shier—Responsible Investing: Making an Impact Prudently

11. What is Responsible Investing?

    Responsible investing is growing and attracting the attention of investors, particularly philanthropic organizations and the "next generation." It aligns investments with the investors' values, or at least not supporting what they consider to be harmful. The phrase "sin stocks" has emerged from this approach. Some investors prefer investing in "responsible" companies thinking they will outperform over the long run.

Responsible investing has come to be known by the term "Sustainable and Responsible Investment" (SRI). Some have identified four levels of strategies: (i) Socially responsible (excluding companies involved in specifically identified activities); (ii) Sustainable (investing in diversified portfolios comprised of companies with high "ESG" ratings (companies are rated based on environmental, social and governance factors); (iii) Sustainable and responsible (investing in diversified portfolios of companies with high ESG ratings that avoid involvement incompatible with specific values-based criteria such as tobacco or nuclear power); and (iv) Environmental (strategies focused on specific environmental themes).

12. Trends

Globally, ESG oriented investments increased from $5 trillion in 2007 to more than $32 trillion in 2012, representing about 25% of all of the world's financial holdings. Europe leads with 65% of measured ESG assets under management. More than $1 of every $9 under professional management in the United States is invested under responsible investing strategies. Assets invested under responsible investment principles represent 11.3% of the $33.3 trillion of assets under management that are tracked by Thompson Reuters Nelson. From 1995 to 2012, responsible investment management increased 486% (compared to 376% growth in assets under management generally).

An estimated 49% of millennials with $1 million or more to invest have a responsible investment perspective. Is this just a "phase" they will grow out of? Following the World War I/World War II generations, millenials are the next civic generation—they have experienced 9/11 and the Great Recession.

13. Background; Alternative Types of Responsible Investing Approaches

Socially responsible investing historically focused on avoiding investments that caused social injury, dating back to anti-slavery efforts in the 1700s. It gained renewed attention with avoiding investments in South Africa in opposition to apartheid in the 1970s and 1980s. Negative screens are used to avoid undesired investments. Negative screening is the most consistently applied approach to responsible investing.

Sustainable and responsible investment using ESG factors is a broader concept than just using negative screens. It considers both positive as well as negative ESG factors. It places emphasis on long-term investing with reduced risk and improved shareholder value. Positive screening is particularly used in the United States.

Impact investment emphasizes investments for the primary purpose of achieving a particular impact. It is a strategy used increasingly by philanthropists and philanthropic organizations to fulfill their missions (*e.g.*, sustainable farming, immunization, affordable housing, etc.). Most thematic investments originate from Europe and Africa.

Program-related investment and mission-investing are strategies used in the philanthropic context. Program-related investments are made by a charitable organization in furtherance of its charitable activity (*e.g.*, a dormitory for homeless shelter). Mission-investing is the investment of the "investable assets" of an organization in a manner that is aligned with the charity's mission.

Principles for Responsible Investment (PRI) were established by the United Nations in 2006. Among the principles include:

- "We will incorporate ESG issues into investment analysis and decision-making processes;
- We will be active owners and incorporate ESG issues into our ownership policies and practices;
- We will seek appropriate disclosure on ESG issues by the entities in which we invest; …
- We will each report on our activities and progress towards implementing the Principles."

The PRI Principles have over 1,200 signatories including various large pension funds and retirement systems.

14. General Principles Regarding Responsible Investment by Fiduciaries

Fiduciaries invest for the benefit of another, under high fiduciary standards, a standard of behavior described by Judge Cardozo "not honesty alone, but the punctilio of honor the most sensitive." (Ron Aucutt observed in a later seminar—"I don't know if they really talked that way even back in 1928.")

a. ***Duty of Loyalty.*** The duty of loyalty may cause the biggest problem for fiduciaries. The fiduciary must look out solely for the best interests of the beneficiaries of the trust. The fiduciary looks to the settlor's intent expressed in the governing instruments, and then may consider the views and priorities of beneficiaries (but common views and priorities may be difficult to identify if there are multiple beneficiaries). The comments to §5 of the Uniform Prudent Investor Act clearly question "social investing" in light of the duty of loyalty:

> No form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries—for example, by accepting below-market returns—in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause.

The Restatement (Third) of Trusts (§90, comment c) recognizes there is "considerable disagreement" about what the duty of loyalty requires regarding responsible investing. It emphasizes that the trustee may not promote its personal views on social causes, but affirms that the settlor may authorize and beneficiaries may consent to responsible investing.

b. ***Duty of Impartiality.*** If there are multiple beneficiaries, obtaining consents from all may be impossible. Even if all of the existing beneficiaries consent, the fiduciary may be uncomfortable relying on those consents, especially if there are minor or incapacitated beneficiaries or potential unidentified future beneficiaries.

c. ***Duty of Prudent Investment***. The general prudent investor rule is that a trustee has a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust. It requires reasonable care in light of the overall investment strategy, which should incorporate risk and return objectives reasonably suited to the trust. The trustee must diversify unless under the circumstances it is prudent not to do so. Among other things, the prudent investor rule requires the trustee to conform to the duties of loyalty and impartiality and incur only costs that are reasonable.

There is little guidance regarding the application of the prudent investing requirement regarding responsible investment principles absent specific guidance in the trust instrument. The Restatement (Third) of Trusts gives no direct guidance regarding responsible investing. Scott on Trusts has historically looked favorably on the ability to trustees to take into account responsible investing considerations:

> Trustees in deciding to invest, or to retain, the securities of a corporation may properly consider the social performance of the corporation. They may decline to invest in, or to retain, the securities of corporations whose activities or some of them are contrary to fundamental and generally accepted ethical principles. They may consider such matters as pollution, race discrimination, fair employment, and consumer responsibility.... Of course they may well believe that a corporation that has a proper sense of social obligation is more likely to be successful in the long run than those what are bent on obtaining the maximum amount of profits. But even if these were not so, the investor, though a trustee of funds for others, is entitled to consider the welfare of the community, and refrain from allowing the use of the funds in a manner detrimental to society. Austin Scott, The Law of Trusts, §227.14 (4th ed. 1988).

The subsequent Fifth Edition of Scott on Trusts takes a more constrained view, recognizing that the issue of responsible investing by trustees "has generated a massive literature over the last few decades."

> Only to the extent permitted by the terms of the trust or by the consent of the beneficiaries may the trustees of private trusts properly take social considerations into account in making investment decisions. In the case of the trustees of charitable trusts, however, the Restatement somewhat softens its opposition: social considerations may be taken into account in investing the funds of charitable trusts to the extent that charitable purposes would justify an expenditure of trust funds for the social issue or cause in question .... The Uniform act identifies the duty of loyalty as the basis of its opposition to social investing: "No form of so-called 'social investing' is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries—for example, by accepting below-market returns– in favor of the interests of the persons supposedly benefited by the pursuing the particular social cause.

15. Practical Application of the General Rules for Responsible Investing by Fiduciaries

If the instrument is explicitly clear in authorizing socially responsible investments, the answer is easy –socially responsible investing (SRI) is permitted. However, that rarely happens.

If the trust instrument does not clearly authorize SRI principles, a trustee may consider a beneficiary request for responsible investing in the context of appropriate investment standards. That is permissible if the trustee can demonstrate that SRI will match or exceed the performance of other types of investments. That is the goal of "SRI II."

Conclusion. If the trustee thinks that the SRI returns will be below-market, SRI investing is very risky for the trustee to undertake absent specific language in the trust agreement or a binding release from the beneficiaries (which is very hard to get).

16. General Principles Regarding Responsible Investing by Charitable Fiduciaries

The Uniform Prudent Management of Institutional Funds Act (UPMIFA), completed in 2006, articulates prudence standards for the management of charitable funds by charities. UPMIFA does not apply to trusts managed by non-charitable corporate or other fiduciaries, even if they include charitable interests. While §3 of UPMIFA is based on the Uniform Prudent Investor Act, the rules are not identical. The rules in §3 are merely default rules that can be modified; however, the duty of care, the duty to minimize costs, and the duty to investigate are mandatory. A gift instrument or the governing instruments of a charitable organization can modify non-mandatory duties, subject to the charitable purpose doctrine. Therefore, responsible investment goals of an institution and its donors may be documented.

Professor Susan Gary has written a detailed analysis of whether responsible investing is prudent for a charity. She concludes that as long as a fiduciary acts as a prudent investor, the fiduciary of a charity may consider the charity's mission along with other factors as part of the charity's investment strategy. Susan N. Gary, *Is It Prudent to Be Responsible? The Legal Rules for Charities That Engage in Socially Responsible Investing and Mission Investing*, 6 NW. J. L. & SOC. POL'Y 106, 129 (2011). The trustee cannot invest merely according to the trustee's personal preferences, values and ethics; that would be a breach of the duty of loyalty. But the charitable fiduciary may consider the charity's mission in the prudent investor analysis.

17. Retrofitting Existing Trusts to Authorize Socially Responsible Investing

Trust Instrument. Read the trust instrument carefully to see if there is any language that might permit an alternative investment approach that would include SRI.

Consents. Beneficiary consents might authorize responsible investing, but they are difficult to obtain, especially with large multigenerational trusts.

Construction. For very old trusts, few settlors were considering SRI strategies. Can the SRI concept be read into the instrument when the settlor almost certainly never considered it? That is very difficult.

Reformation. Reformation to allow responsible investing requires making the argument that not being able to invest the trust with an SRI approach undermines the purposes of the trust. Reformation is difficult to justify in jurisdictions that employ the "purposes of the trust" standard. (Some jurisdictions have looser standards for reformations.)

Nonjudicial Settlement Agreement. A nonjudicial settlement agreement is possible, but subject to the same problems described above for obtaining consents.

Decanting. Decanting is generally a better option to modernize the investment language in the instrument. However, by changing the investment standard, has the exoneration of the trustee been broadened? Some decanting statutes do not allow that.

Conclusion. If the trust document does not include SRI language, switching to permit SRI after the fact is difficult. Trustees will have a major problem taking on uncompensated risk.

18. Socially Responsible Investing by Private Foundations

    a. ***Section 4942 Minimum Investment Return.*** Section 4942 requires non-operating foundations to expend 5% of the foundation's prior year's investment assets on a combination of administrative expenses and distributions to qualified charities. Program related investments (special investments for which the primary purpose is to accomplish one or more of the private foundation's charitable purposes) are not treated as investment assets of the private foundation while the investments are outstanding. Therefore, they are excluded from the investment assets in the calculation of the 5% annual distribution requirement. The income generated by the program related investment, however, is treated as investment income. When the principal of the program related investment is returned to the foundation, that value is added to the distribution requirement in the year received, mandating the distribution of those funds either into other program related investments or into outright grants to qualified charities.

    b. ***Section 4944 Jeopardizing Investments and Program Related Investment Exception***. Program related investments (as defined in §4944(c)) are excepted from being treated as jeopardizing investments.

19. Evaluating Socially Responsible Investments

    "ESG" ratings for a wide variety of corporations are available for positive and negative screening of investments. The general approach of "SRI II" is that a company with a strong ESG rating maybe less volatile, which may generally be attractive to clients. However, theoretical research is evolving and not entirely consistent.

    Various indices are available to evaluate the performance of SRI investments. The "GIIRS Report" is a quarterly ratings and analytics report for impact investing. The GIIRS Index allows investors to benchmark their impact performance against a current index over time.

Items 20-31 are observations from a panel by Christine L. Albright and Dana G. Fitzsimons—Fiduciaries and the Courts Today (or at Least, Lately)—Including Discussion of Fiduciary Issues Related to the Net Investment Income Tax

20. Net Investment Income Tax Considerations for Grantor Trusts.

    For estates and trusts, §1411(a)(2) imposes a tax equal to 3.8% times the lesser of —

(i) the estate's or trust's adjusted gross income (as defined in §67(e)) in excess of the highest income tax bracket threshold ($11,950 for 2013, $12,150 for 2014, $12,300 for 2015), or

(ii) the estate's or trust's undistributed net investment income.

The §1411 tax is not imposed on grantor trusts, but items of income, deduction or credit are treated as if they had been received or paid directly by the grantor for purposes of calculating that person's individual net investment income. Reg. §1.1411-3(b)(1)(v). The net investment income from the trust is treated as owned by the grantor, and will be taxed based on the grantor's individual threshold ($250,000/$200,000). Material participation (for purposes of the active business income exception, discussed below) is tested based on participation by the grantor. *See* General Explanation of the Tax Reform Act of 1986 by the Staff of the Joint Committee on Taxation, at 242, n.33. Spousal attribution of material participation, allowed generally under §469(h)(5), should be applicable.

21. Net Investment Income Tax—Non-Grantor Trust Qualification for Active Business Income Exception.

The non-passive trade or business income exception from what constitutes "net investment income" subject to the 3.8% tax requires that (1) there be an activity that involves a trade or business (within the meaning of §162) and (2) is a non-passive activity within the meaning of §469, which requires material participation by the taxpayer. Reg. §1.1411-5(a-b).

There is no guidance regarding how a trust or estate "materially participates" in a trade or business, under either the §469 or §1411 regulations. The 2014-2015 Treasury Priority Guidance Plan includes a new item: "Guidance regarding material participation by trusts and estates for purposes of §469." There are informal indications that this "guidance" will be proposed regulations.

a. ***IRS General Position Based on Legislative History***. The IRS position is that the trustee must be involved directly in the operations of the business on a "regular, continuous, and substantial" basis. The IRS points to the legislative history of §469, which states very simply:

> Special rules apply in the case of taxable entities that are subject to the passive loss rule. An estate or trust is treated as materially participating in an activity if an executor or fiduciary, in his capacity as such, is so participating. S. Rep. No. 99-313, at 735.

b. ***Activities by Non-Trustee Employees***. *Mattie K. Carter Trust v. U.S.*, 256 F. Supp.2d 536 (N.D. Tex. 2003) addressed a trust that operated active ranch operations, and the trustee hired a ranch manager (who was not a trustee). The IRS maintained that was not material participation for the trust because the trustee individually did not materially participate. The taxpayer maintained that, analogous to a closely held C corporation (see footnote 3 of the opinion), it could only participate in an activity through its fiduciaries, agents, and employees and that the activities of employees and agents of the trust should be included. The District Court sided with the taxpayer, concluding that material participation should be determined by reference to all persons who conducted the business on the trust's behalf, including employees as well as the trustee. *Aragona Trust* (discussed below) in footnote 15 said that it was not faced with and did not address whether activities by non-trustee employees are considered in determining a trust's material participation.

c. Very Strict IRS Position in Private Rulings.

TAM 200733023. disagreed with the *Carter Trust* decision and said that activities of "Special Trustees" would not be considered in determining the trust's material participation if they did not have the authority to commit the trust to any course of action without approval of the trustees.

PLR 201029014; No Strict Application of "In Such Capacity" Clause in Legislative History. PLR 201029014 was taxpayer friendly in recognizing that a trust could materially participate in the activities of a multi-tiered subsidiary through the activities of its trustee even though the trustee had no direct authority to act with respect to the business in its capacity as trustee (because of the remote relationship of the trust to the subsidiary). The issue was whether a trust could materially participate in the business of a subsidiary (Sub 2) of a subsidiary (Sub 1) owned by a partnership in which the trust owned an interest. In light of the trust's remote relationship with Sub 2, a strict application of the "in such capacity" clause in the legislative history would seemingly have prevented the trustee from being able to materially participate, because any actions of the trustee in the business of Sub 2 would have been taken in some capacity other than as trustee. In PLR 201029014, the IRS did not apply this strict approach, but agreed with the taxpayer that the trustee could materially participate in Sub 2 through the trustee's regular, continuous and substantial involvement in the operations of Sub 2.

TAM 201317010; Activities of Co-Trustee Who Was President of Business Not Counted in Determining Trust's Material Participation. If a trust owns an interest in an active trade or business operation, a planning consideration will be whether to name some individual who is actively involved in the business as a co-trustee. However, the IRS questioned that strategy in Technical Advice Memorandum 201317010 (released April 26, 2013). The trust in that TAM had owned stock in an S corporation. The trust had a trustee and a "Special Trustee." The trustee "did not participate in the day-to-day operations of the relevant activities" of the company. The individual who was the Special Trustee was also the president of a qualified Subchapter S subsidiary of the S corporation. The trust instrument limited the Special Trustee's authority in selling or voting the S corporation stock. The IRS concluded that the trust did not materially participate in the activities of the company for purposes of the §469 passive loss rules. The ruling highlights two issues: (1) the Special Trustee's authority was limited to voting and selling the S corporation stock; and (2) the Special Trustee's activities as president were not in the role as fiduciary.

d. ***Character is Determined At Trust Level***. The final regulations say that the character of an item of trust income as NII (or not) is determined at the trust level (for trusts that are not deemed to be owned by the grantor or a third party for income tax purposes under the grantor trust rules including §678), and that determination does not change when the income item is distributed to a beneficiary. Reg. §1.1411-

3(e)(3)(ii). (This position was surprising to planners.) Presumably, the reverse would be true as well— active business income that is not NII to the trust would not be NII to the beneficiaries. (The IRS has indicated informally that is the case.) Accordingly, even if a beneficiary is clearly materially participating in a business, a distribution of business income from the trust to the beneficiary will not qualify for the "active business income" exception if the trust did not materially participate in the business to qualify for the exception at the trust level (and how a trust materially participates is subject to great uncertainty).

e. ***Material Participation by Trustee Recognized in* Frank Aragona Trust v. Commissioner**. In a case of major importance, the Tax Court recently decided a case addressing the requirements for material participation by a trustee for purposes of the passive loss rules. *Frank Aragona Trust v. Commissioner,* 142 T.C. No. 9 (March 27, 2014). This case directly addresses the "real estate professional exception" in §469(c)(7), but one of the requirements of that exception is material participation by the taxpayer. The case states that (1) trusts can qualify for the real estate professional exception and (2) activities of three of the six co-trustees as employees of the manager of the business are counted in determining material participation by the trust. The case, which is a "regular" Tax Court decision, repudiates the "hard-nosed" position taken by the IRS in TAM 201317010.

Three of the six co-trustees were full time employees of an LLC that managed the rental properties. The court concluded that the activities of the trustees, including their activities as employees of the LLC, are considered in determining material participation. The court reasoned that their activities as employees counted because (1) Michigan statutory law requires trustees to administer the trust solely in the interests of the beneficiaries, and (2) a Michigan case makes clear that trustees are not relieved of their duties of loyalty by conducting activities thorough a separate entity controlled by the trust.

> The trustees were required by Michigan statutory law to administer the trust solely in the interests of the trust beneficiaries, because trustees have a duty to act as a prudent person would in dealing with the property of another, i.e., a beneficiary. Mich. Comp. Laws sec. 700.7302 (2001) (before amendment by 2009 Mich. Pub. Acts No. 46); see also In re Estate of Butterfield, 341 N.W.2d 453, 459 (Mich. 1983) (construing Mich. Comp. Laws sec. 700.813 (1979), a statute in effect from 1979 to 2000 that was a similarly-worded predecessor to Mich. Comp. Laws sec. 700.7302).
>
> Trustees are not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust. Cf. In re Estate of Butterfield, 341 N.W.2d at 457 ("Trustees who also happen to be directors of the corporation which is owned or controlled by the trust cannot insulate themselves from probate scrutiny [i.e., duties imposed on trustees by Michigan courts] under the guise of calling themselves corporate directors who are exercising their business judgment concerning matters of corporate policy.") Therefore their activities as employees of Holiday Enterprises, LLC, should be considered in determining whether the trust materially participated in its real-estate operations.

Also, the court rejected the IRS argument that two of the co-trustees owned minority interests in some of the entities that conducted the rental operations and that some of their activities were attributable to their personal portions of the businesses. The court gave several reasons, including that their interests as individual owners were generally compatible with the trust's goals for the jointly held enterprises to succeed.

The Rule 155 Order was filed August 6, 2014, and the Tax Court website does not reflect that the IRS has filed a Notice of Appeal within the 90 period for filing a Notice of Appeal. (The appeal would have been to the Sixth Circuit Federal Court of Appeals.) *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (March 27, 2014) (Judge Morrison).

Query whether, following its loss in *Aragona Trust,* the IRS will change its harsh attacks on seemingly every effort by a trust to materially participate in a business?

Specific Facts of Aragona Trust Involved Wholly Owned Management Entity. The court's reasoning in *Aragona Trust* was related to the specific facts of the case. The court reasoned that state law requires trustees to look out solely for the interests of trust beneficiaries, and that trustees are not relieved of their duties of loyalty by conducting activities through an entity wholly owned by the trust (citing *In re Estate of Butterfield*, which refers to trustees who are directors of a corporation controlled by the trust). The court's reasoning is understandable in light of the fact that it specifically addressed the fact scenario presented by the Aragona Trust. The court gave no indication that it would necessarily limit its reasoning to that situation. Indeed, the first rationale (that the trustee must look out solely for the interests of trust beneficiaries) seems to acknowledge that any activities of a trustee must be consistent with the trustee's duties to the beneficiaries.

Can a Trustee Ever "Take Off Its Hat" As Trustee? Some commentators have described this issue in terms of whether a trustee can ever "take off its hat" as a fiduciary. Under this approach, all activities of a trustee should be considered in determining material participation by the trust.

> A review of the existing tax guidance supports considering all of a trustee's actions in a trust-owned business in whatever capacity the trustee acts in determining whether the trust materially participates. The non-tax authorities support this conclusion too: the trustee is unable to completely remove her trustee "hat" when donning a different "hat" in a different capacity in the business. Where a trustee also acts in a potentially managerial role (e.g., for an entity the equity interests of which are trust assets), the trustee's fiduciary duties extend to her managerial activities. A trustee cannot disregard her fiduciary obligations to the beneficiaries when acting in another capacity, for example, as an employee or director, in a business owned by the trust. Because the trust will be a shareholder, the fiduciary duties a trustee owes the beneficiaries will not conflict with the fiduciary duties a director owes the shareholders. If they do, however, the director/trustee will have to recuse herself. Thus, all of the actions undertaken by an individual trustee with respect to any activity owned directly or indirectly by the trust are subject to her fiduciary obligations to the trust beneficiaries and, therefore, relevant to determine whether the trust materially participates under Code sections 469 and 1411.
>
> Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 1, Tax Notes 683, at 688-700 (Aug. 12, 2013) (Question 10)* and Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 2*, TAX NOTES 785 (Aug. 19, 2013).

In support of his analysis, Mr. Dees cites (and quotes) the RESTATEMENT (THIRD) OF TRUSTS §78, BOGERT ON TRUSTS AND TRUSTEES §543 (Dec. 2012), and *In re Schulman,* 165 A.D.2d 499, 502 (N.Y. App. Div. 3d Dep't 1991).

f. ***Summary of Practical Planning Considerations.*** The planner should determine the economic impact of this decision on a trust. If a trust has $10,000 of business income, the 3.8% tax is $380 and is relatively insignificant. However, for trusts with large amounts of business income, this issue can be significant. The *Aragona Trust* case provides a "hint of salvation," but we still need guidance. While we proceed with caution, we must proceed; we cannot just ignore the issue. Many trusts have recently filed income tax returns on which the 3.8% tax was included, sometimes with a very large additional tax.

Beneficiaries may also attempt to assert the net investment income tax to justify larger distributions if the beneficiaries are below the threshold of owing the tax ($250,000 for married individuals/ $200,000 for single individuals).

22. Duties of Trustees Holding Business Interests; "Wearing Multiple Hats"

a. ***Common Law Rule—Investment By Trustee in Entity***. The traditional common law rule drawn from a series of older New York cases is that where a trustee contributes trust assets to an entity, the trustee's duties follow into that entity. The trustee cannot hide from trustee duties by investing in an entity.

Two recent cases address a trustee's duty with respect to entity activities where the trust owned the entity and its assets when the trust was created.

b. ***Rollins v. Rollins.*** In *Rollins,* a trust was initially funded with stock of an S corporation. The trustee purchased additional shares of the same entity and another family entity. Four grandchildren sued alleging breaches of fiduciary duty by changing the business entities to shift more power to the trustees, by making the trust assets illiquid, and by implementing at the entity level a "code of conduct" establishing conditions on distributions to trust beneficiaries (including participation at family business meetings, engaging in serious pursuits, and considering contributions to the family). Grandchildren who complained about trustee actions received no distributions. One of the issues was whether the trustees' actions should be tested and the trustees should account under fiduciary standards or the general business duty standards. The Georgia court of appeals held that the trustees were required to account for entity level actions. The Georgia Supreme Court reversed and held that trustee duties did not attach to corporate level activities. Some of its reasons included (i) that one of the settlor's two sons shared control of the business but was not a trustee, suggesting that the settlor must have intended that the trustees would not be held to higher fiduciary standards when carrying out corporate duties, and (ii) that the trust holds minority interests in the businesses and the corporate directors should act in the interests of all shareholders and be held to a corporate level standard of conduct when acting as directors. *Rollins v. Rollins,* 2013 Ga. App. LEXIS 332 (March 29, 2013); 20 Ga. LEXIS 179 (March 3, 2014).

c. ***Harris v. Bonander***. Parents funded a trust with their 75% interest in a car dealership and land on which the dealership operated. The dealership ended up in a limited partnership of several family trusts. After father died, mother was the sole general partner and she lowered the rent on the land that was leased to the dealership. After mother died, the son became the general partner. Eventually, the dealership passed to the son who ran the business; equalizing cash passed to two daughters and the land was in a limited partnership owned by a trust including the daughters as beneficiaries. The daughters eventually sued the son, alleging that as general partner he undercharged his dealership for the leasing of the land. In an unpublished decision that lacks precedential value under state law, the California court of appeals held that there was no liability. It reasoned that the son acted as general partner and not as trustee in setting the lease payment amounts, and therefore a settlement that released all claims other than trustee claims resulted in the claims being barred. *Harris v. Bonander*, 2014 Cal. App. Unpub. LEXIS 3804 (2014).

23. Importance of Good Faith and Good Process

Trusts are creations of equity and equitable maxims may be a useful lens through which to analyze and attempt to reconcile breach of fiduciary duty cases. Two maxims that seem especially important in understanding the outcome of cases: (i) One who seeks equity must do equity; and (ii) Where the equities are equal, the legal principles will control (and a defense that a provision in the trust protects the trustee is a legal defense.) How does a trustee establish equality as to the equities?—by showing good faith and good process.

24. Investment Losses

a. ***Matter of Strong (N.Y.).*** The trustee was liable for investment losses (Kodak stock), despite the existence of an exculpatory provision in the trust instrument. There were allegations that the trustees held no meetings with beneficiaries, did not keep the beneficiaries informed, retained concentrated investments, and did not have a long-term investment plan. The court listed various reasons for its conclusion, including (i) the trustee recognized the need to diversify but did not follow any plan to do so, (ii) Kodak was often sold only when needed to pay the trustee's own expenses, (iii) for one trust there was no annual trust reviews for 10 years, (iv) there was no record that beneficiaries preferred to retain the Kodak stock and they always consented to selling the stock when requested, (v) the tax cost of selling stock did not justify its retention where there was no staged diversification plan in place, and (vi) the trustee did not meet its own internal guidelines and did not act on its own recommendations. *Matter of Strong*, 2013 N.Y. Misc. LEXIS 5447, 38 Misc.3d 1210(A) (2013).

b. ***Matter of Littleton (N.Y.).*** The trust was funded with a concentration of Corning stock. The trust provided "to the extent that the trustee retain any stock, it shall not be held responsible for any loss or depreciation that may occur." The beneficiaries sued the trustee for failing to develop an investment plan, for failing to keep the beneficiaries informed, and for not divesting 90% of the Corning stock within 5 months of funding the trust. The court refused to grant summary judgment in favor of the trustee. Among the reasons given were that fact questions remained, the trustee could not produce any policy or procedural manuals for its trust practices, and there was no evidence the trustee met with or communicated with the beneficiaries. *Matter of Littleton*, 2014 N.Y. Misc. LEXIS 2586 (2014).

c. ***J.P. Morgan Chase Bank N.A., et al v. Loutit et al.*** A GRAT held AIG stock and the beneficiaries sued the trustee for failing to diversify the stock. The trust contained exculpatory clauses which are generally not respected in New York, but the trust instrument provided that Massachusetts and North Caroline law applied. The court dismissed the charge on summary judgment, reasoning that the choice of law provision was valid (the differences between New York and the other states' laws does not rise to the "vicious or immoral" standard for refusing to apply other states' laws), and the trust instrument authorized the retention of AIG stock either by waiving the diversification requirement, waiving the prudent investor rule, or holding the trustees liable only for their own willful default. *J.P. Morgan Chase Bank N.A., et al v. Loutit et al*., 2013 N.Y. Misc. LEXIS 452 (New York County Supreme Court 2013).

25. Distributions

In *O'Riley v. U.S. Bank,* N.A., 2013 Mo. App. LEXIS 1074 (2013), there was a pattern of favoring a widow over the settlor's children regarding trust distributions. The trust provided that the widow was the primary beneficiary and should be favored in the administration of the trust. The court held that the trustee did not breach its fiduciary duties by favoring the spouse over the children in distribution decisions, and by investing trust assets to maximize income rather than principal growth. Equities favoring the trustee included that there was a process for distribution decisions, the widow complied with the procedures and the son who brought the suit did not, and the widow was not a drug addict and the son was.

26. Trust Protectors and Directed Trusts

a. ***Shelton v. Tamposi (N.H.).*** Investment directors had the authority to direct the trustee, and the trustee followed their directions. There was no trustee liability for doing so. (New Hampshire has a directed trustee statute. RSA 564-B:7-711.) *Shelton v. Tamposi*, No. 2010-634 (N.H. 2013).

b. ***McLean v. Davis (Mo.).*** The attorney for a successful plaintiff in a personal injury lawsuit was named as trust protector of a trust that received the settlement proceeds. He had the power to remove the trustees and appoint successor trustees or trust protectors. When the original trustees resigned, the trust protector named as successor trustees the attorneys who had referred the personal injury case (as well as other cases) to him. The family alleged that the trustees were wasting trust funds, and sued the trust protector for failing to monitor the actions of the trustee, failing to act when the trustees acted against the interests of the beneficiary, and giving his loyalty to the trustees rather than to the beneficiary. The trust protector sought summary judgment in part because he had no duty to supervise or direct the actions of the trustee. The court of appeals denied summary judgment, reasoning that since the trust agreement granted authority to the trust protector in a fiduciary capacity, the protector owed at least the basic fiduciary duties of undivided loyalty and confidentiality. Also, the limitation of liability in the trust agreement implies the existence of a duty of care and liability for actions taken in bad faith. Following a jury trial, the court granted a directed verdict in favor of the trust protector and the court of appeals affirmed, finding no basis for a breach of duty by the trust protector for various factual reasons.

The court specifically addressed the issue of to whom the trust protector owed duties:

> An important question of material fact also exists in the instant case as to who this fiduciary duty of good faith is owed to. Appellant assumes it is owed to the Beneficiary, but the trust provision that created the position of Trust Protector does not explicitly indicate who or what is to be protected.... {I]t is possible that the Trust Protector's fiduciary duties are owed to the trust itself.

McLean v. Davis, 283 S.W.3d 786 (Mo. Ct. App. 2009), *aff'd following remand*, *Robert T. McLean Irrevocable Trust u/a/d March 31, 1999 ex rel. McLean v. Ponder*, 418 S.W.3d 482 (Mo. Ct. App. 2013).

c. ***Schwartz v. Wellin.*** A trust protector sued the trustees (who were also beneficiaries of the trust) to allege that their liquidation of about $95 million of assets and distribution to them as beneficiaries was improper and frustrated the trust purposes. The children removed the case to federal court. The federal court in one 2014 decision refused to grant an injunction extending a TRO from the probate court to protect trust assets pending the outcome. The federal court earlier in 2014 also determined that the trust protector lacked standing and allowed 15 days from the April 17, 2014 Order to substitute a party in interest or else the case would be dismissed with prejudice. The children purported to exercise their power to remove the trust protector on April 29, 2014 but did not appoint a successor. On May 2, 2014 the trust protector purported to appoint a new trustee and to substitute the new trustee as a party in the proceeding. The court on October 9, 2014 approved the substitution of the new trustee, reasoning that the children violated the trust terms by removing the trust protector and not appointing a replacement for 3 months, and that the protector therefore had the power to appoint a new trustee. *Schwartz v. Wellin*, 2014 U.S. Dist LEXIS 143644 (D. S.C. Oct. 9, 2014).

27. Arbitration Provisions in Trust Agreements

a. ***Rachal v. Reitz (Tx).*** The Texas Supreme court upheld the validity of a provision in a trust agreement requiring that any breach of fiduciary duty lawsuit against the trustee be resolved by binding arbitration. The reasoning of the case has been roundly criticized. Oversimplified, the court reasoning is as follows. The arbitration act in Texas applies to "agreements." The trust might seem not to be an agreement because the beneficiaries did not sign it, but the act of suing the trustee was asserting rights, which constitutes "direct benefits estoppel,", so the beneficiary is a party to the contract. *Rachal v. Reitz*, 2011 Tex. App. LEXIS 5598 (July 22, 2011).

b. ***Archer v. Archer (TX).*** A trust provision -- "I request that disputes be submitted to arbitration" –was merely precatory, and the court distinguished *Rachal* and denied the motion to compel arbitration. *Archer v. Archer*, 2014 Tex. App. LEXIS 6551 (2014).

c. ***Warren v. Geller.*** The trustee was the advisor who developed the plan for the trust to own life insurance. The trustee stole all the death benefits from the trust. The beneficiaries' received $4,000 per month distributions. The decision held that the binding arbitration provision in the trust agreement was given effect. The acceptance of the $4,000 per month of distributions, even though the beneficiaries did not know further information about the trust, was enough to bind them to the arbitration provision in the trust agreement under equitable estoppel principles. *Warren v. Geller*, 2014 U.S. Dist. LEXIS 117332 (E.D. La. Aug. 22, 2014).

28. Tax Basis and Fiduciary Duties

In *McCormick v. Cox,* No. 3D12-1289 (Fl. 3rd Dist. Ct. App. August 14, 2013), a low value was reported for the value of a large parcel of real property on the estate tax return. The trustee (who was also the settlor's attorney) was aware the property could have a higher value because of its suitability for residential development. After filing the estate tax return, the nearby town expressed interest in purchasing the property for development as affordable housing. Rather than amending the estate tax return to report a higher value, the trustee sold the property and bought replacement property in a like-kind exchange under §1031 (and incurred $2.15 million in professional expenses paid to his own firm) to defer the capital gains tax. The appeals court affirmed a judgment against the trustee, in part because the trustee breached his duty by undervaluing the trust assets for estate tax purposes and failing to amend the estate tax return.

29. State Income Taxation of Trusts; Basing Taxation Solely on Domicile When Trust is Created Held Unconstitutional

Three cases have recently invalidated state tax systems that taxed the income of trusts based on the domicile of the settlor when the trust was created when there are no continuing contacts with the state. *Linn v. Dep't of Revenue*, 2013 IL App (4th) 121055 (Dec. 2013)(no Illinois connections with inter vivos trust other than that the settlor was an Illinois resident when the trust was created; "what happened historically with the trust in Illinois has no bearing on the 2006 tax year")(case was not appealed); *Kassner v. Division of Taxation*, 2013 N.J. Tax LEXIS 1 (January 3, 2013)(mere fact that testator of testamentary trust resided in New Jersey not sufficient authority for New Jersey to tax trust on its out of state income; "source income" allocated to New Jersey from S corporation was subject to New Jersey taxation]); *McNeil v. Commonwealth of Pennsylvania*, Pa. Comm. Court, Nos. 651 F.R. 2010, 173 F.R. 2011 (May 24, 2013) (trust's "only presence in Pennsylvania was Settlor's status as a resident in 1959 when he created the Trusts and the residences of the Trusts' discretionary beneficiaries, neither of which provides the necessary substantial nexus with Pennsylvania for the Trusts to be subject to the PIT on all of their income…. Settlor retained no continuing control or power of appointment over the Trusts' property and the in-state beneficiaries are discretionary and have no current or future right to the Trusts' income or assets"; imposing Pennsylvania tax in that context violates Commerce Clause).

A similar case is still pending in North Carolina. *Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, 2013 NCBC 9 (Feb. 11, 2013 summary judgment) (New York trust with non-North Carolina trustees, several beneficiaries live in North Carolina but no distributions have ever been made to the North Carolina resident beneficiaries; State's request for summary judgment is denied, allowing trust to proceed with argument that state statute permitting North Carolina to tax undistributed trust income if beneficiaries live in the state violates the Due Process and Commerce Clauses of the U.S. Constitution and violates §19 of the North Carolina constitution).

Practice Pointer: This appears to be a trend in the recent cases; if a state taxes a trust based solely on the resident status of the settlor when the trust was created, the tax is likely unconstitutional. The planner must decide between filing returns each year and taking the position on the returns that the trust is not a resident trust in order to cause a statute of limitations to run (which puts the state taxing authority on notice to audit the return), or not filing with the risk that the state years later could seek taxes, penalties and interest.

30. Trustee Removal

    a. ***In re McKinney (Pa.).*** The Uniform Trust Code changes the grounds for trustee removal to replace a fault standard with (among others) a "substantial change in circumstances" standard. This is apparently the first reported case to address what is a sufficient change of circumstances to justify removal of a trustee. The court held that a string of mergers resulting in the loss of bank personnel coupled with the movement of the beneficiaries from Pennsylvania (where the trustee's officers were located) was a "substantial change of circumstances" justifying removal of the trustee. *In re McKinney,* 2013 Pa. Super. 123 (2013).

    b. ***Testamentary Trust of Conti (Pa.).***

       There was an attempt to reform a trust to allow a trustee to resign without court approval (even though there was not a resignation provision in the original instrument) and to allow removal of the trustee without cause. The court refused to approve the nonjudicial settlement agreement of the beneficiaries (under the Pennsylvania UTC) to modify the trust. The court viewed that as eviscerating the role of the judge to determine if a resignation were justified or if the fault standards for removal of the trustee were satisfied. *Testamentary Trust of Conti*, 2014 Phila. Ct. Comm. Pl. LEXIS 289 (Sept. 17, 2014).

    c. ***Taylor Intervivos Trust (Pa.).*** Under the Pennsylvania UTC, a court may modify a trust where all of the trust beneficiaries agree and the modification does not violate the material trust purposes. The beneficiaries tried to use a trust reformation to remove the trustee without cause and without going to court. The court held that the *McKinney* case does not go that far, reasoning that the courts have an important role in determining if the removal standard is met. *Taylor Intervivos Trust*, 2014 Phila. Ct. Comm. Pl. LEXIS 239 (Aug. 18, 2014).

31. Elder Abuse

    Each day Dana Fitzsimons reviews fiduciary cases from all over the country. He says that by far the largest category of fiduciary cases fall in the broad area of elder abuse. Another category with a large number of cases deals with the adequacy and effect of fiduciary disclosures to beneficiaries, which is the subject of several other panels.

Items 32-43 are observations from a panel by Mickey R. Davis, Ronald D. Aucutt, and Melissa J. Willms—Directed Trusts and the Slicing and Dicing of the Trustee's Duties. In addition, these items reflect observations about directed trusts from a panel by Dominic J. Campisi, Dana G. Fitzsimons, and Michael Gordon—A Litigator's View of Directed Trusts, Quiet Trusts and Silent Trusts: A Little Magic or a Lot of Bad Mojo?

32. Overview of Issues Regarding Dividing Trustee Duties

A division of trustee power can be accomplished by the trustee (in a permitted delegation of powers) or by the settlor by provisions for trustee directions.

A division of powers by the settlor can be either by (i) providing a director to direct particular trustee actions, or (ii) having co-trustees with a bifurcation of their respective powers. In addition, a trust protector can be named with settlor-like powers, such as the power to modify or amend the trust agreement, change beneficial interests, veto or direct distributions, modify powers of appointment, change the trust situs, change trustees or advisors, terminate the trust, or appoint successors.

A comment to §808 of the Uniform Trust Code describes the use of "directors" and "protectors":

> Subsections (b)-(d) ratify the use of trust protectors and advisers.... "Advisers" have been used for certain trustee functions, such as the power to direct investment or manage a closely-held business. "Trust protector," a term largely associated with offshore trust practice, is more recent and usually connotes the grant of greater powers, sometimes including the power to amend or terminate the trust. Subsection (c) ratifies the recent trend to grant third persons such broader powers.

Trustee duties are being divided for various reasons. For trust directors or bifurcated co-trustees, reasons include specialization of skill sets or specialized assets. (There is significant jurisdictional competition for directed trusts or trusts with bifurcated co-trustees because state laws vary significantly to the extent that these provisions are respected.) For trust protectors, reasons include tax considerations, a desire to impose checks and balances, and the perceived need to adapt to change.

A settlor might want a corporate trustee to be responsible for "investable assets" without being responsible (or charging fees) for detailed oversight of a closely held business in which the trust owns an interest.

33. Considerations of Core Elements of a Trust Regarding What "Slicing and Dicing" Should be Enforceable

To determine if the "slicing and dicing" of trustee duties is enforceable, refer back to whether it upsets any of the four essential elements of a trustee's responsibility—custody, administration, investments, and distributions. Ron Aucutt concludes that in light of the modern evolution of trust law, there are two core elements for a trust to be workable and respected—the ability to change and the ability to challenge.

a. ***Flexibility to Adapt to Changing Circumstances.*** Ron Aucutt at the Heckerling Institute on Estate Planning challenged the notion that "there is no such thing as an irrevocable trust." In his exploration of the issue, he ended up embracing change. In establishing the trust, the settlor expects the trust to work; for that to happen with changing circumstances, the flexibility to make changes may be necessary. With the rule against perpetuities extensions, trusts may last for hundreds of years. "How can we be so arrogant as to think we can draft a trust that will last that long unless there is the flexibility to adapt to changing circumstances?" Another example is the growing need to deal with the "new biology technology" with respect to the determination of "lives in being." (Ron asks, what happens if all the heirs are "in the freezer." Does the trust go in the freezer?)

b. ***Ability to Challenge.*** Ron Aucutt concluded in his exploration of the decline of the truly irrevocable trust that a key fundamental policy requirement is the ability of someone to challenge inappropriate trustee actions. Key to the ability to challenge is the existence of fiduciary duties, access to information by beneficiaries, and access to a forum for enforcement actions.

Fiduciary Duties. The fundamental nature of the trust is the existence of a fiduciary relationship, subjecting the fiduciary to *duties* to deal with the trust property for the benefit of beneficiaries. The duties of loyalty and prudence are non-negotiable to have a trust. *Someone* must have fiduciary duties to the beneficiaries with respect to each of the basic trustee functions of custody, administration, investment, and distribution. Judge Learned Hand summarized that unless a court can intervene when "it appears that [the trustee] has utterly disregarded the interests of the beneficiary,… the power would not be held in trust at all; the language would be no more than a precatory admonition." *Stix v. Commissioner*, 152 F.2d 562, 563 (2d Cir. 1945). But the standard or degree of scrutiny can be altered, either by state laws or trust instruments. The minimal standard of scrutiny is defined in various state laws by terms such as bad faith, reckless indifference, willful misconduct, gross negligence, or intentional malfeasance.

***Access to Information**.* Section 813 of the Uniform Trust Act describes the trustee's duty to inform and report. It has strict requirements about keeping beneficiaries informed, including duties to inform beneficiaries of the existence of the trust and to respond to requests for information. Section 105(b) of the Uniform Trust Code provides that the trust terms prevail over the UTC provisions except for various enumerated exceptions. Among those enumerated exceptions, which are mandatory provisions, are the duty to notify qualified beneficiaries who have attained 25 years of age of the existence of the trust, the identity of the trustee, and their right to request trustee reports (§813(b)(2)) and the duty under §813(a) to respond a request for trustee reports and other information reasonably related to the administration of the trust. Those two provisions, however, were placed in brackets in the UTC in light of the lack of consensus as to the extent to which a settlor should be able to waive those requirements. Indeed, various states have changed the provisions regarding the requirements of providing information to beneficiaries.

Forum to Enforce Rights. Extremely broad exculpatory provisions and arbitration requirements raise questions as to whether the trust allows access to a forum in order to satisfy the essential element of an ability to challenge. (The IRS has also expressed discomfort with arbitration clauses regarding the tax treatment of a gift in trust. PLR 201117005, CCA 201208026.)

34. Growing Trend of Developments Regarding Dividing Duties and Giving Third Parties "Settlor-Like" Duties

"Grantors don't trust trustees or beneficiaries, trustees don't trust beneficiaries, beneficiaries don't trust grantors or trustees. There's a lot of distrust with trusts." -Melissa Willms

Offshore trusts have historically used trust protectors, leading to growing use in the United States. In one respect, many trusts have "trust protectors" to the extent that they authorize specified persons to remove and replace trustees, among other possible actions. The Uniform Law Commission has a new project dealing with "divided trusteeships." The project will likely deal with directed trusts and well as co-trustees with bifurcated duties.

35. Law Development Regarding Trust Protectors

A "trust protector" may be given "grantor-like" powers that can be very limited or very broad to make changes regarding the trust. (Examples of specific broad powers are mentioned in Item 32 above.)

A variety of the state directed trust statutes have language broad enough to apply to trust protectors as well. *E.g.,* 12 DEL. C. §3313(f) ("For purposes of this section, the term "advisor' shall include a "protector"; a non-exclusive list of example powers includes removing and appointing fiduciaries, modifying or amending the instrument for tax or other efficiency reasons, or modifying powers of appointment). A few states have enacted statutes addressing the powers of trust protectors specifically (including, among various others, Alaska, Delaware, Idaho, Illinois, Nevada, New Hampshire, South Dakota, and Wyoming) that list example powers that trust protectors could hold. *E.g.,* 760 ILL. COMP. STAT. §16.3(d) (non-exclusive list of 10 example powers that trust protectors could hold); NEV. REV. STAT. §163.5553 (non-exclusive list of 12 example powers that trust protectors could hold).

So far, there is little case law regarding the powers, liabilities or duties of trust protectors. *E.g.*, *McLean v. Davis,* SD28613 (Missouri Court of Appeals 2009); 418 S.W.3d 482 (2013). *See generally* Richard Ausness, *The Role of Trust Protectors in American Trust Law,* 45 REAL PROP., TR. & EST. L.J. 319 (2010); Larry Frolik, *Monitoring Trustees: When, Why and How to Use a Trust Protector*, UNIV. OF NOTRE DAME EST. PLAN. ANN. SEMINAR (2013).

36. Potential Tax Concerns With Abuse of Extremely Broad Trust Protector Powers; *SEC v. Wyly*

A potential concern with giving extremely broad "grantor-like" powers to trust protectors is that abuse of the power by continued grantor "control" may result in adverse treatment:

> [T]he IRS may attempt to attack a trust protector arrangement where it believes the appointment has been used to allow a settlor to retain power over trust property that would otherwise subject the assets to estate tax inclusion under IRC § 2036 or IRC § 2038. For this reason, it is important that a trust protector remain an independent actor and not subject to

> the control of a settlor. While flagrant actions may, as always, open the door to attack as a sham, the appointment of a trust protector by itself should not subject trust property to inclusion. Jonathan C. Lurie & William R. Burford, *Drafting Flexible Irrevocable Trusts*, 33 ACTEC L.J. 86, 91-92 (Summer 2007).

As an example, *SEC v. Wyly*, 2014 WL 4792229 (S.D.N.Y. Sept. 25, 2014) was a securities law violation case in which the court determined that the amount of disgorgement would be based in part on the income taxes that the defendants avoided by an offshore trust structure. Trust protectors had the power to remove and replace independent trustees located in the Isle of Man. The court determined that the settlors controlled all decisions for the trust, by expressing their "recommendations" to trust protectors who relayed those recommendations to the trustee, who *always* did as instructed. The court determined that the independent trustee exception to the grantor trust rules under §674(c) did not apply because the settlors in fact controlled all decisions. The specifically stated that it viewed the settlors as having retained the power "through the trust protectors who were all loyal Wyly agents, … to terminate and replace trustees." In *Wyly* the trust protectors merely had the power to replace the trustee. But if an instrument gives a trust protector very broad powers, there may be an even greater likelihood of the IRS arguing that the grantor kept effective control of the trust through those broad powers of the trust protector if the protector does not act with some degree of independence.

37. Should We Be Dividing Fiduciary Duties?

Fiduciary duties can either be divided between trustees, or a trust director or trust protector can be given specified responsibilities.

a. ***Multiple Trustees.*** There is a notion that "one travels fastest who travels alone." On one level, having a single trustee is more efficient. "You can have two people drive a car, but that does not mean it is the smart thing to do." On the other hand, co-trustees (or co-holders of fiduciary powers) may help in providing long term continuity and a diversity of perspective. Having multiple co-fiduciaries can result in confusion, deadlock, and exasperation; address those concerns with transparency and communication. One panelist has seen trust officers serve that role of bringing the team of co-trustees together (including the individual co-trustees).

b. ***Division of Responsibilities.*** As long as each co-fiduciary with specific responsibilities has dignity, having divided responsibilities can serve the interests of efficiency. Each co-fiduciary deals with responsibilities specifically within his or her skill set. (Observation: The efficiency is reduced if each co-fiduciary with divided responsibilities ultimately has a continuing duty to monitor and liability for actions within the scope of the co-fiduciary's responsibilities.)

c. ***Need for Communication and Coordination.*** Even though multiple fiduciaries may have divided responsibilities, they still must communicate and coordinate with each other. For example if the investment and distribution trustee functions are separated, how will the distribution-fiduciary plan appropriate distributions without knowing what the available cash flow will be, or how can investments be made without knowing anticipated distributions?

d. ***Concerns About Practical Uses of Divided Duties.*** Divided duties are sometimes used to deal with a particular asset or to avoid a diversification requirement.

- "If the trustee is being directed to do something, it is usually because a reasonable person would not do it. They are typically used to assure the trust retains family stock, closely-held businesses, the family ranch, etc."
- "Overconcentration is a terrific risk. We are in a time of enormous change. New technologies are destroying existing industries. There is a huge economic risk in not diversifying. China can hack the company, or new technology may run the company out of business. That is all the more reason not to concentrate investments."

38. Key Questions Regarding Fiduciary Responsibilities With Divided Duties

What is the fiduciary status of a trust director? A trust protector? A directed trustee?

There may be a spectrum of fiduciary duties. For example, a power of appointment is a personal power, but if an independent party can change the trust beneficiaries, that seems to be a fiduciary power. As another example, a spouse may have the power to veto a sale of the personal residence, which might be meant as a personal power without duties to remainder beneficiaries, but a business partner with investment powers over particular trust assets is likely intended to exercise some duty of care to beneficiaries in the exercise of those powers.

An individual at a committee meeting expressed it this way: "The trustee can never take off its trustee's hat—but in some circumstances it may be a Yamaka and sometimes a Stetson."

One of the possible distinctions is whether the direction from the advisor/protector is active or passive—actively giving directions or merely holding a veto power. The Comment to §808 of the Uniform Trust Code explains it this way:

> A power to direct must be distinguished from a veto power. A power to direct involves action initiated and within the control of a third party. The trustee usually has no responsibility other than to carry out the direction when made. But if a third party holds a veto power, the trustee is responsible for initiating the decision, subject to the third party's approval. A trustee who administers a trust subject to a veto power occupies a position akin to that of a cotrustee and is responsible for taking appropriate action if the third party's refusal to consent would result in a serious breach of trust. *See* Restatement (Second) of Trusts § 185 cmt g (1959); Section 703(g)(duties of cotrustees).

39. General Rules Regarding Ability of the Settlor to Change Trustee Duties

a. ***Restatement (Third) of Trusts.*** Under §70, comment a, powers held by a trustee must be exercised with fiduciary obligations. A settlor cannot exonerate bad faith and indifference to the interest of the beneficiaries. Under §81, each trustee has the duty to use reasonable care to prevent a co-trustee from committing a breach of trust, and to obtain redress if a breach occurs.

b. ***Uniform Trust Code.*** Section 105(b) provides that a trustee must act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries (but does not otherwise have specific prohibitions about relieving a trustee from liability where there are divided responsibilities). Under §1008(a), exoneration is unenforceable if it relieves the trustee of liability for a breach in bad faith or with reckless indifference to the purposes of the trust or the interests of the beneficiaries, or is inserted due to abuse by the trustee of a fiduciary or confidential relationship to the settlor.

40. Protection of Trustee When Acting in Reliance on Directions From Trust Directors or Protectors

A number of states have directed trust provisions, recognizing the authority of a third person to direct certain actions of the trustee. The state statutes vary regarding the extent to which the trustee may rely on that direction without liability. *E.g.,* UNIF. TRUST CODE §808(b) (trustee may act in accordance with the direction "unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty that the person holding the power owes to the beneficiaries of the trust"). (One panelist remarked on the impracticality of those standards—it would seem that every breach is serious and if the breach is not manifest we would not know about it anyway.)

The comments to §808 indicate that a settlor could relax those standards in the trust instrument:

> The provisions of this section may be altered in the terms of the trust. *See* Section 105. A settlor can provide that the trustee must accept the decision of the power holder without question. Or a settlor could provide that the holder of the power is not to be held to the standards of a fiduciary.

Section 105 of the Uniform Trust Code, referenced in that comment, is the section listing what duties cannot be altered in the trust agreement. The comment suggests that §105 would not prohibit a trust instrument from overriding the manifestly contrary to terms of trust/serious breach of trust liability default standard of §808(b). (One panelist expressed surprise at that comment.) Section 105(b)(10) makes the limitation on exculpatory clauses under §1008 mandatory. Arguably, unless a default rule provides that the trustee has no (or greatly reduced) liability in particular situations (such as acting in reliance on a director), the trustee is always liable to the extent of the minimum required standard in §1008 (cannot exculpate beyond bad faith or reckless indifference standard).

See also RESTATEMENT (THIRD) OF TRUSTS §75 (a trustee is required to follow directions unless "the trustee knows or has reason to believe that the attempted exercise violates a fiduciary duty that the power holder owes to the beneficiaries").

A third person may also be given the power to direct the modification or termination of the trust. *E.g.*, UNIF. TRUST CODE §808(c).

These statutes typically provide that the third person holding the direction power is "presumptively a fiduciary" (which presumably means that a trust instrument could override that). *E.g.,* UNIF. TRUST CODE §808(d).

Some state statutes provide broader authority for the trustee to act in reliance on directions from the advisor without liability. *E.g.,* ALASKA STAT. §13.36.375(c) (a "trustee ... required to follow the directions of the advisor is not liable, individually or as a fiduciary, to a beneficiary for a consequence of the trustee's compliance with the advisor's directions, regardless of the information available to the trustee, and the trustee does not have an obligation to review, inquire, investigate, or make recommendations or evaluations with respect to the exercise of a power of the trustee if the exercise of the power complies with the directions given to the trustee"); 12 DEL. C. §3313 ("then except in cases of willful misconduct on the part of the fiduciary so directed, the fiduciary shall not be liable for any loss resulting directly or indirectly from any such act"); 760 ILL. COMP. STAT. §16.3(f)(1) (willful misconduct); R. S. MO. §456.8-808(8) (bad faith or reckless indifference). For a detailed listing of directed trust statutes, see Richard W. Nenno, *State Directed Trust Statutes With Related Uniform Trust Code Statutes* (2014), reprinted in the seminar materials.

General Conclusions. Based on the core requirement of accountability, as long as *someone* has to be accountable for each of the fundamental functions of the trust, there appears to be no necessity of finding liability at multiple levels in order for the trust to satisfy the core requirements of trusts. There can potentially be "upstream" liability to the one who makes the decision and gives direction and "downstream" liability to the one who receives the direction and has the power to second-guess the directions as being inconsistent with the purposes of the trust or otherwise not in the beneficiaries' best interests. The extent to which there is both upstream and downstream liability differs among the various states. One panelist concludes that no matter what the trust instrument says, the way that trustee powers are exercised is always subject to review. "If there's no purpose to the division of powers other than to obscure responsibility, you shouldn't sleep at night."

The "manifestly contrary to trust terms/serious breach of trust" standard in the UTC in effect means there is a standard; "we just don't know what it is, but it is not zero." One panelist observes: That must be determined in each situation based on the law, the trust instrument, and a common sense application of the nonwaivable rules.

The Alaska statute avoids any downstream liability but provides upstream liability because the advisor/responsible co-trustee has fiduciary duties.

The other state statutes afford different levels of downstream liability. It is a very weak potential liability in some of the statutes—but not zero. The "willful misconduct" standard perhaps requires an "evil mens rea"—and may be a very low standard for downstream liability. A direction contrary to the terms of the trust may be willful misconduct; criminal conduct is not necessarily required.

Example: If the distribution advisor directs the trustee to distribute tens of millions of dollars to buy a yacht (for support and maintenance), should the trustee follow that direction? One panelist expressed that the trustee should have a duty to inquire and communicate with the advisor. See if there is a plausible story. If the distribution is arguably appropriate, the trustee should follow the directions. If it is laughable, the trustee should act. If the trustee is satisfied that there is a plausible story, the trustee should be under no duty to advise the beneficiaries; otherwise the trustee may have a duty to inform beneficiaries of the seemingly inappropriate action.

41. Protection of "Excluded Trustee" For Trustees With Bifurcated Powers

Co-trustees have limited authority to split their duties and responsibilities. See Unif. Trust Code §703(e) (delegation to a co-trustee of function the settlor reasonably expected the trustees to perform jointly not permitted). A comment to §703(e) explains that

> trustees should be encouraged to delegate functions they are not competent to perform. Subsection (e) is premised on the assumption that the settlor selected cotrustees for a specific reason and that this reason ought to control the scope of a permitted delegation to a cotrustee. … The exact extent to which a trustee may delegate functions to another trustee in a particular case will vary depending on the reasons the settlor decided to appoint cotrustees. The better practice is to address the division of functions in the terms of the trust, as allowed by Section 105.

Absent an effective delegation of duties among co-trustees or a division of responsibilities in the trust agreement, all co-trustees generally have an obligation to participate in all elements of the trust administration. UNIF. TRUST CODE §703(c). Trustees generally take action by majority vote, but if a co-trustee disagrees with the decision made by the majority, that co-trustee may refuse to join in the action and avoid liability for the action except that each co-trustee must exercise reasonable care to prevent a co-trustee from committing a 'serious breach of trust" and to compel a co-trustee to redress a serious breach of trust. UNIF. TRUST CODE §703(f)-(g). The co-trustee who disagrees with an action may nevertheless join in the action but dissent and avoid liability for the action unless it constitutes a "serious breach of trust." UNIF. TRUST CODE §703(h). (The "serious" breach of trust standard for liability seems to offer little protection to a co- trustee for actions taken by other co-trustees. Presumably, the argument will be made in any lawsuit that any breach of trust that results in enough damages to justify the lawsuit is a "serious" breach of trust.)

The trust agreement, however, may divide the responsibilities among co-trustees. For example, there may be an investment/administrative co-trustee and a distribution co-trustee; the sole authority and responsibility of the distribution co-trustee would be to make distribution decisions. (Some of the statutes that address bifurcation of powers among trustees refer to the trustee who does not have responsibility for a particular action as the "excluded trustee" as to that action.)

If the instrument bifurcates the duties of co-trustees, can the trust instrument also relax the "serious breach of trust" standard of liability of the excluded co-trustee for actions by the co-trustee having responsibility for a particular action? The Uniform Trust Code provides that the terms of a trust generally control and can change the rules that would otherwise apply, as long as the trustee must act in good faith in accordance with the terms of the trust for the interests of its beneficiaries and as long as the trust terms are for the benefit of its beneficiaries and have a lawful purpose that is not contrary to public policy. UNIF. TRUST CODE §105(b)(2)-(3). (If *some* fiduciary is accountable for every essential trustee function, does a provision limiting the liability of co-trustees for actions taken by other co-trustees violate the general "good faith/ interests of the beneficiaries" basic standard in §105(b)(2)-(3)?) Section 105(b) lists other specific provisions that are mandatory and may not be modified, but dividing responsibilities/liabilities among co-trustees is not listed as one of the specific prohibited modifications. The comments to §808 suggest specifically that a settlor could relax the standards for downstream liability if there is a directed trust, but does not so specifically address the bifurcated trustee situation. However the comment to §703(e), quoted above, possibly *hints* that the same result might apply, by stating that "[t]he better practice [than relying on a delegation of powers to a co-trustee] is to address the division of functions in the terms of the trust, as allowed by Section 105." (Section 105(b)(10) makes the limit on exculpatory clauses under §1008 mandatory. While the liability provisions in §703 (f)-(h) are not mentioned as being a mandatory requirement, §105(b)(10) makes the limitation on exculpatory clauses under §1008 mandatory. Arguably, unless a default rule provides that the trustee has no (or greatly reduced) liability in particular situations (such as for actions by a co-trustee), the trustee is always liable to the extent of the minimum required standard in §1008 (cannot exculpate beyond bad faith or reckless indifference standard).

A few states have adopted statutes that specifically address the ability of a settlor to divide the duties of co-trustees. The Alaska statute relieves the "excluded trustee" from any duty whatsoever with respect to responsibilities allocated to a co-trustee:

> Notwithstanding the other provisions of this section, if the terms of a trust instrument provide for the appointment of more than one trustee but confer on one or more of the trustees, to the exclusion of other trustees, the power to direct or prevent specified actions of other trustees, the excluded trustees shall act in accordance with the exercise of the power. An excluded trustee under this subsection is not liable, individually or as a fiduciary, for a consequence that results from complying with the exercise of the power, regardless of the information available to the excluded trustee. An excluded trustee does not have an obligation to review, inquire, investigate, or make recommendations or evaluations with respect to the exercise of the power. A trustee having the power is liable to the beneficiaries as a fiduciary with respect to the exercise of the power as if the excluded trustees were not in office and has the exclusive obligation to account to and to defend an action brought by the beneficiaries with respect to the exercise or the power. In this subsection, "power" means the power to direct or prevent specified actions by other trustees. ALASKA STAT. §13.36.072 (amended in 2013, applicable to pre-existing or subsequent trusts).

Other states have not been as expansive in relieving a co-trustee for all responsibility with respect to duties allocated to another co-trustee. For example, the Florida statute is similar to the Alaska statute, but provides that the excluded trustee has no liability for actions allocated to another co-trustee "except in cases of willful misconduct on the part of the excluded trustee." FLA. STAT. §736.0703. The Florida experience is interesting. Florida law previously stipulated that for bifurcated co-trustee powers, the "excluded" co-trustee was liable only for actual knowledge of willful misconduct by the directing co-trustee. The statute was changed effective July 1, 2014 to provide that the excluded co-trustee is liable only for "willful misconduct on the part of the excluded trustee"--not for knowledge of willful misconduct by the directing co-trustee (referred to in the legislative history as the "included co-trustee"). The revised statute specifically states that the excluded trustee is not required to review the actions of the other co-trustee, and the included co-trustee is liable to the beneficiaries as if the excluded co-trustee were not in office. The legislative history clarifies this intent:

> Effect of changes. The bill amends s. 736.0703(9) to allow drafting of a trust document that fully exonerates an excluded cotrustee. The bill enhances the previously existing exoneration of an excluded cotrustee by fully removing any duty of inquiry. The excluded cotrustee is exonerated under the new provision even if he or she has actual knowledge of willful misconduct by the included cotrustee, and regardless of the information available to the excluded cotrustee. The bill provides that the excluded cotrustee is exonerated from liability

for following the direction of the included cotrustee, except in cases of its own willful misconduct.

42. Advisor Seeking Input From Directed/Excluded Trustee

If the advisor or trustee having the responsibility for a certain action seeks input from the directed/excluded trustee, should the directed/excluded trustee give that advice? On the one hand, dialogue and communication are good things. Having divided responsibilities does not mean that each party is a silo. But if there is an agenda of finger pointing, that is not healthy. If the trustee decides to discuss the issue and give advice, the directed/excluded trustee should make clear that it is not taking over the responsibility for that issue. (One Fellow expressed concern about giving such advice. Once the trustee undertakes to start giving advice, there may be some degree of duty with respect to that advice. The trustee may have accepted the trusteeship (and on the compensation terms agreed to) because the trustee does not have responsibility for particular actions; if so, that Fellow would not advise the directed/excluded trustee to give input to the "decision maker.")

43. Drafting Considerations and Issues

(Much of the following information is taken directly from the seminar PowerPoint materials.)

a. Drafter's Role.

- Who is our client?
- How do we explain these issues to clients?
- What about federal transfer tax issues? (§§674, 2036(a)(2), 2038, 2041)
- Does the domicile of the director/protector attract *state* income taxation? (As Mickey Davis puts it, "anything earned while facing west is taxable in California.")
- Do grantors really want to give fiduciaries indemnification and exoneration?

b. Drafting Issues.

- Is the power personal or fiduciary? (The offshore trust cases say the protectors are fiduciaries. Judges are generally protective of their right to review actions relating to trust administration.)
- If a fiduciary, to what degree is the person exonerated?
- Can the person seek indemnification from the trust before acting?
- To what extent (if any) can the trustee override the person?
- Is the power active or passive? (Is the trustee to do nothing until directed or does the trustee act until directed otherwise by an advisor? Alternatively, does the advisor/protector have no authority to advise until called up [like a Genie in a bottle—the Genie is to disappear back into the bottle until the master calls again]?)
- When does the person act, and how are actions/inactions documented?
- Is the person entitled to compensation? How determined?
- Can the person employ agents? Legal counsel? At the trust's expense?

- Can the person delegate?
- Is the person entitled to access trust records, documents, and accounts?
- Can the person resign? Is there a mechanism to remove the person? For cause only and what is that?
- How will successors be appointed?
- What is the trustee to do during a vacancy? (What if the protector/advisor simply cannot be located?)
- The grantors are our clients. "Whatever the grantors want or say they want (which could be two different things), we have an obligation to give them something that works—not a car that cannot turn after it goes over a hill."

Items 44-52 are observations from a panel by David M. English, Michael M. Gordon, and Kevin D. Millard—The Trustee's Duty to Inform: What Must the Trustee Tell Which Beneficiaries and When? In addition, these items reflect observations about "quiet trusts" from a panel by Dominic J. Campisi, Dana G. Fitzsimons, and Michael Gordon—A Litigator's View of Directed Trusts, Quiet Trusts and Silent Trusts: A Little Magic or a Lot of Bad Mojo?

44. "Silent/Quiet Trust" Description

A silent or quiet trust is a trust that directs the trustee not to inform beneficiaries of its existence, its terms, or information about the trust administration, at least for some specified period of time or until the beneficiaries reach a specified age. These terms are often used interchangeably. However, some planners refer to a "quiet" trust as one for which the beneficiaries are not informed of the trust or its activities, but a surrogate is to receive information on behalf of the beneficiary, and a "silent" or "secret" trust is one for which no information is given to anyone for a designated period of time.

Some planners have observed a significant trend over the last several years of clients wanting silent/quiet trusts. Perhaps one reason is the increase of the federal gift exemption from $1 million to $5 million indexed, resulting in considerably larger trusts, with settlor concerns about the impact on the beneficiary of knowing about such a large trust.

45. Perceived Advantages and Disadvantages of Silent/Quiet Trusts

a. Advantages.

- ***Destroy Incentive***. The settlor believes that about the beneficiary's knowledge of the trust would discourage the beneficiary from being productive and will encourage wasteful activity.
- ***"Disability."*** If the beneficiary is mentally ill or has a substance abuse problem, the settlor may be particularly wary of the beneficiary learning of the trust's existence.
- ***Promote Family Harmony***. The settlor may not want family members to know about the interests of other beneficiaries to avoid family disputes.

- ***Distribution Pressure***. Limiting disclosure may deter beneficiaries from discouraging other beneficiaries to request distributions. Also, limiting disclosure will keep the beneficiary from haranguing the trustee for distributions.
- ***Avoid Conflict Between Settlor and Beneficiary***. The settlor may have a concern that "my kids will find out what stupid things I am doing with the closely-held business or other property and interfere and make my life miserable."
- ***Protection***. Limited disclosure may protect a beneficiary from physical harm by another beneficiary who wishes to accelerate or increase his or her interest.

b. Disadvantages.

- ***Children Know There's Wealth; Implicit Messages from Parent to Child***.

> [I]s it really credible that the children or other beneficiaries will not see wealth and guess there is a trust? And if the trust is too large to tell the beneficiaries about, when will they be told about it? Ever? And what will they think when they learn about the trust? What message from their parents, or other grantor, will that send? -Ronald D. Aucutt, *Identifying and Respecting the Core Elements of a Modern Trust*, 48TH ANN. HECKERLING INST. ON EST. PLAN. ¶ 1305.2 (2014)

From panelists:

> "You live on Pacific Heights and you think your kids don't know you have money?"

> "Keeping money from beneficiaries until they are 40 years old won't accomplish anything but to leave the beneficiaries thinking 'grandfather was a wacko.'"

Similarly, Jon and Eileen Gallo conclude that failing to disclose the existence of a trust is a mistake, because the children eventually will discover the trust and will be confused and upset over why their parents kept the trust a secret. EILEEN GALLO AND JON GALLO, SILVER SPOON KIDS 186 (2002).

- ***Address Incentive Concern with Trustee Discretion***.

> [K]eeping a trust secret from a beneficiary is seldom, if ever, the best choice, particularly when the issue is being addressed at the drafting stage. For example, knowledge of a trust's existence should not create a disincentive to the beneficiary's leading a productive life if the trust makes clear that the trustee's discretion should not be exercised to enable a non-productive lifestyle. If the trust is written so as to reward industrious lifestyles and to penalize "loafers," then the trustee should not be forced to support an unhealthy lifestyle and, to the contrary, the beneficiary might have more incentive to be more productive than would be the case in the absence of the trust. Benjamin H. Pruett, *Tales From the Dark Side: Drafting Issues From the Fiduciary Perspective,* AMERICAN INST. ON FEDL. TAX'N (in Birmingham, Alabama), ¶X.E. (2014).

- ***Family Communication and Training Is Preferable***. A silent trust says "I'm throwing up my hands. Let someone else do it until he reaches age 45." A better approach is to analyze what the client really wants and design plans best structured to achieve those goals. Talk about what motivates really good children. Some family offices devote a lot of resources and effort to train children and foster family values.

"Keeping the beneficiary in the dark is a really stupid idea. If the goal is to motivate the beneficiaries to be productive people, this will not work."

- ***Conflicting Studies Re Effect of Family Wealth on Ambition***. Anecdotal evidence and academic studies point in many directions regarding the connection between inherited wealth and personal ambition.
- ***Deprives Beneficiary of Information to Plan***. Keeping the beneficiary from knowing about the trust deprives the beneficiary of information about the trust assets and inhibits the ability to engage in rational planning about financial matters. The child may have made higher quality (and more expensive) education choices if the beneficiary had known about the trust.

"If your kids think they have no money, they end up living in a city three flights from you. By depriving your children of money, you have fewer grandchildren (or you rarely see them)."

- ***Lack of Oversight***. If neither the beneficiary nor anyone else is receiving information about the trust, there is no one to correct breaches of trust. The trust assets may be largely dissipated before the beneficiary has the opportunity to become aware of the trust and of serious breaches of trust that have occurred in the meantime.

"You will often get terrible performance without someone watching the show."

This goes to the fundamental policy consideration that trusts must have accountability of the fiduciary.

46. Fundamental Policy Considerations

There are conflicting policy considerations:

a. ***Accountability***. One of the core elements of a trust is accountability of the fiduciary. Empowering beneficiaries with information needed to enforce the trust creates a disincentive to misbehavior by the trustee.

The trustee has a mandatory duty to inform the beneficiaries because only they have both the financial incentive and legal authority to fulfill the monitoring and enforcement functions. - Prof. Thomas Gallanis

For the unscrupulous trustee, … trust privacy provides opportunity and cover for wrongdoing …. Under the law of trusts, the beneficiary is the first—and often the last—line of defense against an incompetent, partial, stingy, or larcenous trustee. Only an informed beneficiary can fulfill this role as monitor and enforcer of trusts. –Prof. Frances Foster

Failure to comply with this duty [to inform] may make it impossible for the beneficiaries to protect their interests. It may also mask more serious violations by the trustee. - UTC §706 cmt.

b. ***Carrying Out Settlor's Intent***. A primary tenant of trust law is to carry out the settlor's intent. Under this fundamental principle, the settlor should be able to express his intent to have a quiet trust if that is his desire.

Anyone with experience with personal trusts has come across a settlor who'd prefer that one or more of the beneficiaries of his irrevocable trust not be told about the wealth it holds, or even

> that the trust exists .... [I]t is inconsistent with a respect for private property to prohibit quiet trusts by specifying what trustees must disclose, even if it contradicts a settlor's best judgment. Donald Kozusko, *In Defense of Quiet Trusts,* Tr. & Est., March 2004, at 20, 22, 24.

Thus, there is a conflict between these two fundamental trust law policies.

c. ***Potential Effects if Quiet Trust Provision Is Unenforceable on Policy Grounds.*** If a direction in the trust instrument not to inform beneficiaries of the trust or its terms or administrative details is ultimately determined to violate fundamental policies and be unenforceable, there are three different approaches that courts have taken: (i) there is no trust and the transfer is a gift to the named trustee; (ii) enforce the trust but refuse to enforce the provision waiving the duty to inform, or (iii) the settlor intended to create a trust but the trust is unenforceable and the trustee will hold the assets as a resulting trust for the benefit of the settlor and the settlor's successors.

47. Silent/Quiet Trust Puts Trustee at Greater Risk

a. Perceived Advantages for Trustee.

- ***Buffer With Beneficiary.*** Quiet trust provisions may be perceived as creating a buffer from having to deal with the beneficiaries. (But that seems just to delay the inevitable; the situation may be worse when the beneficiary finds out years later that he or she was a beneficiary and did not know.)
- ***Avoid Hounding for Distributions.*** The trustee will not have to put up with numerous requests for distributions that the settlor anticipates would be unreasonable distribution requests.
- ***Avoid Conflict of Duty to Inform and Duty of Confidentiality.*** If the duty to inform is not waived, giving information to one beneficiary about the trust might in some situations conflict with the trustee's duty of confidentiality to another beneficiary (for example, the reasons for distributions to the other beneficiary). Waiving the duty to inform as to some but not all beneficiaries may solve the duty of confidentiality problem but may then cause a trustee to be in breach of its duty of impartiality.

b. Disadvantages for Trustee.

- ***Poison the Relationship.*** Lack of disclosure may cause the beneficiary to be suspicious of the trustee once the beneficiary learns about the trust. "When trustees make an effort to communicate with beneficiaries, beneficiaries feel valued. This is important because it means that if investments later fail or concerns arise, beneficiaries will be less likely to sue." Maureen Batemen & Ellen Berkowitz, *Can We Talk?*, TR. & EST., Mar. 2005, at 44.
- ***Greater Danger When Possible Breach Is Discovered Long After the Fact.*** If a beneficiary learns of a breach long after the event occurred, the beneficiary may react more negatively than if the beneficiary is kept apprised of decisions as they occur.

- ***Good Faith/Bad Faith***. Disclosure and transparency are indications of good faith. Concealment may be viewed as evidence of bad faith.
- ***Duty of Impartiality***. Having to limit the information given to some but not all beneficiaries may inhibit the trustee's duty to comply with the duty of impartiality. For example, the beneficiaries would not all have equal opportunity to submit requests for distributions. However, even without a quiet trust provision, a trustee may provide some types of information to some beneficiaries and not to others without violating the duty of impartiality as long as the decisions are "fair, reasonable, and impartial in light of the context and reasons for the communication." RESTATEMENT (THIRD) OF TRUSTS §79 cmt d.
- ***Statute of Limitations Concerns***. If the beneficiary is not apprised of trust activities, is the statute of limitations tolled on breach of duty actions until after the beneficiary has learned of the trust?

  The Uniform Trust Code has a two-part statute of limitations. (i) A claim for a breach of trust must be commenced within five years after the first to occur of the trustee's removal, resignation, or death, the termination of the beneficiary's interest in the trust, and the termination of the trust itself. UNIF. TRUST CODE §1005(c). (Some UTC states have reduced this time from 5 years to 1-3 years. *See* Alan Newman, *You Don't Know What You've Got Till Its Gone: Time-Barred Claims Under the Uniform Trust Code,* 48 REAL PROP. TR. & EST. L.J. 459, at 480 n.84 (2014) (listing statutes for 11 states plus the District of Columbia with such shortened time periods). (ii) The time period can be shortened to one year after "the beneficiary was sent a report that adequately disclosed the existence of a potential claim for breach of trust and informed the beneficiary of the time allowed for commencing a proceeding." UNIF. TRUST CODE §1005(a). The report must provide enough information so the beneficiary (or the beneficiary's representative "knows of the potential claim or should have inquired into its existence." UNIF. TRUST CODE §1005(b). While a beneficiary may waive the right to receive a report, the one-year statute of limitation does not begin to run until the report is delivered. If the trustee cannot give any information about the trust to beneficiaries, the one-year statute would not be available. Furthermore, the statute of limitations to contest the validity of a revocable trust may be shortened to 120 days by informing a beneficiary of the existence of the trust, UNIF. TRUST CODE §604(a)(2), and that ability would be lost in a silent/quiet revocable trust.

  Because the trustee may be open to breach of duty claims for a very long time, some trustees may be unwilling to serve as trustee for silent trusts (or will serve only if it charges a higher fee).

- ***Statute of Limitations May Be Unfair to Beneficiaries as Well***. The Uniform Trust Code provisions may also work to allow the limitations period to run against a beneficiary before he or she even knows of the existence of the trust. The five-year general limitation period begins to run, for example, when the trustee ceases to serve as trustee. If state law allows a settlor to waive the duty to inform indefinitely (or even just for qualified beneficiaries until the beneficiary is age 25), the five-year period may have run long before the beneficiary learns of the trust. For example, if the trustee resigns when a qualified beneficiary is 10 years old, the limitations period will expire in 5 years, when the beneficiary is age 15 --

10 years before the beneficiary may learn of the trust's existence upon reaching age 25. Furthermore, a "qualified beneficiary" under the UTC does not include remote remainder beneficiaries, so the settlor can waive giving notice of the existence of the trust or information about the administration of the trust to remote beneficiaries; nevertheless the five-year statute may have run long before they were aware of their interest as a remote remainder beneficiary. *See generally* Alan Newman*, You Don't Know What You've Got Till Its Gone: Time-Barred Claims Under the Uniform Trust Code,* 48 REAL PROP. TR. & EST. L.J. 459, at 475-482 (2014). **Some planners are wary of using silent trusts for this reason.**

48. Practical Difficulties of Administering Silent/Quiet Trusts

   a. **Distributions.** A distribution to or "for the benefit of" a beneficiary may "carry out" income to the beneficiary that must be reported on a K-1, so the beneficiary would become aware of the existence of the trust. Furthermore, the trustee may be under a duty to inquire about financial or other information about the beneficiary in the course of making distribution decisions. For this reason, using silent/quiet trusts makes no sense during periods in which distributions may be made.

   b. **Various Procedural Alternatives.** Various alternatives to provide for flexibility in the administration of the trust may be unavailable, such as nonjudicial settlement agreements, or the ability to obtain enforceable consents, releases, or ratifications.

49. Uniform Trust Code Provisions Regarding Duty to Inform and Silent/Quiet Trusts

   a. ***Duty to Inform, §813***. The general default rule of §813 is that the trustee must (i) keep "qualified beneficiaries" reasonably informed about the administration of the trust to protect their interests, and (ii) unless unreasonable under the circumstances, must promptly respond to any beneficiary's request for information related to the trust administration. §813(a).

   Section 813(b) lists various specific information that must be provided including a copy of the trust instrument (to any beneficiary), notification to qualified beneficiaries after accepting trusteeship or within 60 days after having knowledge of the creation of an irrevocable trust, and notification to qualified beneficiaries of any change in the method for compensating the trustee.

   Section 813(c) requires that annual reports be given to current permissible distributees of income or principal (or to any other beneficiary who requests it).

   A beneficiary may waive the right to a trustee's report or other information otherwise required to be supplied. §813(d).

   A "qualified beneficiary" is a current or first line remainder beneficiary, but not a beneficiary with a remote remainder interest. §103(12) (amended 2010).

   Thus, silent/quiet trusts would not be permissible under the default rules. The key issue is the extent to which these default duty to inform rules may be waived by the settlor.

b. ***Waiver of Duty to Inform Requirements, §105.*** The UTC is generally just a default law that applies to the extent the settlor does not provide otherwise in the trust instrument. §105(a). Fourteen UTC rules are mandatory and cannot be overridden. §105(b). At the heart of the ability (and limits thereon) to create silent/quiet trusts are two of the UTC rules that cannot be overridden dealing with the mandatory information and reporting rules:

> (i) The duty under §813(b)(2) and (3) to notify qualified beneficiaries who have reach age 25 of the existence of the trust, the identity of the trust, and the right to request reports under §813(c); and
>
> (ii) The duty under §813(a) to respond to the request of a [qualified] beneficiary of an irrevocable trust for trust reports and information reasonably related to the trust administration. §105(b)(8)-(9).

The prohibition on overriding these provisions was very controversial when the UTC was being debated. There was deep disagreement over §105(b)(8)-(9), so those sections were placed in brackets as optional provisions. As expected, there has been a great deal of disparity in the manner in which states have adopted the mandatory information and reporting rules under §105(b)(8)-(9). The comments to §105 indicate that those two subsections "generated more discussion in jurisdictions considering enactment of the UTC than [had] any other provisions of the Code."

c. ***Variances in State Adoption of §105.*** Most UTC jurisdictions have not enacted, or have significantly reduced the scope of, the mandatory information and reporting rules in §105(b)(8)(9). Of the twenty-six states that have adopted the UTC, fourteen omitted both rules, arguably making all of the information and reporting rules default rules that can be overridden. *See* Alan Newman*, You Don't Know What You've Got Till Its Gone: Time-Barred Claims Under the Uniform Trust Code,* 48 REAL PROP. TR. & EST. L.J. 459, at 478 n.80 (2014)(citations to those statutes). Most of the other twelve UTC states modified the mandatory information and reporting requirements in various ways. Six states have made minor changes (such as the age at which information must be given), but no UTC state has adopted the mandatory information and reporting rules without change. *Id.* at 478-479. There have been fewer modifications to the mandatory duty to respond to requests for reports or other information in §109(b)(9).

Eight states have revised §813 to limit the affirmative obligation to keep beneficiaries reasonably informed of trust administration issues as a default rule. For example, eight states limit that obligation only to current beneficiaries, not all beneficiaries. If a beneficiary requests a copy of the trust agreement, seven states limit the duty to deliver just the provisions relevant to that particular beneficiary, not the entire trust instrument. A number of states made §813 prospective only in their effective date provisions.

Various states that have not adopted the UTC have adopted mandatory information and reporting rules. For example, the Delaware statute eliminates the duty to inform beneficiaries "for a period of time." The intent was to give the settlor the ability to decide when the beneficiary should receive information, but could not eliminate completely information reporting to a beneficiary.

50. Surrogate Provisions; Quiet Trusts

a. ***Statutes.*** Six states (Florida, Maine, Missouri, Ohio, Oregon, and Pennsylvania) and the District of Columbia allow the settlor to designate a representative to receive information the trustee would otherwise be required to furnish to a beneficiary. *See* Alan Newman*, You Don't Know What You've Got Till Its Gone: Time-Barred Claims Under the Uniform Trust Code,* 48 REAL PROP. TR. & EST. L.J. 459, at 479 n.81 (2014) (listing the statutes). For example, the District of Columbia (first to enact a representative statute) allows the settlor to modify the duties of a trustee to provide information by:

> (3) Designating a person or persons to act in good faith to protect the interests of beneficiaries, to receive any notice, information, or reports required under section 19-1308.13 in lieu of providing such notice, information, or reports to the beneficiaries.

The recent trend of statutes (and in drafting quiet trusts) is to include surrogate provisions.

b. ***Drafting Surrogate Provisions Even Without a Statute.*** Even in UTC states that have not adopted a specific information surrogate provision, the settlor presumably could draft such a provision into the terms of the trust, because "settlors are free to specify their own methods for providing substituted notice and obtaining substituted consent." UNIF. TRUST CODE Art. 3 General Comment.

c. ***Is the Surrogate a Fiduciary?*** If the surrogate is a fiduciary, the accountability policy would seem to be satisfied, because someone with fiduciary duties is informed about the trust with some degree of duty to enforce the trust for the beneficiary's benefit.

Is the information surrogate a fiduciary? Most of the jurisdictions that have enacted surrogate provisions impose a "good faith" standard. The District of Columbia requires the surrogate "to act in good faith to protect the interests of beneficiaries," and the Kentucky statute requires that the surrogate either be a qualified beneficiary or a person having a fiduciary relationship to a qualified beneficiary. The other state surrogate statutes do not specifically mention whether the surrogate is a fiduciary. Commentators (and the panelists) differ as to whether the surrogate is a fiduciary unless the trust instrument specifically provides that the surrogate is or is not a fiduciary (assuming such a designation is enforceable).

d. ***Can the Surrogate Enforce the Trust?*** The comment to §1001 of the UTC says that a person who may represent a beneficiary under the UTC article 3 provisions has standing to bring a petition on behalf of the represented beneficiary. That would be essential in order to satisfy the fundamental accountability policy requirement for trusts. Even if the surrogate can bring an action, various questions arise. May (must) the surrogate tell the beneficiary? Must the surrogate directly seek redress by suing the trustee? May the surrogate be reimbursed for expenses and from what source? These issues could be addressed in drafting the trust instrument.

e. ***Does Notice to Surrogate Start Statute of Limitations?*** Several statutes (Florida [by making the surrogate a representative under UTC art. 3], Maine, and Ohio) provide that notice to the surrogate starts the statute of limitations. In other states that is not clear, even though information to the surrogate is probably intended to start the statue of limitations. The one-year statute begins to run when information is given to a "representative" of the beneficiary, §1005(a), and notice to a representative is treated as if the notice were given directly to the beneficiary, §301(a). But the "representative" cannot have a conflict of interest with the beneficiary, §302-304, and if the surrogate is another beneficiary, there may be a conflict of interest. Similarly, a person is not a "representative" if there is a conflict of interest among those represented, §303, so notice to a surrogate who represents both current and remainder beneficiaries may not start the running of the statute of limitations.

f. ***Beneficiary's Recourse Against Information Surrogate.*** The Bogert treatise states that a beneficiary presumably can hold the representative accountable for its handling of the information. ALAN NEWMAN, GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES §965 (3d ed. 2010). In states that have imposed a good faith standard, there would be no recourse against the surrogate unless the beneficiary can show a lack of good faith. If the beneficiary does have recourse against the surrogate, what is the statute of limitations on that action?

51. Practical Issues in Administering and Drafting Silent/Quiet Trusts

a. ***Large Concern for Trust Companies.*** Trust companies have varying policies. Some (not many) absolutely will not administer quiet trusts. Others require that information be supplied to the beneficiary upon reaching age 25.

b. ***Crummey Trusts.*** Quiet trust provisions obviously do not work with Crummey trusts, under which beneficiaries are typically given a notice of contributions to the trust and their right to withdraw those contributions in a limited period of time. (Amazingly, some trusts have both Crummey trust provisions and quiet trust provisions; they are incompatible.)

c. ***Mere Discretion to Withhold Information***. If the instrument merely authorizes but does not direct the trustee to withhold information from beneficiaries, the trustee will often not be willing to exercise that discretion. A preferable approach is to direct the trustee to maintain a quiet trust. Trustees want clear language of when they are to notify beneficiaries and which beneficiaries are to receive notice.

d. ***Client Request to Withhold Information if No Quiet Trust Provisions in Document.*** If the client requests the trustee not to give information to beneficiaries, but there are not quiet trust provisions in the instrument, the trustee will be unlikely to comply with that request. Some states, such as Alaska, allow quiet trust provisions to be in a free standing instrument other than the trust agreement.

e. ***Often Used by Some.*** One panelist uses quiet trust provisions in almost every trust that he drafts.

f. ***Surrogate Provision.*** That planner almost always drafts the trust to provide for a "Designated Representative" or "Notice Recipient," so that someone receives information on behalf of the beneficiary. That achieves the best of both worlds of relieving the trustee of liability to some extent and having someone to look out for the interest of beneficiaries.

Is the surrogate a fiduciary? One planner typically drafts trusts to provide the surrogate is not a fiduciary. He asks: otherwise who can you get to serve in this position? (Query whether some courts might determine that the person who clearly is expected to act on behalf of someone else is determined as a matter of law to be a fiduciary, with the only question being the scope and standard of duty owed to the beneficiary?)

Also address what authority the surrogate has to act on information that is received, for example to bring an action against the trustee (and address whether attorneys' fees are paid out of the trust). If an action is filed, can you avoid giving notice of the proceeding to the beneficiary? The agreement may provide that the representative has the authority to act on behalf of the beneficiary and receives notices of court proceedings for the beneficiary.

Can the beneficiary still bring claims against the trustee? Can the beneficiary remove the surrogate? Typically not, or else the beneficiary would then know about the trust. A trust protector could have the authority to remove the surrogate.

g. ***Time Period for Quiet Trust.*** Trusts typically provide a particular age at which beneficiaries will receive information. Alternatively, the trust could be a quiet trust during the life of the settlor, or perhaps the settlor and the settlor's spouse (subject to state mandatory information reporting requirements that cannot be overridden).

g. ***What Information is Shared?*** The quiet trust provisions can also specify what information can be shared with beneficiaries. (Of course, if the trust is in a jurisdiction with a mandatory notice requirement after age 25, the statute will typically cover what information must be shared.)

i. ***Pre-Nuptial Agreement.*** The beneficiary may not pursue negotiating a pre-nuptial agreement, not realizing that he or she has any significant assets. If the beneficiary does sign a pre-nuptial agreement, the trust assets will not be disclosed (because the beneficiary did not know about them) and the agreement may be invalid. The settlors may think this would not be marital property in any event that could be divided on divorce (but that may not be true in the jurisdiction where a beneficiary is ultimately divorced). In any event, quiet trusts present significant problems for beneficiaries regarding pre-nuptial agreements.

52. Adding Quiet Trust Provisions to Existing Irrevocable Trust Agreements

Alternatives to add quiet trust provisions to an existing trust include the following.

a. ***Judicial Modification.*** For a consent petition, all beneficiaries must consent. That obviously would not work because the beneficiary would know about the modification petition (and would therefore know about the trust). Virtual representation often will not work because the beneficiary's parent knows about the trust and the beneficiary does not, possibly creating a conflict of interest. When a guardian ad litem is used, one planner has been able to negotiate the addition of quiet trust provision with provisions for disclosing information at a designated age, surrogates to receive information, etc.

b. ***Decanting.*** This may be the only viable option that does not require some kind of potential disclosure to beneficiaries. Trust companies may want beneficiaries to sign a release or indemnification to authorize the decanting transaction, but then the beneficiary would find out about the trust. Adopting a quiet trust provision relieves the trustee of duties he would otherwise have; is it a breach of trust to decant to a trust with quiet trust provisions?

c. ***Merger.*** The trust might be merged to a new trust from the pre-existing trust. But under most merger statues, the merger cannot result in a material change in the interests of the beneficiaries. Merger typically is not helpful for this purpose.

d. ***Nonjudicial Settlement Agreement.*** Some jurisdictions allow trust modifications in the nonjudicial settlement agreement provisions. A requirement is that the modification cannot violate a material purpose of the trust. Is having information about the trust a material purpose of the trust?