INDIVIDUAL TRUSTEES, INVESTMENT DECISIONS AND DUTIES

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Many clients, for a variety of reasons, create trusts at their death. The trustees for such trusts are oftentimes their friends and family members, as opposed to corporate trustees. How do individual trustees navigate the maze of statutes and requirements and invest trust funds? This article will attempt to give a very general foundation for how individual trustees can sit down with their investment advisor and attorney to map out an investment strategy for trust investments.

To begin, it is of paramount importance that an individual trustee develop an investment plan that is written down. To prepare such an investment plan, the trustees, with their advisors, should review the document establishing the trust; determine the particular situations of the current and remainder beneficiaries; and review the transfer and income tax consequences of the particular trust.

Review of the Trust Document.

The statutes principally governing trustee's duties and obligations concerning investments, the Prudent Investor Rule[1] and the Pennsylvania Uniform Trust Act[2], give great deference to the intent of the person who created the trust, the settlor[3]. The document creating the trust is the first and sometimes only place a court will look to to determine the settlor's intent. As such, it becomes critically important to review the terms and language of the trust to determine such intent, if possible. For example, in the *Magargle Trust*, 29 Fiduc. Reporter 2d 62 (Montg. 2008), the Court stated that the surviving spouse, who was the initial beneficiary of a trust which specified that the assets were to be used for her health, support and maintenance, enjoyed the inference of having a favored-beneficiary status over the children who were discretionary and remainder beneficiaries.

A review of the trust document may also give some indication as to how much discretion the trustees are given with regard to investment decisions. Some settlors strictly curtail such investment decisions. Section 7202 of the Prudent Investor Rule states that such decisions will usually be upheld unless a court having jurisdiction over the trust funds finds that adherence to the restriction is impractical, or that the existing or reasonably foreseeable economic conditions are so different from those prevailing at the creation of the trust that adherence to the restriction might deprive the respective beneficiaries of the income and principal that the settlor intended them to enjoy. Such a standard, however, is oftentimes difficult to meet and, as such, the instructions set forth in the trust document may prevail.

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[1] 20 Pa.C.S. §7201 et. seq.
[2] 20 Pa.C.S. §7701 et. seq.
[3] For purposes of this article, "settlor" shall include a testator who creates a trust in his Last Will and Testament at his death, as well as the person who creates an inter vivos trust.

Determining the Beneficiaries' Situation.

After reviewing the terms of the trust document carefully, the trustees need to decide the needs of the primary and secondary beneficiaries. Does the primary beneficiary have significant assets of his or her own? Does the primary beneficiary have a source of income outside of the trust? Is the primary beneficiary solely reliant on the trust as a means of support? What is the size of the trust in relation to the needs of the beneficiary? Consider, for example, a trust that is created for the lifetime of a surviving spouse with a remainder interest passing to children from a prior marriage. While this is a fairly common situation, it presents a complex and conflicting set of interests that the investment portfolio should consider. The trust assets and investments must not only produce a sufficient return and adequate distributions to provide for the surviving spouse's support, but it also must not, to the extent possible, lose value to inflation. Can all such competing interests be accommodated? This determination is a particularly sensitive one because often the surviving spouse and the children from a prior marriage are not on the best of terms and the decisions of the trustees will be scrutinized by all parties.

Determining the Tax Consequences.

Many trusts are created not only to address family issues, but also are for tax purposes. A common estate plan for estates subject to the Federal Estate tax prior to 2010 was to create a trust by Will and fund it at the death of the first spouse with a sum equivalent to the deceased spouse's credit against such a tax. Such a trust is often referred to as a by-pass or credit shelter trust and is not subject to Federal Estate tax at the surviving spouse's death. The balance of the estate would be left outright or in a qualifying marital trust to the surviving spouse. The marital trust, however, would be subject to Federal Estate tax at the surviving spouse's death.

The tax differences between a by-pass and marital trust can also include income taxes. Many marital trusts are drafted as a "QTIP" trusts (qualified terminable interest property trust) in which the net income must be distributed at least annually to the surviving spouse. A by-pass trust, however, may allow the income to either be sprinkled among a group of beneficiaries or accumulated.

In the QTIP trust, the net income of the trust is distributed to the surviving spouse who then reports and pays income tax on such net income. But, any trust that accumulates net income rather than distributing it to the beneficiaries, pays the income tax on such net income. The income tax brackets for trusts are compacted and reach the highest rate (35% for 2010) at $11,200 for the calendar year 2010. The income tax differential between what a surviving spouse may pay versus what the trust may pay can be substantial.

The difference in the tax aspects of these two trusts would indicate two possible different investment strategies. It may be prudent for the marital trust to be invested to produce more income and less growth, while the by-pass trust could be invested for more growth and little income production. These factors will also be influenced by the terms and size of the respective trusts as well.

Developing the Investment Strategy.

Section 7203 of the Prudent Investor Rule states that a fiduciary shall invest and manage property held in trust as a prudent investor would by considering the purposes, terms and other circumstances of the trust and by pursuing an overall investment strategy reasonably suited to the trust. This concept is further enumerated in the Pennsylvania Uniform Trust Act under Section 7774 which states that a trustee shall administer the trust as a prudent person would by considering the purposes, provisions, distributional requirements and other circumstances of the trust and by exercising reasonable care, skill and caution.

The direction given to the trustees is a two part direction, in essence. The trustee is directed to invest the trust assets as a prudent person would, and to invest the assets according to the purposes, terms and other circumstances of the trust. The Restatement of Trusts, while not adopted in Pennsylvania, gives us some guidance as to the principles of prudence[4]. These principles include not only diversification, which is fundamental to risk management, but also the idea that risk and return are so directly related that trustees have a duty to analyze and make conscience decisions concerning the level of risk appropriate to the purposes, distribution requirements and other circumstances of the trust they administer. The Restatement goes on to state that trustees have a duty to avoid fees, transaction costs and other expenses not justified by the needs and realistic objectives of the trust investment program. Furthermore, the trustees have a fiduciary duty of impartiality which requires a balancing of elements of return between production of current income and protection of purchasing power. To assist them with these duties, the trustees have the ability to delegate authority as prudent investors would[5]. Many of these concepts are adopted by both the Prudent Investor Rule and the Pennsylvania Uniform Trust Act.

Section 7203(b) of the Prudent Investor Rule gives great discretion to fiduciaries. A fiduciary may invest in every kind of property and type of investment, but should consider, among other things, the size of the trust; the nature and estimated duration of the fiduciaries' relationship; the liquidity and distribution requirements of the trust; the expected tax consequences of investment decisions and of distributions of income and principal; the role that each investment plays in the overall investment strategy; the assets special relationship, if any, to the purpose of the trust or to one or more beneficiaries; the needs of the beneficiary for present or future distributions; and, the income and resources of the beneficiaries and related trusts.

In Section 7204, diversification is addressed and direction is given to the fiduciary to reasonably diversify investments unless the fiduciary reasonably determines that it is in

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[4] Restatement (Third) of Trusts, Chapter 7 (Introduction, pp. 5-6) (1992).
[5] Id.

the interest of the beneficiaries not to diversify, taking into account the purposes, terms and other circumstances of the trust and requirements of this chapter. The concepts of delegation and costs are also set forth in Section 7206 of the Prudent Investor Rule and Section 7775 of the Pennsylvania Uniform Trust Act.

All of this is a lot for anyone to digest and to formulate in an investment strategy, and as such, a trustee should consider seeking professional guidance from an investment advisor if the trustee does not feel up to the tasks described. Given the mandates of the Prudent Investor Rule, a trustee is not free to ignore the risk and return analysis and the determination of trust purpose simply because he or she is unsophisticated. Because the statutes allow a trustee to delegate investment responsibilities, not to do so and to ignore such an opportunity could be viewed as a breach of trust.

Trustees can take some comfort in the judgment of their decisions as set forth in Section 7213 which states that the rules set forth under the Prudent Investor Rule statutes are standards of conduct and not of outcome or performance. Compliance with the rules shall be determined in light of the facts and circumstances prevailing at the time of the fiduciaries decisions or actions and not by hindsight. A fiduciary is not liable to the extent he or she acted in substantial compliance with the rules or in reasonable reliance on the terms and provisions of the trust document. A trustee’s investment and management decisions respecting individual assets are considered in the context of the trust portfolio as a whole and as part of an overall investment strategy and not in isolation. No specific investment or course of action taken alone shall be considered inherently prudent or imprudent.

So how does one address competing interests, especially where the surviving spouse may be unrelated to the remainderman who are children from a prior marriage? Section 7773 of the Pennsylvania Uniform Trust Act states that trustees shall act impartially in investing, managing and distributing the trust property. The trustee must treat the beneficiaries equitably in light of the purpose of the trust, but there is no duty to treat the beneficiaries equally.

Section 7780.4 further states that the trustee shall exercise a discretionary power in good faith and in accordance with the provisions and purposes of the trust and the interests of the beneficiaries, notwithstanding the breadth of discretion granted to a trustee in a trust instrument, including the use of the terms absolute, sole or uncontrolled.

All of this leads us back to the written investment strategy that needs to be carefully thought through with professional guidance from an investment advisor and an attorney both of whom understand the terms of the trust document and the general analysis for fiduciary investing. Accepting the role of trustee for individuals is not for the faint of heart. The duties and obligations regarding investment decisions should be considered carefully before accepting such a position.

This article originally appeared in the Philadelphia Estate Planning Newsletter, Spring 2010, Vol. XIX No. 3.