Minimizing Trustee Risk

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MINIMIZING FIDUCIARY RISK ---

COMMON-SENSE ADVICE FROM A CORPORATE TRUSTEE

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CONTENTS

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I. INTRODUCTION

Being named as an executor or trustee is an honor that should not be taken lightly. Unfortunately, many individuals named to these trusted roles do not have a clear understanding of the duties, responsibilities and potential risks that serving as a fiduciary entails. As fiduciary litigation becomes increasingly common, assuming a position as executor or trustee is not for the faint of heart.

This outline will explore the basic fiduciary duties owed by an executor or trustee, some of the potential pitfalls that may lead to litigation and a few best practices from a professional fiduciary.

II. FIDUCIARY DUTIES

By its very terms, a trust is a fiduciary relationship. The role of a fiduciary is a challenging one which may involve managing the trust on behalf of multiple parties with different or competing interests.[2] But what exactly does that mean? Developing a strong understanding of a fiduciary's duties and responsibilities is the first key step in minimizing fiduciary risk.

The simplest definition of a trust is that it is a legal arrangement where one (the fiduciary) holds legal title to property for the benefit of another (the beneficiary). It is the relationship between the fiduciary, the beneficiary and the settlor's intent that is key. The Restatement (Third) of Trusts defines the term "trust" as "a fiduciary relationship with respect to property, arising from a manifestation of *intention* to create that relationship and subjecting the person who holds title to the property to *duties* to deal with it for the benefit of charity or for one or more persons, at least one of whom is not the sole trustee."[3]

Because of the very special nature of the trust relationship, fiduciaries are held to the highest standard of conduct under the law. As Justice Cardozo famously stated in Meinhard v. Salmon:

> *"Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."*[4]

Not only is the fiduciary held to a heightened standard of conduct, but the fiduciary also owes certain duties to the trust beneficiaries. Breaches of these duties, whether intentional or unintentional, may result in litigation. Any individual or corporate fiduciary must take steps to ensure that these fundamental fiduciary duties are met.

A. Duty of Loyalty

The duty of loyalty is the core of all fiduciary relationships. It is well-settled that "a fiduciary owes a duty of undivided and undiluted loyalty to those whose interests the fiduciary is to protect."[5] This duty is absolute and may not be waived.[6]

The duty of loyalty requires that the fiduciary administer the estate or the trust solely in the interest of the beneficiaries.[7] This duty, which is also sometimes referred to as the "sole interest rule," means that the fiduciary must place the interests of the beneficiaries ahead of the fiduciary's own interests, as well as the interests of other parties.

In keeping with this duty, the fiduciary must avoid all actual and potential conflicts of interest. A fiduciary may not enter into any transaction directly with the trust or estate and must also avoid any transactions which would benefit the trustee or a closely related person or entity, directly or indirectly.[8] In addition, the trustee must deal with beneficiaries fairly and communicate to the beneficiaries all material facts that the trustee knows or should know in connection with the matter.[9]

The rationale underlying the rule against self-dealing was summarized by the New York Court of Appeals as follows:

> *"The rule is founded in the highest wisdom. It recognizes the infirmity of human nature, and interposes a barrier against the operation of selfishness and greed. It discourages fraud by taking away motive for its*

perpetration. It tends to insure fidelity on the part of the trustee, and operates as a protection to a large class of persons whose estates . . . are intrusted to the management of others."[10]

B. <u>Duty of Care</u>

In addition to the duty of loyalty, a fiduciary has a duty to administer the estate or the trust and to carry out the settlor's intentions as expressed in the governing instrument in good faith, with reasonable skill, care and caution.[11] The fiduciary must employ the degree of care that a prudent person of discretion and intelligence in such matters would exercise in the fiduciary's own affairs.[12]

In addition, a fiduciary who holds himself or herself out as having special skills, must employ those skills or run the risk of surcharge.[13] With regard to corporate fiduciaries, Section 11-2.3(b)(6) of the New York Estates, Powers & Trusts Law ("EPTL") specifically requires a bank, trust company or other paid investment professional that is serving in a fiduciary capacity to exercise such diligence in investing and managing trust assets as a prudent investor having special skill would do.

Traditionally, the duty of care prohibited a trustee from delegating functions related to the administration of the trust that the trustee could reasonably be expected to perform. However, in recent years that rule has shifted. Today, particularly with regard to the investment of trust assets, the law imposes a duty to delegate if the trustee does not have the

requisite skill or experience. The delegation of a trustee's investment or management responsibilities still requires the trustee to exercise care, skill and caution in selecting a suitable delegee, establishing the scope and terms of the delegation, overseeing the exercise of the delegated function and managing costs.[14] In addition, New York law permits co-trustees to delegate amongst one another, especially where one trustee has an expertise in a particular aspect of the trust management. However, a trustee who delegates administrative functions to a co-fiduciary is not relieved from the duty to exercise oversight responsibility.[15]

C. Duty of Impartiality

The duty of impartiality requires a trustee to treat beneficiaries equitably, if not equally, while taking into account the terms and purposes of the trust. In all facets of trust administration, including distribution decisions, investment decisions and communication with beneficiaries, the trustee must consider not only the interests of the current beneficiaries, but also the remainder beneficiaries.

A trustee must be careful to not favor one beneficiary or one class of beneficiaries over another unless such priority is clearly stated in the governing instrument.[16] However, even when the governing instrument does authorize giving preference to one beneficiary over others, the trustee must be certain to exercise that preference only in furtherance of the settlor's intentions.[17]

The duty of impartiality is "especially robust" where the trustee also has a beneficial interest in the trust.[18] According to one distinguished commentator, "the duty of impartiality regulates trustee/beneficiary conflicts when the trust terms create a conflict that abridges the sole interest rule."[19]

D. Duty to Inform and Account

The trustee also has a duty to provide information about the trust and to account to the beneficiaries. This common law duty has steadily expanded over the years.[20] While under the Restatement (Second) of Trusts, a trustee had no affirmative duty to provide information to a beneficiary except under limited circumstances, the more modern view is that the trustee must provide sufficient information about the trust assets and administration to enable the beneficiaries to protect their interests in the trust.[21]

Today, in most jurisdictions, a trustee has an affirmative duty to keep the beneficiaries reasonably informed about the trust administration and of the material facts required for them to protect their interests.[22] As one court has noted "even in the absence of a request for information, a trustee must communicate essential facts, such as the existence of the basic terms of the trust. That a person is a current beneficiary of a trust is indeed an essential fact."[23]

Under New York law, a trustee must provide certain information to the current income beneficiaries and to any other beneficiary interested in the income or principal of the trust

upon request or else forgo annual commissions. A trustee may retain annual commissions provided that the trustee gives the income beneficiaries an annual statement that details the principal on hand, all receipts of income and principal, any commissions retained and the basis upon which the commissions were calculated.[24] A trustee who takes annual commissions without providing the required reports may be ordered to repay the commissions plus 9% interest.[25] Furthermore, a proceeding may be commenced against a fiduciary who has failed to provide information to compel the fiduciary to supply information including the assets and affairs of the trustee.[26]

At the same time, a trustee also owes a duty of confidentiality to the beneficiaries and must not share personal and financial information with others. "[T]he trustee's duty of loyalty carries with it a related duty to avoid unwarranted disclosure of information acquired as trustee whenever the trustee should know that the effect of disclosure would be detrimental to possible transactions involving the trust estate or otherwise to the interest of the beneficiaries."[27]

E. Duty to Prudently Invest Trust Assets

A trustee also has the duty to prudently invest trust property.

1. Prudent Investor Rule

The law regarding a trustee's duty with regard to trust investments has evolved significantly over time from the old "legal list" and Prudent Man rules to today's Prudent Investor Rule. While, "[f]or more than one hundred years, protecting trust principal while generating the highest possible income marked the fundamental purpose of fiduciary investment standards,"[28] today the law regarding trust investment has shifted to a more holistic view.[29]

The Prudent Investor Rule, as promulgated under the Restatement (Third) of Trusts and the Uniform Prudent Investor Act ("UPIA"), made five fundamental changes to the standards for prudent trust investing:

- Investments are to be judged as a part of the total portfolio rather than investment by investment;
- The trustee's central consideration in investing trust assets is the tradeoff between risk and return;
- No category of investments is per se imprudent -- any investment may be made so long as it plays an appropriate role in achieving the risk and reward objectives for the trust and meets the other requirements for prudent investment;
- Diversification is an integral part of the definition of prudent investment; and
- Delegation of investment management functions is expressly permitted.[30]

A trustee must invest and manage trust assets as a prudent investor would by considering the purposes, terms, distribution requirements and other facts and circumstances particular to the trust.[31] In so doing, the trustee is required to exercise reasonable care, skill and caution and to develop an overall investment strategy that incorporates risk and return objectives reasonably suited to the trust.[32] A trustee's investment decisions are not considered in isolation, but rather in the context of the trust portfolio as a whole.[33]

2. New York Prudent Investor Act

The New York Prudent Investor Act is embodied in EPTL § 11-2.3. Very generally, a trustee has a duty to invest and manage property held in a fiduciary capacity in accordance with the prudent investor standard, except as otherwise provided by the express terms and provisions of a governing instrument.[34] Among the circumstances that a trustee must consider in investing and managing trust assets are:

- the size of the portfolio;
- the nature and estimated duration of the fiduciary relationships;
- the liquidity and distribution requirements of the governing instrument;
- general economic conditions;
- the possible effect of inflation or deflation;
- the expected tax consequences of any investment decision or strategy and of distributions of income and principal; and
- the role that each investment or course of action plays in the overall portfolio.[35]

In addition, the trustee must adhere to the general fiduciary duties of loyalty and impartiality, must act prudently with regard to the delegation of investment management and in the selection and supervision of agents and incur only reasonable and appropriate costs.[36]

3. Standard of Process, Not Performance

In determining whether a trustee has complied with this fiduciary duty, the court looks at the trustee's overall process around investments. "[T]he test is prudence, not performance, and therefore evidence of losses following the investment decision does not, by itself, establish imprudence."[37] Rather, the court must view a fiduciary's actions in totality and "in light of the history of each individual investment."[38]

4. Intersection of Investments and Impartiality

In investing trust assets, the trustee must also adhere to the general duty of impartiality and balance the interests of current and remainder beneficiaries.[39] With regard to trust investments, the duty of impartiality requires the trustee to take into account the financial situations and risk tolerance of the beneficiaries and develop an appropriate investment strategy.

The shift to total return investing made balancing the beneficiaries' competing interests challenging for a trustee. The trustee must balance the competing interests of all of the current beneficiaries, as well as the remainder beneficiaries in a fair and reasonable manner.[40] The

beneficiaries may have different levels of risk tolerance and have differing expectations with regard to income versus capital growth.

Investment decisions can be all the more difficult when the trust has multiple current beneficiaries. In the context of a sprinkle trust for multiple beneficiaries, "[t]he divergent economic interest of trust beneficiaries give rise to conflicts of interest of types that simply cannot be prohibited or avoided in the investment decisions of typical trusts."[41] Put simply, an investment strategy that is appropriate for one beneficiary may not meet the needs of another beneficiary.

5. Balancing Competing Interests

The UPIA and New York law give trustees two tools by which they can better balance the divergent needs of income and remainder beneficiaries while still investing for total return: the power to adjust and the unitrust conversion.[42]

a) Power to Adjust

The "power to adjust," embodied in EPTL § 11-2.3(b)(5), permits a trustee to adjust between income and principal if the trustee determines that, in light of its investment decisions and the consideration of other factors, that such an adjustment would be fair and reasonable to all of the beneficiaries.[43] Generally speaking, before a trustee can exercise the power to adjust, three conditions must be satisfied:

- The trust must be invested as a prudent investor would invest (ie. invested for total return);
- The terms of the governing instrument must describe the amount that may/must be distributed by referring to trust income; and
- The trustee must determine that the trustee is otherwise unable to administer the trust impartially based on what is fair and reasonable to all beneficiaries (unless the governing instrument clearly expresses the settlor's intent for the trustee to favor one or more beneficiaries over the others).[44]

In determining whether and to what extent the power to adjust should be exercised, a fiduciary may consider a number of factors including: (i) the settlor's intent as expressed in the governing instrument; (ii) the assets held in the trust; (iii) the extent to which an asset is used by a beneficiary; (iv) whether an asset was purchased by the trustee or received from the settlor; (v) the net amount allocated to income under the Principal and Income Act; (vi) the increase or decrease in the value of the principal assets; and (vii) to what extent the terms of the trust give the fiduciary the power to invade principal or accumulate income and the extent to which the fiduciary has previously exercised those powers.[45]

The statute provides some limitations on the power to adjust.[46] A trustee may not make an adjustment: (i) over a charitable trust; (ii) that changes the amount payable to a beneficiary as a fixed fraction or fixed annuity amount; (iii) from any amount that is permanently set aside for charity unless the income is also earmarked for charity; (iv) if possessing the power would cause the individual to be treated as the grantor for income tax purposes; (v) that would cause the assets to be includible in the estate of an individual who has the power to remove and

replace trustees and such assets would not otherwise be included if the individual did not have the power to adjust; or (vi) that would potentially cause the trust to be considered as an available asset for the purposes of determining an individual's eligibility for public benefits assistance.[47] Notably, the power to adjust may not be exercised by a trustee who is a current or remainder beneficiary or who would benefit, directly or indirectly, by the adjustment.[48]

b) Unitrust Election

EPTL § 11-2.4 allows trustees to elect to treat a trust to a unitrust so as to create a reasonable income stream and to invest the trust assets for growth without regard to whether individual investments are productive of income. Alternatively, the court may, upon the petition of the trustee or a beneficiary and notice to all interested parties, may direct that the trust be converted to a total return unitrust.[49]

In determining whether to make the unitrust election, the trustee must consider the nature, purpose and expected duration of the trust, the settlor's intent, the needs of the beneficiaries and the nature of the assets held in the trust. If the trustee elects to have this section apply, he must give notice of the election to the creator of the trust (if living), all persons interested in the trust and to the court that has jurisdiction over the trust.[50] In the first year that the trust is treated as a unitrust, the unitrust amount based on the net fair market value of the trust calculated as of the beginning of the year, while in subsequent years, the

unitrust amount is calculated on a rolling average so to smooth out the effects of market volatility.[51]

In Matter of Estate of Ives, the court directed the trustee to treat a testamentary credit shelter trust as a unitrust.[52] The governing instrument gave the trustee the power to invade trust principal as needed for the beneficiary's support and maintenance in her accustomed standard of living. The court determined that the decedent's primary intent had been to provide for his wife, the income beneficiary, and that her income was insufficient to provide for her needs. By converting to a unitrust, the beneficiary's income would reasonably be expected to nearly double. Last, the remainder beneficiaries had no present need for distributions from the trust and would not be adversely impacted by the unitrust conversion.[53] Under these circumstances, the court approved the conversion.

Used properly, the power to adjust and the unitrust conversion can aid a fiduciary in making appropriate distributions to the current beneficiaries while still preserving the corpus for the remainder beneficiaries and investing for total return in accordance with the prudent investor rule employed today.

III. COMMON GROUNDS FOR AN ALLEGATION OF FIDUCIARY LIABILITY

Fiduciaries who fail to comply with the basic fiduciary duties described above are at risk.

A. Breaches of the Duty of Loyalty

1. Overview

Many fiduciary litigation cases involve breaches of the duty of loyalty. As one commentator has noted, "[t]he duty of loyalty is . . . not the duty to resist temptation but to eliminate temptation, as the former is presumed to be impossible."[54] However, the case law indicates that eliminating all temptation is sometimes easier said than done.

Breaches of the duty of loyalty frequently involve self-dealing transactions, but breaches can take other forms as well. Oftentimes, duty of loyalty issues arise simply as a result of the settlor's choice of trustee. For example, a trustee who is also one of multiple beneficiaries may find himself/herself in a conflicted situation where the duty of loyalty may be inadvertently breached. Another common situation is where the trustee is an officer or director of a company in which the trust is invested.[55] Transactions between the trust and members of the individual trustee's family or affiliates of a corporate trustee may also give rise to a breach of the duty of loyalty.

2. "No Further Inquiry" Rule

A trustee must understand that the duty of loyalty is a rule of "uncompromising rigidity" and a breach of this duty generally cannot be overcome by any amount of good faith.[56] Rather, the New York courts apply the "no further inquiry" rule to a transaction that involves a conflict of interest between the trustee and the trust.[57] This rule prohibits a fiduciary from profiting from any self-dealing transaction entered into without prior consent or approval from a court or the trust beneficiaries.[58] Any such transaction is voidable by the beneficiaries regardless of whether the terms were reasonable or in the best interests of the beneficiaries.[59] Furthermore, the fiduciary is held per se liable simply upon a showing that the fiduciary had a personal interest in the transaction.[60] The "no further inquiry rule" applies in all self-dealing transactions and whenever the trustee's personal interests are "substantially affected."[61] Whether the transaction involved fair and reasonable terms or compensation is immaterial.[62]

3. Purchase/Sale of Trust Property To/From the Trustee

The purchase of trust assets for the fiduciary's own use or the sale of a fiduciary's own assets to the trust constitutes a breach of the duty of loyalty.[63] These types of situations involve a direct conflict of interest and should be strictly avoided.

In re Kilmer's Will is a good example of the prohibition on self-dealing and the "no further inquiry rule" in action.[64] There, the co-executors sought to sell certain commercial real

estate in order to raise case for the payment of estate taxes. Although the property had been properly appraised and marketed, the executors had only received one lowball bid. One of the executors believed that he could arrange for the property to be sold to another bidder and he offered to match the purchase price if the potential new buyer did not materialize. When the third party declined to purchase the property, the executor purchased the property from the estate in accordance with his guarantee. Later, some of the beneficiaries sought to void the transaction. Although the court found that there was "no doubt" that the sale was free of any ulterior motive, it refused to uphold the sale. The court reasoned:

> *The law does not stop to inquire whether the contract of transaction was fair or unfair. It stops the inquiry when the relation is disclosed, and sets aside the transaction or refuses to enforce it, at the instance of the party whom the fiduciary undertook to represent, without undertaking to deal with the question of abstract justice in the particular case.*

Practical Pointers: The law does not easily forgive the self-dealing trustee. The potential purchase or sale of property in which the trustee has an interest is perhaps the clearest of all self-dealing transactions.

- A fiduciary should avoid any and all situations where the fiduciary may be find itself on the other side of the table in any transaction with the trust or the estate that the fiduciary is charged with administering;
- If the fiduciary cannot be dissuaded from entering into a direct transaction with the estate or trust, full disclosure should be made and consents should be obtained from all beneficiaries; and
- The fiduciary may also seek court approval before entering into any such transaction.

4. Investment of Trust Assets in Property Owned by the Trustee

Another common situation is where the trustee invests trust assets in property that is owned by the trustee or in which the trustee or a closely related person or entity has an interest. Generally, this would be an impermissible act of self-dealing. However, the courts have held that the conflict may be waived by an express provision in the trust instrument or with the consent of the settlor or beneficiaries.

One recurring fact pattern that is often the subject of litigation is the purchase or retention of shares of the corporate fiduciary's own stock. While investment in the stock of the corporate fiduciary is generally prohibited by the duty of loyalty as it is considered to be an impermissible act of self-dealing,[65] this general rule may be overridden by a provision in the governing instrument expressly authorizing the purchase.[66]

In City Bank Farmers Trust Co. v. Cannon, the court found that the settlor's actions in approving the retention of the corporate trustee's own stock estopped the remainder beneficiaries from later objecting .[67] The facts were as follows:

In 1926, the settlor, Mary E. Cannon, created a revocable trust for her lifetime benefit and named Farmer's Loan Trust Company as trustee. Under the terms of the governing instrument, the settlor was to receive all of the trust income during her lifetime and she

retained the power to amend or revoke the trust at will. Upon her death, the remainder was to be divided into equal shares and held in further separate trusts for each of her five children.

The trust was funded with cash and securities, including 300 shares of National City Bank stock. The governing instrument authorized the trustee to retain securities for "so long as it may deem proper" and to sell and reinvest the proceeds in the trustee's discretion.

At some point during the settlor's lifetime, the trustee, Farmer's Loan and Trust, became affiliated with National City Bank and the trustee, with the settlor's knowledge and consent, exchanged the shares of National City Bank initially held in the trust for new shares which reflected the trust's interest in the newly affiliated entity. In addition, over time, the settlor approved of continued investment in National City Bank stock and resisted sales.

Many years later, the trustee sought to settle its account. The guardian ad litem for the infant remainder beneficiaries raised objections and sought to surcharge the trustee for losses incurred in connection with the retention of National City Bank stock.

The court noted that "[u]ndivided loyalty is the supreme test unlimited and unconfined by the bounds of classified transactions."[68] While the retention of the National City Bank stock might, in another case, be a breach of the duty of loyalty, in the instant case, the court held that the actions of the settlor estopped any beneficiary, including the remainder beneficiaries, from objecting to the retention of the National City Bank shares. Since the settlor had reserved the

right to "exercise all of the powers of ownership insofar as the trust was concerned," the settlor's actions in approving the exchange of the original shares in National City Bank for shares carrying a beneficial interest in the trustee and opposing any sale of the new shares estopped the remainder beneficiaries form later objecting. "The donor approved the investments and their retention in advance with full knowledge of the resulting divided loyalty and of her own power to remove the trustee or otherwise revoke or amend the trust."[69]

Practical Pointers: At a minimum, trustees who have or who are considering investing trust assets in an entity in which the trustee has an interest should tread very carefully. Before taking any further steps, the trustee should:

- Review the governing document to determine whether such investment would be permitted under the terms of the trust;
- Disclose the potential investment to the beneficiaries; and
- Obtain the written consent of the settlor (if living) and the beneficiaries or the court.
- Unless court approval was obtained, the consent of the interested parties should be periodically reviewed and ratified.
- Furthermore, the trustee should continue to monitor the investment even if judicial approval or consent has been obtained.

5. Indirect Self-Dealing

The duty of loyalty bars not only "blatant self-dealing," but also requires the trustee to avoid situations where the trustee's personal interest conflicts with the interest of the beneficiaries."[70] As noted above, a trustee is strictly prohibited from engaging in any transaction that might directly or indirectly benefit the fiduciary, directly or indirectly.[71] It is in

these "indirect" self-dealing situations that an unsuspecting fiduciary may find itself inadvertently breaching the duty of loyalty.

Matter of Rothko is illustrative.[72] When Mark Rothko, the abstract expressionist painter, died in February 1970, 798 paintings composed the primary asset of his estate. Rothko's Will was admitted to probate in April and letters testamentary were issued to three individuals, Bernard Reis, Theodoros Stamos and Morton Levine. The executors acted quickly to arrange for the sale of the paintings and, within a three week period, they contracted to sell all of the paintings to two affiliated entities, Marlborough AG and Marlborough Gallery, Inc. Pursuant to the first contract, the executors sold 100 canvases to be selected by Francis K. Lloyd (a powerful art dealer who effectively controlled both Marlborough entities) to Marlborough AG for the sum of $1.8M payable over a 12 year period of time without interest. The remaining paintings were consigned to Marlborough Gallery upon terms that were very favorable to the gallery.[73]

Rothko's daughter, Katie Rothko, brought suit to remove the executors, rescind the contracts and enjoin the galleries from selling the paintings. Joining in the petition were the guardian for Rothko's son, Christopher, and the New York Attorney General, on behalf of the Mark Rothko Foundation. They also sought damages for breach of fiduciary duties.

The Surrogate found that numerous conflicts of interests existed. First, in addition to being a co-executor of the estate, Bernard Reis was a director, secretary and treasurer of the Marlborough Gallery. The second co-executor, Theodoros Stamos, was himself an artist under contract to Marlborough who benefited personally by currying favor with Marlborough through the arrangement with the estate. Last, while the third co-executor, Morton Levine, had no direct conflicts of interest, he was not only aware of Reis' position with Marlborough but also believed Stamos was seeking personal advantage with regard to the contracts.

The court held that the executors had breached their duty of loyalty to the estate. The Surrogate's Court quoted City Bank Farmers Trust Co. v Cannon:

> *"The standard of loyalty in trust relations does not permit a trustee to create or to occupy a position in which he has interests to serve other than the interest of the trust estate. Undivided loyalty is the supreme test, unlimited and unconfined by the bounds of classified transactions."* [74]

While the executors' conduct did not amount to direct self-dealing as in the case of buying or selling estate assets directly to/from an executor, the court held that the executors had indirectly benefited themselves to be the equivalent of self-dealing. Reis had prioritized his own status and financial interests through the sales of his and his family's art collection through Marlborough over the financial interests of the estate. Stamos acted in a self-serving manner and negligently in light of his knowledge of Reis' position with Marlborough. Last Levine failed

to exercise the ordinary prudence required in the performance of the fiduciary obligations he assumed.

As the Rothko case illustrates, the fiduciary need not directly profit from a transaction in order for the court to find that the fiduciary has breached the duty of loyalty by self-dealing. Indirect benefit is sufficient grounds for a court to find a breach to have occurred.

Practical Pointers: Before engaging in any transaction with or on behalf of a trust, the fiduciary should:

- Identify any existing or potential conflicts of interest;
- Seek reasonable alternatives; and
- If no reasonable alternatives exist, seek the consent of all interested parties and/or court approval before proceeding

6. Co-Mingling Trust Property

Co-mingling trust property with the fiduciary's own property is a serious breach of the duty of loyalty and may be cause for removal of the fiduciary.

EPTL § 11-1.6(a) provides in pertinent part:

> *Every fiduciary shall keep property received as fiduciary separate from his individual property. He shall not invest or deposit such property with any corporation or other person doing business under the banking law, or with any other person or institution, in his own name, but all transactions by him affecting such property shall be in his name as fiduciary. . .*

The statute contains an exception which allows banks or trust companies to hold securities in the name of a nominee[75]

Commingling is not excused by the fiduciary's good faith or lack of intent to cause harm to the trust estate. If a trustee co-mingles trust fund with the trustee's own personal assets, the entire amount becomes subject to the trust and the beneficiary's equitable right of recovery is not destroyed, even if it becomes impossible to specifically identify the trust property.[76]

In In re Coe's Will, the Surrogate's Court noted: "EPTL § 11-1.6 makes it very clear that a fiduciary must segregate assets it holds as a fiduciary from that of its individual property."[77] Accordingly, it held that the fiduciary could not hold estate assets in an account which also included his personal property.

Practical Pointers: In order to ensure that the fiduciary does not inadvertently co-mingle estate or trust assets with the fiduciary's personal assets, the fiduciary should be certain to:

- Establish one or more dedicated investment management accounts for assets that have been transferred to the trust or the estate;
- Retitle any real estate in the name of the trust or the estate;
- Ensure that all necessary steps have been taken to transfer any interest in a closely-held companies from the name of the settlor or decedent to the trust or the estate; and
- Keep trust assets separate from the settlor or trustee's own assets.

7. Beneficiary as Trustee

Another common factor in cases involving a breach of the duty of loyalty is the interested trustee. As noted above, the duty of loyalty requires a fiduciary to act solely in the interests of the beneficiaries. But how does this duty square with a fiduciary who also has a beneficial interest in the trust?

Arguably, the settlor who has named a beneficiary as a trustee has waived any conflict of interest and has decided that "the advantages of having that person serve outweigh the risk of harm."[78] In most cases, the conflicted trustee serves without issue but "[i]n the rare case in which the conflicted trustee does seek improper advantage, the law responds by enforcing a fairness norm, derived from the duty of loyalty, called the duty of impartiality, which places the trustee 'under a duty to the successive beneficiaries to act with due regard to their respective interests.'"[79]

How and why an interested fiduciary exercises discretion is critical in determining whether a breach has occurred. In Matter of Jacob Heller, the court considered whether interested trustees were permitted to make a retroactive unitrust election which had the effect of indirectly benefitting the trustees in their position as remainder beneficiaries.[80] The trust in question was created by the settlor, Jacob Heller, for his wife, Bertha. The governing instrument provided that all income was to be distributed to Bertha during her lifetime, with

the remainder passing to his two children, Herbert and Alan. Jacob died in 1986 and following the death of the initial trustee in 1997, Herbert and Alan became successor co-trustees.

In 2003, Herbert and Alan, in their capacity as co-trustees, elected under EPTL 11-2.4 to retroactively convert the trust to a unitrust. As a result, Bertha's income dropped dramatically.[81] Bertha's daughter brought a proceeding on her mother's behalf seeking an order to annul the unitrust election and to remove the trustees. The Surrogates' Court granted a portion of the relief sought by annulling the retroactive effect of the unitrust election but denied the rest of the motion. The Appellate Division reversed that portion of the lower court ruling that annulled the retroactive application of the unitrust election and affirmed the rest of the order.

On appeal to the Court of Appeals, Bertha's daughter argued that the trustees should be barred from making the unitrust election because they were also remainder beneficiaries of the trust and that a retroactive unitrust election was improper. The Court of Appeals compared the power to adjust statute, EPTL 11-2.3(b)(5) which specifically prohibited an interested trustee from exercising the power to adjust with the unitrust statute, EPTL 11-2.4 and concluded that the legislature did not intend to prohibit interested trustees from making the unitrust election.

Determining that the interested trustees had a fiduciary obligation to protect the interest of all beneficiaries and their course of action was not prohibited by the applicable

statute, the court affirmed their action. The trustees owed fiduciary obligations not only to the income beneficiary, but to the remainder beneficiaries as well. In the court's view, the fact that the trustees' personal interests happened to align with the interests of the remainder beneficiaries did not relieve the trustees of their duties to them nor did it lead the court to the conclusion that interested trustees should be prohibited from electing unitrust treatment in all cases. Rather, the court determined that a unitrust election which directly or indirectly benefits the trustee should be scrutinized by the court, with an emphasis on the process and fairness of the trustees' election.

Practical Pointers: Beneficiaries who are also serving as fiduciaries should be especially careful in the exercise of their fiduciary duties.

- The fiduciary should read the governing instrument carefully to determine the bounds of the fiduciary's discretion. What power(s) is the interested fiduciary prohibited from exercising? Will the exercise of the power directly or indirectly benefit the fiduciary?
- The interested fiduciary should keep careful records and document the process employed with regard to both investment decisions and distribution decisions.

8. Using Trust Property to Discharge a Trustee's Personal Obligations

The use of trust assets to discharge the fiduciary's personal obligations is generally a breach of the duty of loyalty.

However, the New York courts take a nuanced view, as Matter of Wallens illustrates.[82] There, the court was called upon to consider whether the trustee breached his fiduciary duties to the beneficiary of the trust with regard to certain distributions made for the beneficiary's education and medical expenses. The facts were as follows:

In 1992, the testator, Burton Wallens, executed a Last Will and Testament that created a trust for the benefit of his granddaughter, Maggie, and named Charles Wallens, the testator's son and Maggie's father, as a co-trustee. The other co-trustee was the testator's cousin. The Will authorized the trustees to distribute income and principal for Maggie's "proper support, maintenance, education and general welfare" as the trustees deemed advisable. The trust was scheduled to terminate when Maggie reached age 30 and any remaining trust assets were to be distributed to her outright.

Several years after the Will was executed, but prior to the testator's death, Maggie's parents divorced. The separation agreement required Charles to pay for Maggie's private school and college or university tuition, as well as any of Maggie's uninsured medical and dental expenses.

The testator died in 1997. Once the trust was funded, the co-trustees made distributions from Maggie's trust to pay for her private school education expenses. By August, 2000, Maggie was residing with her father and the court relieved him from his child support

obligations and ordered that the trust be used for her college expenses. In 2003, Maggie petitioned the court to compel her father (who was by then acting as the sole trustee) to account. Maggie objected to the payment of her private school and certain health care expenses from the trust and argued that the separation agreement required her father to pay such expenses from his personal assets rather than from the trust for Maggie's benefit.

The Surrogates' Court sustained the objections with regard to the payment of her private school and certain health expenses, but rejected Maggie's objections regarding the payment of her college tuition from the trust. On appeal, the Appellate Division dismissed the objections, concluding that Maggie's father, in his capacity as trustee, did not engaged in self-dealing or a breach of his fiduciary obligations. Upon remittal the Surrogate's Court approved the accounting.

The case was appealed again and the Court of Appeals concluded that an evidentiary hearing should be held in order to determine whether Maggie's father, exercised his fiduciary discretion in good faith with respect to Maggie's interest. Although both the Appellate Division and the Court of Appeals held that the education and medical expenses at issue fell within the standards for which distributions could be made from the trust, the Court of Appeals concluded that "even when the trust instrument vests the trustee with broad discretion to make decisions regarding the distribution of trust funds, a trustee is still required to act reasonably and in good

faith in attempting to carry out the terms of the trust."[83] Because Maggie's father, as trustee, had failed to obtain court permission to distribute trust funds for her private school and health care expenses, the court ordered that a hearing be held to determine whether the expenditures were made in good faith and in furtherance of the beneficiary's best interests.

9. Excessive Compensation

Excessive compensation is another fertile ground for fiduciary litigation.

While fiduciaries are generally entitled to be compensated for their services, compensation is generally limited to such amounts as is provided by statute, in some states, or by "reasonable" compensation in others.[84] In addition, fiduciaries are also entitled to be reimbursed for expenses incurred in connection with the administration of the trust or estate. However, the taking of excessive compensation is a breach of the duty of loyalty.

A fiduciary who is performing multiple services to the estate or trust must be mindful of this rule. If the fiduciary's services overlap with one another and there are multiple layers of fees, the fiduciary may be found to be in breach. This principle is illustrated in two cases involving the estates of fairly high-profile decedents: Doris Duke and Dr. Robert Atkins.

In Matter of Duke, the court found that the individual coexecutor of the estate of Doris Duke had wasted estate assets by virtue of taking a substantial salary and "lavish fringe benefits" for his services as a "live in" employee.[85] The fiduciary in question was the

decedent's former butler, Bernard Lafferty. The court found that Lafferty lived as if the estate properties were his own, rather than as a household employee. The court found no justification for these additional payments and held that the entire arrangement amounted to self-dealing because the arrangement was authorized only by Lafferty and the co-executor who Lafferty had the power to remove and replace.[86]

Unwinding the additional compensation paid to the individual co-trustees of certain trusts created by the late famed diet doctor, Robert Atkins, was much more complicated. In Matter of Atkins, the court was called upon to consider several layers of compensation paid to the trustees for various services including (i) trustee commissions, (ii) a royalty services agreement and (iii) an employment agreement that automatically renewed every 10 years.[87]

When Dr. Atkins died in April of 2003, his estate was valued at several hundred million dollars. Shortly after his death, Dr. Atkins' widow, Veronica, became re-acquainted with D. Clive Metz, an individual who she and Dr. Atkins had met at a Caribbean hotel some years before. Metz quickly ingratiated himself, as well as two of his friends, John J. Mezzanotte (a CPA) and John P. Corrigan (an attorney/CPA), with Veronica.

Over the next few months, the parties entered into several legal, accounting and consulting agreements by which Metz and his friends proffered various services to Veronica personally and to the estate. At the same time, by August 2003, Metz, Mezzanotte and

Corrigan convinced the two fiduciaries named under Dr. Atkins' Will to resign and in early 2004, they were named as co-fiduciaries with Veronica.

Dr. Atkins' Will was silent as to trustee commissions, but did permit his fiduciaries to take "additional reasonable compensation" from the estate and trust for any special or additional services that they were called upon to provide as a result of the interest in Dr. Atkins' business. More agreements were then struck between the new fiduciaries and Veronica including a fee agreement whereby Veronica waived her share of the executors' commissions (resulting in a larger share being paid to the other fiduciaries) and a "royalty services" agreement which granted the co-fiduciaries (through their alter-ego LLC) the exclusive right to oversee Dr. Atkins' publishing and royalty for the next 10 years for a fee of $100,000/month.

For undisclosed reasons, the relationship between Veronica and the three co-fiduciaries soured. In December 2006, her three co-fiduciaries commenced an action against her for breach of the royalty services contract. Several months later, Veronica brought a proceeding in the New York Surrogate's Court seeking the removal of the co-fiduciaries pursuant to SCPA 711.

The court quickly concluded that a prima facie case had been made for removal and then turned to the question of the compensation that had been paid both in the form of trustee commissions and the various side agreements. Looking through the agreements, the

court determined that the payments were not duplicative, but rather, amounted to "triple-dipping" for the same services that should be rendered by them in their fiducary capacity.[88]

While the Atkins case is extreme, it does demonstrate the extent to which the New York courts will look through side or consulting agreements to determine whether the services purportedly provided under those agreements should be properly characterized as part of the fiduciary's duties rather than additional services.

Practical Pointers: A fiduciary who plans to offer additional services to the estate or trust would be wise to:

- Enter into a separate engagement letter detailing the scope of the additional services;
- Document the basis on which compensation is to be calculated, whether statutory or by agreement;
- If compensation is based on hourly rates, maintain separate time records for the time spent on estate or trust administration from time spent on such additional services;
- Maintain copies of any separate fee agreement and provide to beneficiaries upon request;
- Disclose any compensation paid in the trustee's annual statement to beneficiaries; and
- If additional or extraordinary services are to be performed, disclose any additional fees and obtain consent.

10. Defenses to a Breach of the Duty of Loyalty

Generally speaking, a breach of the duty of loyalty cannot be overcome by any amount of good faith on the part of the trustee.[89]

There are few circumstances under which a transaction which otherwise would constitute a breach of the duty of loyalty may be permitted: (i) the governing instrument expressly authorizes the transaction, (ii) a court has approved the transaction; or (iii) the beneficiaries have approved the transaction.[90] However, even if the beneficiaries have consented, a transaction involving self-dealing is voidable if the trustee failed to disclose material facts which the trustee knew or should have known induced the beneficiaries' consent or if the transaction was not fair and reasonable in all respects.[91]

11. Remedies/Damages for Breach

A transaction that has been tainted by a conflict of interest is voidable by the beneficiaries unless they have consented to the transaction. A fiduciary who is found in breach of the duty of loyalty may be forced to rescind the transaction or may be charged for the loss or depreciation in value of trust assets resulting from the breach or for any profits made by the fiduciary that would not have otherwise been made.[92]

B. Breaches of the Duty of Care

1. Negligence in the Investment/Sale of Trust Property

Negligence on the part of the fiduciary may also be grounds for finding a breach of the duty of care. One example is where a fiduciary sells trust or estate property without doing his/her due diligence.

In Matter of Billmyer, the court found an executor who sold the decedent's Brooklyn brownstone valued at appx. $1.5M at a price that was far below market value to have breached his fiduciary obligations.[93] The case arose in the context of the settlement of the executor's final account. The residuary beneficiaries and the NYS Attorney General, as representative of the charitable beneficiaries under the decedent's Will, objected to the account on the basis that the executor was negligent in selling the property at below-market value.

Upon review, the court found that the executor was negligent in several regards: (i) he failed to obtain an appraisal of the property to determine the fair market value, (ii) he hired a real estate agent who was unfamiliar with the area and who failed to actively market the property and (iii) he had no explanation for the subsequent sale of the property for a much higher price.

The court noted that "[a] fiduciary acting on behalf of an estate is required to employ such diligence and prudence to the care and management of the estate assets and affairs as

would prudent persons of discretion and intelligence in their own like affairs."[94] To that end, the executor was required to use good business judgment and was subject to surcharge if the executor acted negligently and imprudently.[95] Finding that the executor was indeed negligent and in breach of his fiduciary obligations to the beneficiaries, the court upheld the ruling of the Surrogate's Court imposing 6% interest upon the surcharge.

Practical Pointers: With regard to the sale or purchase of any property, the trustee should:

- Obtain independent valuations of any closely held, real estate or tangible personal property;
- Gather several (ideally three) independent proposals from any brokers or agents required to sell the property;
- Periodically review the marketing and sales efforts of the agent; and
- Monitor compensation and commission expenses

2. Improper Delegation to Co-Fiduciaries

Another breach of the duty of care, as well as the duty of loyalty, is where the fiduciary has improperly delegated the investment or management of the trust or estate to a co-fiduciary or third party.

Although some jurisdictions, such as Delaware, have adopted statutes allowing for the bifurcation of fiduciary duties between multiple trustees, New York has not yet adopted such a rule. Rather under New York law, unless otherwise specified by the governing instrument, co-fiduciaries must act jointly or, if there are three or more fiduciaries, by majority.[96] If a fiduciary

has reason to know of a co-fiduciary's acts and has assented to or acquiesced in them, the fiduciary is bound by those acts and is jointly liable for them.[97]

A fiduciary who fails to act, due to absence or disability, or a dissenting fiduciary who joins in carrying out the decision of the others and who has promptly expressed his dissent to the co-fiduciaries in writing is protected from liability for the consequences of the majority decision.[98] Likewise, a fiduciary will not be held liable for the actions of another fiduciary if even the exercise of prudent behavior would not have raised any suspicion as to the imprudent or improper acts of the other fiduciary.[99]

However, the law does not protect a fiduciary who has essentially abdicated responsibility to one or more co-fiduciaries.

In Matter of Goldstick, the court was called upon to consider whether a "passive" co-trustee should be surcharged and made to forfeit commissions as a result of the actions of the other co-trustee. The case arose from a proceeding for the settlement of the final account of David Goldstick and Florence Levine, co-trustee of a testamentary and several intervivos trusts created by the late Martin Tananbaum for the benefit of his daughters, Minnie and Barbara. Among other transgressions, the facts indicated that Goldstick had invested over $181,000 of trust funds in various real estate partnerships in which he and certain related parties already had substantial interests. Eventually, these investments yielded over $2,500,000 in profits for

Goldstick and over $160,000 in profits for the trusts. The Surrogate's Court determined that all of the profits were realized in part from self-dealing and surcharged the trustees the full amount realized by Goldstick in both profits and fees.

The Appellate Division overturned the measure of damages but undertook an informative analysis of the responsibility of Levine, as co-trustee. Noting first that a trustee may delegate particular functions to a co-trustee, particularly if the other trustee has special skills or expertise, the court observed that the right to delegate does not permit a trustee to abdicate responsibility to be personally active in the trust administration."[100] The court found that Levine had "shirked her fiduciary responsibility' by deferring absolutely to Goldstick with regard to the real estate investments.

The court then turned to the appropriate measure of damages. The court observed that the general rule under New York law is that a fiduciary is held as much accountable for damages to the trust caused by the fiduciary's negligent inaction as for affirmative wrongdoing.[101]

C. Investment Issues

Investment issues can pose a virtual minefield of risk for the trustee.

1. Standard of Conduct

As noted above, the Prudent Investor Rule requires a standard of conduct from the trustee, not a particular outcome or performance.[102] In determining whether a trustee has

breached the duty to prudently invest trust assets, the court should not review each act in hindsight, but rather, must examine the fiduciary's conduct over the entire course of the investment.[103]

It is important to note that the Prudent Investor Rule is a default rule which may be expanded, modified or eliminated by the terms of the governing instrument.[104] "A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust."[105] However, there is limited protection for a fiduciary who fails to comply with the general duty of due care when investing trust assets or who mishandles concentrated positions.

2. Diversification Cases

Diversification of investments is a key component to the Prudent Investor Rule. Under the New York statute, a trustee must diversify assets "unless the trustee reasonably determines that it is in the interests of the beneficiaries not to diversify, taking into account the purposes and terms and provisions of the governing instrument."[106] The Restatement (Third) and UPIA take similar approaches.[107] In light of the fact that many trusts are funded with a combination of cash, securities and other assets held by the settlor, the trustee is given a reasonable amount of time to review the funding assets and make decisions regarding the retention or sale of trust assets.[108]

Many fiduciary litigation cases involve allegations that the trustee breached the duty to prudently invest trust assets because the trustee failed to diversify the trust portfolio. While some states, such as Delaware, have adopted statutes which specifically provide that the duty to diversify may be waived by express language in the trust instrument, New York does not offer such protection. Despite that fact, many trust instruments governed by New York law include provisions which direct or authorize a trustee to retain particular investments.

a) Diversification Required

In determining whether a fiduciary has acted prudently with regard to the retention of a concentrated position, the courts look at the totality of circumstances.

In Matter of Janes, the New York Court of Appeals held that a trustee was negligent in failing to diversify a concentrated position in Kodak stock.[109] As the facts indicated, the trustee fell down in a number of regards.

Janes involved several trusts created under the Will of Rodney B. Janes, a former NYS Senator and businessman, for the benefit of his wife, Cynthia and certain charities.[110] When the decedent passed away in 1973, over 70% of his estate consisted of 13,232 shares of Kodak stock, then valued at approximately $135 per share. By the time the trustee filed its initial accounting in 1980, the value of the stock had dropped to $47 per share. Objections to the

account were filed by the beneficiary and by the New York State Attorney General on behalf of the charitable beneficiaries.

The trustee argued that New York law did not permit a fiduciary to be surcharged for failure to diversify in the absence of additional elements of "hazard."[111] Rather, since that Kodak was a "blue chip" security, popular with many investment managers and mutual funds, a concentrated investments was, therefore, not imprudent.

The court disagreed. The court first noted that during the period in question, the New York courts followed the prudent person rule which held that "[a] fiduciary holding funds for investment may invest the same in such securities as would be acquired by prudent [persons] of discretion and intelligence in such matters who are seeking a reasonable income and the preservation of their capital."[112] Under that standard, the courts had found in many instances that a fiduciary's retention of a concentrated position was imprudent without any reference to the elements of hazard cited by the trustees.[113]

Rather, retention of Kodak stock was held to be improper for several reasons. First, the fiduciary had failed to consider the investment in relation to the entire portfolio. Second, the annual yield on the Kodak stock was barely 1% and, with Kodak stock comprising over 70% of the trust portfolio, the concentration jeopardized the interests of the income beneficiary and forced her to rely on principal invasions from another trust. Third, and perhaps most

importantly, the trustee failed to exercise due care and the skills it held itself out as possessing as corporate fiduciary. The trustee failed to establish an investment plan, failed to follow its own internal protocols and failed to conduct more than routine analysis of the Kodak concentration over a 7 year period of steady decline the stock's value.[114]

Accordingly, the Court of Appeals held that the fiduciary had acted imprudently. The stock should have been sold back in 1973 when the fiduciary had recommended that some of the shares be sold so as to raise cash for estate taxes. In light of the delay, damages were calculated by determining the value of the lost capital, plus interest.

b) Diversification Not Required

When might diversification not be appropriate?

Despite the general rule favoring diversification, a trustee need not diversify if it determines, in light of the particular facts and circumstances, that diversification is not appropriate.[115] As noted in Matter of Janes, "the very nature of the prudent person standard dictates against any absolute rule that a fiduciary's failure to diversify, in and of itself, constitutes imprudence. . ."[116]

(1) Tax Considerations

Tax considerations are an important element that the trustee must take into consideration when setting investment strategy. One example given in the UPIA as a situation

where diversification would not be required is that of a taxable trust that owns an undiversified concentration in low-basis securities. In such a case, "the tax costs of recognizing the gain may outweigh the advantages of diversifying the holding."[117] Issues which frequently arise in managing trust investments are (i) the cost/benefit of preserving the step-up in basis for low basis assets versus selling and diversifying the trust assets and (ii) the income tax status and residence of the individual beneficiaries.

Margesson v. Bank of New York is a good example of a situation where diversification was not warranted, in a large part because of the negative tax implications that ensued.[118] There, the corporate trustee diversified large positions in very low basis stocks without consulting with the sole income beneficiary and contrary to a longstanding informal understanding that the trust would be managed so as to avoid any unnecessary sales of the stock. At the time of the sale, the sole income beneficiary was 75 years old and the resulting capital gains tax liability, for which the beneficiary was left personally responsible amounted to over $22,000. Not surprisingly, the beneficiary objected and the trustee agreed to resign pending settlement of its account and allowance of commissions. The trustee commenced an accounting proceeding in the Surrogate's Court seeking approval of its account and payment of commissions and fees. The beneficiary objected and commenced a separate proceeding in the Supreme Court alleging that the trustee had breached its fiduciary duty and engaged in negligence and conversion. The matters were ultimately consolidated and the Supreme Court

granted the trustee's motion for summary judgment on the settlement of its account and payment of commissions and fees.

On appeal, the court considered whether the trustee had acted prudently with regard to the sale of the stock. The court noted that, prior to the sale in question, there had been a diversification plan set forth which limited sales to "odd lots" of appreciated securities, presumably in an effort to minimize the capital gains tax impact on the trust. The court also noted that the beneficiary had not been consulted prior to the sale and learned about the sale when his accountant received a year-end tax statement from the trustee. Furthermore, despite the trustee's duty to communicate, neither the trust officer nor the portfolio manager consulted with the beneficiary prior to the sale. Accordingly, the appellate court held that the lower court erred in granting the motion for summary judgement.

(2) Closely Held Business

When else might diversification not be required? A trust which holds an interest in a family business that the family wishes to control is another situation where the duty to diversify can be overridden by other purposes of the trust.[119]

In Matter of Hyde, the New York court affirmed the decision of the trustees to retain a concentrated position in a closely held company with an unusual capital structure.[120] The trusts in question were established by two sisters and the primary asset of the trusts consisted of

interests in family company. The trust instruments gave the trustees full discretion but were silent as to whether the trustees should invest in or retain shares of the company. About 20 years after the trusts were funded, the trustee sought approval of its accounting. The beneficiaries objected and argued that the trustee had breached its fiduciary duty by failing to diversify the trust assets.

The trustee alleged, and several industry experts testified, that there was no market for the stock. Because the company was a closely held corporation with an unusual capital structure, there was a very limited market of potential buyers. Additionally, the trustee had determined that diversification was not warranted given the general economic situation, the expected tax consequences and the needs to the beneficiaries. The stock paid out a significant dividend which was not easily replaced and the capital gains tax cost of diversification outweighed the benefits of sale. Last, the trustee had considered the settlors' intention in keeping the stock in the family.

3. Effect of Retention Clauses

Can a fiduciary rely on a retention clause contained in the governing instrument? The answer is "it depends." Far from being a blanket protection against liability for retaining an investment, the New York courts have stated that "a retention clause almost requires a greater level of diligence and work."[121] Mandatory, and not precatory, language is critical.[122]

In In re Charles G. Dumont, the court held that the corporate trustee erred in relying on a retention clause authorizing the retention of Kodak stock.[123] The retention clause in question provided:

> *"It is my desire and hope that said stock [Kodak] will be held by my said executors and by my trustee to be distributed to the ultimate beneficiaries under this will, and neither my executors nor my said trustee shall dispose of such stock for the purpose of diversification of investment and neither they nor it shall be held liable for any diminution in the value of such stock."*

The governing instrument further provided:

> *"The foregoing shall not prevent my said executors or my said trustee from disposing of all or part of the stock of Kodak in case there shall be some compelling reason other than diversification of investment for doing so . . . . The foregoing provisions shall not prevent my said Executors or my said Trustee from disposing of all or part of the stock of Eastman Kodak Company in case there shall be some compelling reason other than diversification of investment for doing so."*

The corporate trustee, JP Morgan Chase, maintained the investment in Kodak stock from 1958 to 2001 when it embarked on diversification plan. Meanwhile, the beneficiaries objected to the accounting filed by the trustees alleging breach of fiduciary duty following steep declines in the stock's value.

The facts indicated that the trustee never questioned whether the retention clause was fully binding on the trustee such that it prohibited sale, nor did it consider what might constitute a "compelling reason" for sale.

In the court's view, it is incumbent upon a fiduciary who is acting under the directives of a retention clause to develop a "uniform understanding of the testator's words," based on the input of experienced professionals and in-house legal counsel. "It is also critical that the fiduciary's actions reflect an understanding that a retention clause does not exculpate itself from poor judgment and laziness. . ."

Turning to the matter at hand, the court then examined the trustee's processes around the administration of the trust, the interpretation of the trust terms, communication with the beneficiaries and the ultimate decision to retain the stock in light of the specific circumstances. It found that the trustee did not have a uniform process for interpreting trust instruments, did not engage in conversations with the beneficiary to determine her financial needs, and that the various trust officers who managed the account did not have a consistent understanding of the effect of the retention clause.

Ultimately, the court found that the trustee's internal processes to be lacking and that the trustee's failure to communicate with the beneficiaries and to consider their income needs "directly caused [the trustee] to avoid selling the stock despite a compelling reason for sale."

4. Consent of Settlor and/or Beneficiaries as Bar to Cause of Action

The consent of the settlor and the beneficiaries, either expressly or impliedly, may be a far better protection to a trustee who decides to retain a concentrated investment. A number

of cases, including City Bank Farmers Trust Co v. Cannon, discussed above, have held that the consent of the settlor to certain actions serves as a bar to objections from a remainder beneficiary. For example, in Central Hanover Bank Trust Co. v. Russell, the New York court held that the settlor of a trust who retained a testamentary power of appointment over the remainder and who had approved trust investments in the stock of the corporate fiduciary precluded the remainder beneficiaries from objecting to such investments.[124] Likewise, the consent of the beneficiaries will also preclude them from later objecting to actions that they had previously approved. In Matter of Bloomingdale, the court held that the remainder beneficiaries/co-trustees could not object to the retention of concentrated positions in certain stocks during the period of time that they served as co-trustees with a third party, independent trustee.[125] However, since silence does not equate with consent, a triable issue of fact existed as to whether they were estopped from objecting to the retention of the stock during the period of time which preceded their appointments as co-trustees.

D. Difficulties with Discretion

A trustee's exercise of discretion, particularly with regard to distribution decisions, is a frequent source of conflict and potential litigation.

1. Determination of Settlor's Intent

The first step in properly exercising discretion is for a trustee to develop an understanding of the settlor's intent. The trustee must act "in a state of mind contemplated by the settlor."[126] If the settlor's intent is unclear, the courts traditionally have looked to the four corners of the governing instrument. [127] Although both the UTC and the Restatement Third of Property (Wills and Donative Intent) would allow for the consideration of extrinsic evidence to determine the settlor's intent, the New York courts adhere to the traditional approach. As succinctly stated by the New York Court of Appeals, "'the trust instrument is to be construed as written and the settlor's intention determined solely from the unambiguous language of the instrument itself.'"[128]

2. Judicial Review

The courts are generally reluctant to interfere in a trustee's exercise of a discretionary power when that exercise is reasonable and based on a proper interpretation of the terms of the trust.[129] Rather, a discretionary power is subject to judicial control only to prevent misinterpretation or an abuse of discretion by the trustee.[130]

On the other hand, a court will not permit abuse of discretion by the trustee. What constitutes an abuse of discretion? While there is no hard and fast rule, it depends upon the

purposes and terms of the trust, the standards imposed and the extent of the discretion conferred upon the trustee.[131]

3. Understanding Common Discretionary Standards

With regard to distribution authority, it is critical that the trustee have a clear understanding of the trust's dispositive terms, and whether, or the extent to which, they confer discretionary authority to the trustee.

a) Mandatory Distributions

Trusts with mandatory distribution requirements, such as a trust that calls for the distribution of all net income or a fixed percentage of the trust assets, may be the most straightforward for the trustee to administer from a dispositive standpoint. Trusts which would employ mandatory distribution standards include marital deduction (QTIP) trusts and charitable lead or remainder trusts. It is less common to see mandatory distribution requirements in sprinkle or dynasty trust because such trusts are generally designed with maximum flexibility in mind.

b) Trusts with Ascertainable Standards

Many trusts authorize distributions for "health, education, maintenance and support." These ascertainable standards are often used by settlors to ensure that the beneficiaries' needs are met but in practice, may not give the trustee (or the beneficiaries) a clear enough picture of

the settlor's intent. These four seemingly magic words are derived from the Internal Revenue Code sections 2041 and 2514 and have become so commonplace that they are often referred to as a "HEMS" standard. This language is generally interpreted as allowing the trustee to distribute such funds as are needed for a beneficiary's reasonable expenses.

Traditionally, depending on the precise language used in the governing instrument, trusts with ascertainable standards could be construed as either "discretionary" trusts or "support" trusts. The Restatement (Second) of Trusts describes a "discretionary" trust as one in which "the trustee shall pay to or apply for a beneficiary only so much of the income and principal or either as the trustee in his uncontrolled discretion shall see fit to pay or apply."[132] Neither the beneficiary nor a creditor of the beneficiary may compel the trustee to make a payment from the trust to or on the beneficiary's behalf. Conversely, the Restatement (Second) of Trusts describes a "support" trust as one in which the trustee shall pay or apply only so much of the income [or principal] as is necessary for the education or support of a beneficiary."[133]

A pure "support" trust, where the trustee is directed to distribute so much as is needed for the beneficiary's support in his/her accustomed standard of living, may also limit the trustee's discretion to determine whether a beneficiary's expenses are proper.[134] Today, the

UTC and the Restatement (Third) have eliminated this distinction and treat the latter as discretionary trusts with a standard.

c) Supplemental Language

Sometimes, an ascertainable standard will be supplemented or modified by language referring to a beneficiary's "lifestyle" or "standard of living". While the settlor's intent may be simply to ensure that the beneficiaries will be able to enjoy the same standard of living that they enjoyed during the settlor's lifetime, such language can prove problematic. However, however "there is little uniformity between, or even within, jurisdictions" as to how those standards are interpreted and enforced.[135] In the context of a pot or sprinkle trust with multiple beneficiaries, a so-called "ascertainable standard" may be challenging because beneficiaries may choose to live different lifestyles and lifestyles may change over time.

d) Health and Education

The terms "health" and "education" can pose special difficulties for trustees, particularly those who are managing a trust for multiple beneficiaries. While there is a fair amount of precedent where courts have been called upon to interpret the terms "maintenance and support", the question of how "health" and "education" are to be interpreted is less clear. A fiduciary may find itself at odds with a beneficiary over the settlor's intent.

4. Purely Discretionary Trusts

Last, purely discretionary trusts, where the trustee is authorized – but not required – to make distributions to beneficiaries in the trustee's "sole discretion," can provide the most flexibility, but they also can cause the most friction among multiple beneficiaries. A trustee who is granted "sole" or "absolute" discretion must exercise that power "in good faith and in accordance with the terms and purposes of the trust and in the interests of the beneficiaries."[136]

5. Consideration of Other Resources

One common conflict that trustees encounter in exercising discretionary distribution authority is whether or not the trustee should consider the beneficiaries' other resources. This question frequently arises when the interests of the various beneficiaries are not aligned or where some beneficiaries may take issue with an extravagant lifestyle chosen by other beneficiaries. If the trustee chooses to not consider outside resources, the other current beneficiaries and remaindermen may be disadvantaged, whereas if the trustee does take a beneficiary's own assets into account, the other beneficiaries are benefited.[137]

If the governing instrument directs the trustee to consider a beneficiary's other income and outside resources, or, similarly, expressly prohibits a trustee from doing so, the trustee's

course of action is relatively clear. One the other hand, if the trust instrument is silent, the trustee is placed between a rock and hard place.

There are three different schools of thought as to whether the trustee should consider a beneficiary's income and outside resources when the trust instrument is silent: (i) the trustee is must not consider other resources, (ii) the trustee must consider other resources, and (iii) the trustee may consider other resources in the trustee's discretion.[138] However, there is inconsistency across the country and even within the same jurisdictions as to whether a trustee should or should not consider a beneficiary's other resources in exercising discretionary distribution authority.[139]

6. Unequal Distributions

Provisions authorizing unequal distributions may also prove challenging. Although authorized under the governing instrument, the beneficiaries themselves may take issue with potentially receiving less than another beneficiary who has different financial needs. Although the duty of a trustee to treat beneficiaries impartially does not necessarily mean that beneficiaries should be treated "equally", that can become a sore point in managing the trust. A trustee should be very clear in communicating to the beneficiaries what the distribution standards are and some of the factors that the trustee considers in making those discretionary distribution decisions.

Even when the purpose for which distributions are to be made is clearly expressed and understood by all beneficiaries, differences in ages amongst a large class can result in unequal distributions simply because of rising costs. For example, managing an education trust designed for the collective benefit of the settlor's grandchildren can be particularly tricky. Although the settlor's intent may have been simple – for example, provide for all grandchildren's education costs – in all likelihood, the trustee will be faced with challenging differences such as: how to manage distributions in the face of increasing costs, scholarship opportunities, choice between higher and lower priced schools, and beneficiaries who either choose not to pursue higher education or are a "perpetual student."

7. Process and Procedures

A fiduciary who adopts a clear process and consistent procedures with regard to the exercise of discretion may be protected from fiduciary liability.

In In Matter of JP Morgan Chase Bank (Mark C.H.), the court faulted the corporate trustee for failing to exercise even a reasonable degree of diligence with respect to needs of the beneficiary, a disabled individual.[140] That the beneficiary was significantly disabled and that the settlor had created the trust for the purpose of enhancing his quality of life was abundantly clear. The governing instrument granted the trustees absolute discretion to distribute income and/or principal to the primary beneficiary and his descendants and further specified that the

trustees could pay any income not applied for the primary beneficiary's direct benefit "to any facility he may be residing in and/or to any organization where he may be a client or a participant in any program(s)."[141] The court concluded that that provision reflected both the importance of the primary beneficiary's quality of life to the settlor and the minimum amount of knowledge that the settlor expected the trustee to have.

Communication and knowledge about the beneficiary's circumstances was critical in the prudent exercise of the trustee's discretionary distribution powers. However, the trustee had no process in place to determine what the beneficiary's needs were met. Rather, the trustee was completely inactive in that regard. The court stated that "[i]t is not sufficient for the trustees to simply safeguard the [trust's] assets; instead, the trustees have a duty to [the primary beneficiary] to inquire into his condition and to apply trust income to improving it."[142] Noting that the trustee had failed to keep informed about the beneficiary's needs and had left him to languish in untenable circumstances despite the fact that the trust had sufficient assets to support him, the court ordered a full accounting.

Practical Pointers: Corporate fiduciaries have robust processes around the exercise of discretionary distribution powers. Prior to exercising discretion, a fiduciary might:

- Review the terms of the governing instrument and the standards for which discretion can be exercised. Do not rely on memory or on a trust summary – go back to the source;

- Consider the size of the trust, the yield, other planned or recurring distributions and prior invasions of trust principal;
- Request a budget and other financial information from the beneficiary; and
- If the distribution is for a particular purpose, obtain documentation about the planned expense.

E. Failures to Communicate

As the cases selected above indicate, many fiduciary litigation cases involve some degree of a failure to communicate. As noted above, a trustee has a duty to provide trust beneficiaries with information about a trust that is sufficient for them to protect their interests. At the same time, the trustee also has a duty of confidentiality to keep financial and other personal information about the beneficiaries private. From a fiduciary risk perspective, the provision of information to beneficiaries tends to benefit the fiduciary.[143]

Multiple beneficiaries with concurrent interests are all entitled to information and the provision of this information may cause conflict between the trustee and the beneficiaries or amongst the beneficiaries themselves. Oftentimes, the settlor or older generation beneficiaries will wish to limit the information provided to younger generation beneficiaries but the governing instrument does not relieve the trustee from the duty of disclosure.[144] It is also very common for one beneficiary to appoint himself or herself as the "family spokesperson" who acts as a gatekeeper to the flow of information to and from the beneficiaries.

1. Selective Provision of Information

McNeil v. McNeil is a critical case in understanding a trustee's duty to provide information to *all* of the beneficiaries of a sprinkle trust.[145] While the case was decided in Delaware, it nevertheless is informative for trustees in other jurisdictions. There, the trustees were found to have breached their fiduciary duties by failing to advise the settlor's children that they were actually *current* beneficiaries and not just *remainder* beneficiaries as they had mistakenly been led to believe. Furthermore, the trustees were also in breach for having failed to disclose vital information about the trust to one of the current beneficiaries, even when a specific request for information was made. Last, the facts indicated that [one of the trustees] acted as a conduit for information.

2. Failure to Stay Informed About a Beneficiary's Needs

Many of the cases cited above all involve a breakdown of communication between the trustee and the beneficiary. In Dumont, the trustee was faulted for failing to inquire about the current beneficiary's needs for liquidity or income from the trust.[146] In Matter of JP Morgan Chase Bank (Mark C.H.), the corporate trustee failed to develop an understanding of the beneficiary's living situation and needs.[147]

As noted above, a trust is a fiduciary *relationship*. Communication is a vital element to any healthy intra-personal relationship and that is true with regard to fiduciary relationships as well.

3. Silent Trusts?

Can the settlor relieve the trustees from the duty to provide information to beneficiaries under New York law? The answer at this point is "no". In In Matter of JP Morgan Chase Bank (Mark C.H.), the Surrogate's Court held that a provision in a trust instrument which purported to absolve the trustees from the duty to account (other than a final account) violated public policy and could not be enforced.[148]

4. Communication in Action

What does this all mean in practice? Put very simply, unless the governing instrument provides to the contrary, the beneficiaries are entitled to know about the existence of the trust, to examine the trust property and the accounts and statements related to the trust. [149] While the trustee may find itself under pressure to comply with the desires of the settlor or certain beneficiaries to limit the flow of information, a failure to provide basic information to all beneficiaries who are entitled to such information may lead to a breach. "Even in the absence of a request for information, a trustee must communicate essential facts such as the existence

of the basic terms of the trust. That a person is a current beneficiary of a trust is indeed an essential fact."[150]

Practical Pointers: In order to ensure that the duty to provide information is met, a trustee should:

- Carefully review the governing instrument to determine which beneficiaries have a present right to information about the trust;
- Schedule regular in-person and telephone meetings with the beneficiaries;
- Ensure that all current beneficiaries receive account statements at least annually;
- Maintain current contact information for all beneficiaries and review and update at least annually;
- Maintain a family tree with date of births for all beneficiaries and review and updated annually to ensure that any beneficiary who is no longer a minor receives the information they are entitled to; and
- Document all communications.

F. Effect of Exoneration Clauses

Exoneration clauses are designed to insulate fiduciaries from liability stemming from the failure to exercise reasonable care, diligence or prudence and are not looked upon favorably in New York. The rationale for this view was summarized by the court in Estate of Stralem as follows:

> *"The increasing practice of testamentary draftsmen and corporate fiduciaries in vesting in testamentary fiduciaries almost unlimited powers with a minimum of obligations, is a serious potential menace not only to the rights of a surviving spouse but of the children and other dependents of the testator and of all persons interested in estates. This tendency must be curbed. The primary duties of ordinary care, diligence and*

> *prudence (King v. Talbot, 40 N.Y. 76) and of absolute impartiality among the several beneficiaries (Matter of Stutzer, 156 Misc. 684, 282 N.Y.S. 311) are of the very essence of a trust, and any impairment of these or similar obligations of a fiduciary are contrary to public policy."*[151]

Under New York law, any attempt to exonerate a fiduciary under a testamentary instrument is void as against public policy.[152] EPTL § 11-1.7(a)(1) generally prohibits a testator from exculpating a fiduciary under a Will or codicil from liability for failing to exercise "reasonable care, diligence and prudence."[153]

For many years, there was uncertainty as to whether this general prohibition against exoneration clauses included in testamentary instruments also extended to similar provisions contained in inter-vivos instruments. Because there was no statutory provision addressing the enforcability of exoneration clauses in inter-vivos trusts, the courts in New York reached "divergent views."[154] In Matter of Shore, the court held that the bank on exoneration clauses applied to lifetime trusts.[155] A contrary decision was reached in Matter of HSBC (Knox).[156] Recently, the statute was amended so as to also provide that exoneration clauses contained in lifetime trusts executed are also void as against public policy.

IV. CONCLUSION

What steps can a fiduciary take to protect himself/herself from liability? As noted above, the first step is to develop a deep understanding of the very particular duties imposed upon fiduciaries and how those duties relate to the particular trust or estate at hand.

A few lessons from a corporate fiduciary may be helpful:

1. Understand What You are Getting Into: Corporate fiduciaries often go through an extensive review of the potential situation before accepting an appointment as trustee. This review typically includes:

   a. Know Your Customer review of all interested parties
   b. Review of governing instrument
   c. Review of prior administrative history
   d. Review of all trust assets
      i. Particular attention is paid to special assets such as oil and gas interests, closely held companies, low-basis investments and concentrated positions.
      ii. Concentrations (usually defined as positions exceeding 10%) are considered very carefully. If the trust holds a concentrated position, the fiduciary should develop and implement a plan of diversification that meets with the goals and purposes of the trust and the overall needs of the beneficiaries.
      iii. To the extent possible, a corporate fiduciary will want to develop an understanding about the settlor and/or beneficiaries' intention around any specialty assets before the fiduciary appointment is accepted.

2. Develop and Implement Consistent Processes: Assume that everything you have done will be questioned by people and/or courts who will not take your word for anything.

a. Your process needs to be (and appear to be) reasonable, and it needs to be documented.

b. Corporate trustees usually have a certain amount of "automatic" process built into the way they conduct their fiduciary business including committees, business records, etc.

c. Non-professional fiduciaries need to be able to show:

i. Why did you handle things a certain way?

ii. How often did you re-visit major issues of trust administration and investing?

iii. Did you engage professionals when appropriate?

iv. Did you check in with beneficiaries in a way that most beneficiaries would consider reasonable? (There will always be some beneficiaries who are simply unreasonable by usual standards.)

d. If concerns were raised, how did you deal with them?

e. Even if you are not getting formal releases or accounting settlements along the way, being able to show that you stayed in touch with beneficiaries

about how the trust was being administered and responded respectfully when they raised concerns can be helpful if you end up in an adversarial situation.

3. Understand the Governing Instrument and Clarify Inconsistencies*:* A trustee who fails to fully understand the terms of the governing instrument and to clarify any inconsistencies or ambiguous terms may be faulted for failing to address these issues.

   a. Examine all provisions relating to the relative interests of the beneficiaries, the distribution standards and the rights of the various beneficiaries to receive information about the trust.

   b. Written trust summaries can be very helpful as a reference point, but the trustee should always review the governing instrument itself when questions arise.

4. Maintain balance among beneficiaries: To the consternation of many beneficiaries, the term "balance" does not mean "equality." There are several things that a trustee might do to ensure that the interests of one beneficiary or class of beneficiaries do not unduly take precedence over the others:

   a. Keep a running tally of distributions made to the various beneficiaries. Not only would such a ledger enable a trustee to maintain a sense of whether the beneficiaries are being treated roughly equally (if that is consistent with the

settlor's intent), it may also help a trustee to identify a quiet beneficiary who asks for little and whose interests may be easily overlooked.

b. If the trust instrument calls for equalizing distributions prior to the distribution of principal at the termination of the trust, determine whether periodic "catch-up" distributions are appropriate during the term.

5. Practice Consistent Communication: Proactively communicate with all of the beneficiaries.

a. Schedule regular meetings

b. Ensure that statements and other critical information is sent to all beneficiaries who are then entitled to such information.

c. Don't let the squeaky wheel get the grease or the self-appointed family spokesperson speak for all other beneficiaries. Do not communicate with adult beneficiaries through their parents and, last don't assume that silence means assent.

6. Document all trust administration activity: Maintaining a written record of all trust administration activity is critical.

a. Retain copies of all trust statements, tax returns and other critical information.

b. Keep a record of both decisions to grant a beneficiary's request as well as decisions to deny a request. Any underlying information that the trustee considered should be kept as well.

c. Document investment decisions affecting the trust including investment strategy or asset allocation decisions, the selection of individual investment solutions and any communication with the portfolio manager.

d. Last, maintain copies of all relevant communications with trust beneficiaries.

7. Consider Interim Accountings: While periodic accountings are not required by law in New York, a trustee might wish to render periodic informal accounts to the trust beneficiaries as a way of limiting future liability.

8. Know When to Step Aside and/or to Call Outside Counsel: Relationships change over time. At some point, the interests of the beneficiaries may best be served by the trustee's resignation. If contentious issues arise, the trustee should speak with their outside counsel to determine what steps should be taken to protect the trustee.

[1] Elisa Shevlin Rizzo is a Senior Vice President, Senior Legal Counsel and Senior Fiduciary Officer at The Northern Trust Company ("Northern Trust"). The views expressed are solely those of the author as of the date noted and not Northern Trust or any of its affiliates and are subject to change without notice based on market or other conditions. Portions of this outline were adapted from other material by the author. Elisa would like to gratefully acknowledge her colleagues, Susan D. Snyder and Erica Lord for generously sharing their own written work on these subjects and John Bennett and Jackie Garrod for their comments on this outline.

[2] David C. Blickenstaff, Susan D. Snyder and Erica E. Lord, *Managing Fiduciary Risk in Representing Trustees and Executors*, ACTEC HEART OF AMERICA FELLOWS INSTITUTE (Feb. 28, 2019).

[3] RESTATEMENT (THIRD) OF TRUSTS § 2 (emphasis added).

[4] Meinhard v. Salmon, 249 N.Y. 458, 463–64, 164 N.E. 545, 546 (1928).

[5] Matter of Wallens, 9 N.Y.3d 117, 877 N.E.2d 960, 847 N.Y.S.2d 147 (2007) *citing* Birnbaum v. Birnbaum, 73 N.Y.2d 461, 541 N.Y.S.2d 746 (1989) *quoting* Meinhard v. Salmon, *supra* n.4.

[6] Matter of Wallens, supra n. 5.

[7] RESTATEMENT (THIRD) OF TRUSTS § 78.

[8] Karen E. Boxx, *Of Punctilios and Paybacks: The Duty of Loyalty Under the Uniform Trust Code,* 67 Missouri L. Rev. (2002) *citing* 2A Austin Wakeman Scott & William Franklin Fratcher, THE LAW OF TRUSTS §§ 170-170.25, at 311-437 (4th ed. 1987); *see* RESTATEMENT (THIRD) OF TRUSTS § 78, cmt. c.

[9] RESTATEMENT (THIRD) OF TRUSTS § 78(3).

[10] Charles Bryan Baron, *Self Dealing Trustees and the Exoneration Clause: Can Trustees Ever Profit from Transactions Involving Trust Property?* ST. JOHNS L. REV. Vol. 72: No. 1, Article 2 (1998) available at: https://scholarship.law.stjohns.edu/lawreview/vol72/iss1/2 *quoting* In re Ryan's Will, 291 N.Y. 376, 52 N.E.2d 909 (1943).

[11] RESTATEMENT (THIRD) OF TRUSTS § 77.

[12] King v. Talbot, 40 N.Y. 76, 85–86, *quoted in* Matter of Hahn, 62 N.Y. 821, 466 N.E.2d 144 (1984), Matter of Bank of N.Y., 35 N.Y.2d 512, 518–519, 364 N.Y.S.2d 164, 323 N.E.2d 700 (1974), and Matter of Clark, 257 N.Y. 132, 136, 177 N.E. 397. *See also* Blickenstaff, Snyder and Lord, *supra* n.2 *citing* RESTATEMENT (THIRD) OF TRUSTS § 90, cmt. d.

[13] In Matter of Witherill, 37 A.D.3d 879 (3rd Dept. 2007), the court surcharged the executor of the decedent's estate who claimed to be a "skilled financial advisor" for failing to exercise the same level of diligence as would be expected of a prudent investor with special skills. *See also* RESTATEMENT (THIRD) OF TRUSTS§ 90, cmt. d.

[14] EPTL § 11-2.3(c) provides in pertinent part as follows:

Delegation of an investment or management function requires a trustee to exercise care, skill and caution in:

(A) selecting a delegee suitable to the exercise of the delegated function, taking into account the nature and value of the trust assets subject to such delegation and the expertise of the delegee;
(B) establishing the scope and terms of the delegation consistent with the purposes of the governing instrument;
(C) periodically reviewing the delegee's exercise of the delegated function and compliance with the scope and terms of the delegation; and
(D) controlling the overall cost by reason of the delegation.

[15] Matter of Goldstick, 177 A.D.2d 225, 238-239 (1st Dept. 1998) *citing* Purdy v. Lynch, 145 N.Y.462.

[16] RESTATEMENT (THIRD) TRUSTS § 79.

[17] See generally, LORING AND ROUNDS: A TRUSTEE'S HANDBOOK § 6.2.5; *see also* 3 Scott & Ascher § 17.15 and RESTATEMENT (THIRD) TRUSTS § 79 .

[18] Ira Mark Bloom and William P. LaPiana, Final Report on the EPTL-SCPA Leg. Advisory Comm. 6th Report (Jan. 27, 2016) available at www.nysba.org/FinalReport2016/ *citing* Milea v. Hugunin, 24 Misc.3d 1211(A) (Surr. Ct. 2009), In re Peabody, 198 Misc. 505, 513 (Surr. Ct. 1950) *aff'd. 277* A.D. 905 and In re Watson, 213 N.Y. 177, 183 (1914).

[19] John B. Langbein, *Questioning the Duty of Loyalty,* 114 YALE LAW JOURNAL, 929, 939 (2005) (hereinafter "Langbein, *Questioning*").

[20] For an overview of the expansion of the duty to provide information to beneficiaries, *see* Kevin D. Millard, *The Trustee's Duty to Inform and Report Under the Uniform Trust Code*¸ 40 REAL PROP., PROBATE AND TRUST JOURNAL, (Summer 2005) at 373. *See also* Langbein, *Questioning, supra* n. 19 at 949.

[21] Langbein, *Questioning,* supra n.19 at 949-950 comparing the RESTATEMENT (SECOND) OF TRUSTS § 173, cmt. d and UTC § 813(a). RESTATEMENT SECOND §173, cmt d provides "[o]rdinarily the trustee is not under a duty to the beneficiary to furnish information to him in the absence of a request for such information."

[22] Under UTC § 813(a), a trustee must "keep the qualified beneficiaries reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests." *See also* RESTATEMENT (THIRD) OF TRUSTS § 82.

[23] McNeil v. McNeil, 798 A.2d 503, 510 (Del. 2002)(exclusion of one beneficiary from information regarding the terms and operating results of sprinkle trust for the benefit of the settlor's wife, his descendants and their spouses was a breach of the trustees' fiduciary duties to *all* beneficiaries of the trust).

[24] N.Y. Surrogates Court Procedure Act ("SCPA") § 2309(4).

[25] Margaret Valentine Turano, Practice Commentaries SCPA § 2309 *citing* Matter of Kaskawitz, 25 Misc.3d 1228(A), 906 N.Y.S.2d 771 (Surr. Ct. West. Co. 2009).

[26] SCPA § 2102.

[27] RESTATEMENT (THIRD) OF TRUSTS § 78, cmt. l, cited in Blickenstaff, Snyder and Lord, *supra* n. 2.

[28] W. Brantley Phillips, Jr. *Chasing Down the Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts*, 54 WASH. & LEE L. REV. 335, 336 (1997).

[29] For a comprehensive overview of the development of the Prudent Investor Rule, *see* John H. Langbein, *The Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641 (1996) (hereinafter, "Langbein, *Prudent Investor*"). Professor Langbein describes the Uniform Prudent Investor Act as a "tightly interconnected set of reforms . . . driven by profound changes that have occurred" as a result of the development of the theory of efficient markets and modern portfolio theory. *See also* Max M. Schanzenbach and Robert M. Sitkoff, *The Prudent*

Investor Rule and Market Risk: An Empirical Analysis, JOURNAL OF EMPIRICAL LEGAL STUDIES, Vol. 14, Issue 1, 129-168, (March 2017).

[30] Uniform Prudent Investor Act (UPIA) §§ 2(b), 2(e), 3 and 9. The UPIA has been adopted in 43 states, the District of Columbia and the US Virgin Islands. For the full text of the act, go to https://www.uniformlaws.org/viewdocument/final-act-with-comments-70?CommunityKey=58f87d0a-3617-4635-a2af-9a4d02d119c9&tab=librarydocuments (site last visited 3/15/2019).

[31] UPIA § 2(a).

[32] UPIA §§ 2(a) and (b); RESTATEMENT (THIRD) OF TRUSTS § 90.

[33] UPIA § 2(b).

[34] EPTL § 11-2.3(a). The New York Prudent Investor Act applies to any investment made or held in the trust on or after 1/1/1995.

[35] EPTL § 11-2.3(b)(3)(B).

[36] RESTATEMENT (THIRD) OF TRUSTS § 90(c).

[37] Matter of Janes (Janes II), 223 A.D.2d 20, 27 (4th Dept. 1996).

[38] Matter of Donner, 82 N.Y.2d 574, 585 (1993). *See also* Matter of JP Morgan Chase Bank N.A. (Strong) 2013 N.Y. Slip Op 51946(U)(Surr Ct, Monroe Co. Nov. 26, 2013); Matter of Janes, 90 N.Y.2d 41, 659 N.Y.S.2d 165, 681 N.E.2d 332 (1997); Matter of Wellington Trusts, 165 A.D.3d 809, 813 (2nd Dept. 2018).

[39] Phillips, *supra* n. 28 at 358, comparing RESTATEMENT (SECOND) OF TRUSTS § 227, cmt. y and RESTATEMENT (THIRD) OF TRUSTS § 227, cmt. c.

[40] RESTATEMENT (THIRD) OF TRUSTS § 90, general comment (c); *see also* RESTATEMENT (THIRD) § 79, comment (b).

[41] RESTATEMENT (THIRD) OF TRUSTS § 90, general comment (c).

[42] A full discussion of the UPIA is beyond the scope of this outline. For more information, *see* Susan Porter, *Unanticipated Consequences and Fallout from Tax Planning Strategies: Emerging Issues under the Twin UPIAs:*

Uniform Prudent Investor Act: Restatement Third of Trusts and Uniform Principal and Income Act 1997, ABA JOINT FALL CLE MEETING (2008).

[43] EPTL § 11-2.3(b)(5).

[44] UPIA §§ 104(a).

[45] EPTL § 11-2.3(b)(5).

[46] EPTL § 11-2.3(b)(5)(C).

[47] EPTL 11-2.3(b)(5)(C)(i)-(v), (viii).

[48] EPTL § 11-2.3(b)(5)(C)(vi) and (vii).

[49] EPTL § 11-2.4(e)(2)(B).

[50] ETPL § 11-2.4(e)(B)(III).

[51] EPTL § 11-2.4(b)(1),(2),(3).

[52] Matter of Estate of Ives, (Surr. Ct. Broome Co. 2002).

[53] Id.

[54] Boxx, *supra* n. 8 at 280.

[55] UTC § 802.

[56] 90A C.J.S. Trusts § 335 *citing* In re Carter's Estate, 6 N.J. 426, 78 A.2d 904 (1951) and City Bank Farmers Trust Co. v. Cannon, 264 A.D. 429, 35 N.Y.S. 2d 870 (2nd Dept. 1942), *decision amended on other grounds*, 265 A.D. 863, 38 N.Y.S.2d 245 (2nd Dept. 1942) *and judgement aff'd*. 291 N.Y. 125, 51 N.E. 2d 674, 157 A.L.R. 1424 (1943).

[57] UTC § 802(b). A transaction that is affected by a conflict of interest is voidable by the beneficiary.

[58] Melanie B. Leslie, *In Defense of the No Further Inquiry Rule: A Response to Professor John Langbein*, 47 WM. & MARY L. REV. 541 (2005).

[59] Boxx, *supra* n. 8 at 282.

[60] Leslie, *supra* n. 58 at 546.

[61] Boxx, *supra* n. 8 at 282 *citing* Scott and Fratcher, §170.10 .

[62] RESTATEMENT (SECOND) OF TRUSTS § 170, cmt. f provides: "A trustee can properly purchase trust property for himself with the approval of the court. The court will permit a trustee to purchase trust property only if in its opinion such purchase is for the best interest of the beneficiary. Ordinarily the court will not permit a trustee to purchase trust property if there are other available purchasers willing to pay the same price that the trustee is willing to pay."

[63] RESTATEMENT (SECOND) OF TRUSTS § 170; RESTATEMENT (THIRD) OF TRUSTS § 78.

[64] In re Kilmer's Will, 187 Misc. 121, 61 N.Y.S. 51 (Surr. Ct. 1946).

[65] RESTATEMENT (THIRD) OF TRUSTS § 78, cmt. e(2).

[66] RESTATEMENT (SECOND) OF TRUSTS § 170, cmt. n.

[67] City Bank Farmers Trust Co. v. Cannon, *supra* n.56.

[68] Id. *citing* Meinhard v. Salmon, *supra* n.4.

[69] Id.

[70] Matter of Wallens, *supra* n.5.

[71] RESTATEMENT (THIRD) OF TRUSTS § 78, cmt. c.; Scott on Trusts § 170. *See also* John H. Langbein, *Questioning the Trust Law Duty of Loyalty*, THE YALE LAW JOURNAL, Vol. 114:929, 2005 at 931 *citing* George Gleason Bogert & George Taylor Bogert, THE LAW OF TRUSTS AND TRUSTEES §543 at 217 (rev. 2d ed. 1993); 2A Austin Wakeman Scott & William Franklin Fratcher, THE LAW OF TRUSTS §170 at 311 (4th ed. 1987).

[72] Matter of Rothko, 43 N.Y.2d 305, 401 N.Y.S.2d 449, 372 N.E.2d 291 (1977).

[73] Matter of Rothko, 84 Misc. 2d 830, 379 N.Y.S.2d 923 (Surr. Ct. NY Co. 1975). Under the second contract, up to 35 paintings could be sold per year from each of two groups, pre-1947 and post-1947 for 12 years at a price no less than the estate appraisal and the gallery would receive a 50% commission for each painting sold to a non-dealer or a 40% commission for paintings sold to or through other dealers.

[74] Id. *citing* Dutton v. Willner, 52 N.Y. 312, 318; Munson v. Syracuse G. & C. R. R. Co., 103 N.Y. 58, 74; Meinhard v. Salmon, *supra* n. 4; and Wendt v. Fischer, 243 N.Y. 439, 444.

[75] EPTL § 11-1.6(a), (b) and (c).

[76] 90A C.J.S. Trusts § 737.

[77] In re Coe's Will, 80 Misc.2d 374363 N.Y.S.2d 265 (Surr. Ct. Nassau Co. 1975).

[78] Langbein, *Questioning*, *supra* n. 19.

[79] Id.

[80] Matter of Heller, 6 N.Y. 3d 649, 816 N.Y.S.2d 403, 849 N.E.2d 262 (2006).

[81] Prior to 2001, Bertha Heller had received income distributions averaging about $190,000 per year. After the trustees made the unitrust election, her annual income dropped to about $70,000 per year.

[82] Matter of Wallens, *supra* n.5.

[83] Matter of Wallens, supra n.5 *citing* Matter of Bruches, 67 A.D.2d 456, 415 N.Y.S.2d 664 (2nd Dept.1979) and In re Abert's Estate, 118 N.Y.S.2d 864 (Sur. Ct., N.Y. County 1950).

[84] RESTATEMENT (THIRD) OF TRUSTS § 38(2).

[85] Matter of Duke, 220 A.D.2d 241, 632 N.Y.S.2d 532 (1st Dept. 1995).

[86] Id.

[87] 2010 N.Y. Misc. LEXIS 3228, 243 N.Y.L.J. 61 (March 26, 2010).

[88] Estate of Robert C. Atkins, 2010 N.Y. Misc. LEXIS 3228, 243 NYLJ 61 (March 26, 2010).

[89] 90A C.J.S. Trusts § 335 *citing* In re Carter's Estate, 6 N.J. 426, 78 A.2d 904 (1951) and City Bank Farmers Trust Co. v. Cannon, *supra* n.56

[90] RESTATEMENT (THIRD) OF TRUSTS § 78, cmt. c.

[91] Birnbaum v. Birnbaum 17 A.D.2d 409, 416 (N.Y. App. Div. 1986) citing SCOTT ON TRUSTS 170 (3rd ed. 1967).

[92] RESTATEMENT (SECOND) OF TRUSTS §§ 205, 206. *See* Matter of Witherill, *supra* n. 13; Barry L. Zins, *Trustee Liability for Breach of the Duty of Loyalty: Good Faith Inquiry and Appreciation Damages,* 49 FORDHAM L. REV. (1981).

[93] 142 A.D.3d 1000 (2nd Dept. 2016).

[94] Id. *citing* Matter of Carbone, 101 A.D.3d 866, 868 (2012); cf. Matter of Hahn, 62 N.Y.2d 821, 824 (1984) *supra* n.12 "[A] fiduciary owes a duty of undivided and undiluted loyalty to those whose interests the fiduciary is to protect" Birnbaum v Birnbaum, 73 N.Y.2d 461, 466 (1989); *see* Matter of Wallens, *supra* n.5; Matter of Schultz, 104 A.D.3d 1146, 1148 (2013).

[95] Id. citing Matter of Lovell, 23 A.D.3d 386, 387 (2005). See also Matter of Donner, 82 N.Y.2d 574 (1993), Matter of Marsh, 106 A.D.3d 1009 (2013) and Matter of Pati, 151 A.D.2d 1006 (1989).

[96] EPTL § 10-10.7.

[97] Matter of Bloomingdale, 48 A.D.3d 559 (2nd Dept. 2008) *citing* Matter of Niles, 113 N.Y. 547 (1889) and Matter of McCormick, 304 A.D.2d 759 (2003).

[98] Id.

[99] Matter of Goldstick, *supra* n. 15 *citing* Wilmerding v. McKesson, 103 N.Y.329, Matter of Halstead, 44 Misc. 176 *aff'd sub nom.* Matter of Halstead, 110 App. Div. 909 *aff'd* 184 NY 563.

[100] Matter of Goldstick, *supra* n.15.

[101] Id. *citing* Matter of Howard, 110 A.D. 61, *aff'd* 185 N.Y. 539.

[102] EPTL § 11-2.3(b); Matter of James, 90 N.Y. 2d2 41, 681 N.E.2d 332, 659 N.Y.S.2d 165 (1987) *rearg. den.*, 90 N.Y. 2d 885, 661 N.Y.S.2d 827 (1987); Matter of Wellington Trusts, *supra* n.38.

[103] EPTL § 11-2.3(b). Matter of Wellington Trusts, *supra*, n. 38.

[104] UPIA § 1(b).

[105] Id.

[106] EPTL § 11-2.3(b)(3)(C).

[107] RESTATEMENT (THIRD) OF TRUSTS § 90 provides that a trustee has an affirmative duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so. UPIA § 3 sets forth a similar rule which generally requires diversification unless the trustee "reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.

[108] UPIA § 4.

[109] Matter of Janes, *supra* n. 38. Janes was the first in a line of relatively recent cases where the courts have examined whether a trustee was negligent for failing to diversify investments. For a good summary on the lessons derived from these cases, *see* C. Raymond Radigan, *Rulings on Trustee's Duty to Diversify: What Have We Learned*, NYLJ (Sept. 12, 2011).

[110] Under the Will, 50% of the decedent's estate was to pass to a marital trust for the benefit of Cynthia, 25% of the estate was to be distributed to a charitable trust for the benefit of selected charities and the balance of the estate was to fund a second trust for Cynthia which called for income distributions to her during her lifetime with the remainder passing to charity.

[111] In the trustee's view, elements of hazard would include deficiencies in several investment quality factors including: (i) the capital structure of the company, (ii) the competency of its management, (iii) dividend history, (iv) expected future direction of the company's business, and (v) the opinion of investment bankers and analysts. Janes, *supra* n. 38 at 49.

[112] Id. at 49 citing EPTL § 11-2.2(a)(1).

[113] Id. at 50.

[114] Id. at 54.

[115] EPTL §11-2.3(a)(2)(C).

[116] Janes, *supra* n.38 at 50.

[117] UPIA § 3, comments.

[118] Margesson v. Bank of New York, 738 N.Y.S.2d 411 (3rd Dept. 2002).

[119] UPIA, § 3, comments.

[120] Matter of Hyde, 845 N.Y.S2d 833 (3rd Dept. 2007), *app. den* 881 N.E.2d 1197 (2008), *sub. app.,* 876 N.Y.S.2d 196 (3rd Dept 2009), *aff'd in part, modified in part*, 2010 NY LEXIS 1341 (June 29, 2010).

[121] In re Charles G. Dumont, 791 N.Y.S.2d 868 (2004) *rev'd on other grounds,* 809 N.Y.S.2d 360 (4th Dept. 2006) *app. den.* 813 N.Y.S.2d 689 (4th Dept. 2006) *app. den.* 855 N.E.2d (2006), *rearg. den.* 860 N.E.2d 993 (2006).

[122] RESTATEMENT (THIRD) OF TRUSTS § 228, cmt. e, f.

[123] Dumont, *supra* n. 122.

[124] Central Hanover Bank Trust Co. v. Russell, 290 N.Y. 593.

[125] Matter of Bloomingdale, 853 N.Y.S.2d 92 (App. Div. 2008).

[126] Bogert, TRUSTS AND TRUSTEES § 228 *citing* RESTATMENT (SECOND) OF TRUSTS § 187 and RESTATEMENT (THIRD) OF TRUSTS § 50(2).

[127] Pamela Lucina and John T. Walsh, *That's Not What Mom or Dad Wanted*, TRUSTS AND ESTATES MAGAZINE, (Feb.0 2016) *citing* Bank of America v. Judeine, 26 N.E.3d 555, Kristoff v. Center Bank, 985 N.E.2d 20, Eckles v. Davis, 14 S.W.3d 687, Matter of Cohorn's Estate, 622 S.W.2d 486, Kelly v. Estate of Johnson, 788 N.E.2d 933, Dennis v. Kline, 120 So.3d 11 (Fla. Dist. Ct. App. 2013), Clairmont v. Larson, 831 N.W. 388. *See also* In re Estate of Stahle, NYLJ Jan. 23, 2001, col. 32.

[128] Matter of Chase Manhattan Bank, 6 N.Y.3d 456 (Ct of Appeals 2006) quoting Mercury Bay Boating Club v San Diego Yacht Club, 76 N.Y. 2d 256 (1990). *See also* Matter of Gilbert, 39 N.Y.2d 663, 666 (1976).

[129] RESTATEMENT (THIRD) OF TRUSTS § 50(1), cmt. b. *See* Matter of Roberts, 61 N.Y.2d 782, 473 N.Y.S.2d 163, 461 N.E. 2d 300 (1984), Glenn v. Chase Lincoln First Bank, 201 A.D. 2d 908, 607 N.Y.S.2d 802 (1994).

[130] RESTATEMENT (THIRD) OF TRUSTS § 50(1).

[131] Id., cmt. b.

[132] RESTATEMENT (SECOND) OF TRUSTS § 155(1).

[133] Id.

[134] Bogert, TRUSTS AND TRUSTEES §229.

[135] Id. §228.

[136] *See* Estate of Wallens, *supra* n.5 (trustee granted broad discretion must act "reasonably and in good faith in attempting to carry out the terms of the trust").

[137] Bogert, TRUSTS AND TRUSTEES § 228.

[138] Bridget A. Logstrom Koci, *Discretionary Distributions: Trust Decanting and Consideration of a Beneficiary's Other Resources,* ACTEC FIDUCIARY LITIGATION COMMITTEE MEETING (Fall 2014).

[139] Id.

[140] In re JP Morgan Chase Bank, N.A., 38 Misc. 3d 363, 956 N.Y.S.2d 856, 2120 N.Y. Slip Op. 22387 (Surr. Ct., NY Co. 2012).

[141] Id.

[142] Id.

[143] Blickenstaff, Lord and Snyder, supra n. 2 at 3 *citing* Patricia M. Soldano and Lauren Benenati, *Millenials and the Family Office*, TRUSTS & ESTATES at 29 (Aug. 2016).

[144] Certain states, such as Delaware, do allow for "silent" trusts. A full discussion of that topic is outside the scope of this outline, but for more information, *see* Jocelyn Margolin Borowsky, William Lunger and Gregory J. Weinig,

Silence is Golden – The Best Way to Set Up a Quiet Trust, Roadmap to Navigating the Issues and Pre-Mortem Validation, 11TH ANNUAL DELAWARE TRUST CONFERENCE (October 25-26, 2016).

[145] 798 A.2d 503(Del. 2002).

[146] Matter of Dumont, *supra* n.122.

[147] Matter of JP Morgan (Mark C.H.), *supra* n. 141.

[148] Id.

[149] Charles D Fox IV and Thomas W. Abendroth, *Trustee's Duty to Account and Disclose*, AMERICAN BANKER'S ASSOCIATION BRIEFING/WEBINAR (April 5, 2018).

[150] McNeil v. McNeil, 798 A.2d 503 (2002).

[151] Estate of Stralem, 695 N.Y.S.2d 274 (Surr. Ct. Nassau Co. 1999).

[152] Estate of Stralem, *supra* n. 152 *citing* Matter of Allister, 144 Misc.2d 994, 545 N.Y.S.2d 483; Matter of Robbins, 144 Misc.2d 510, 544 N.Y.S.2d 427; Matter of Lang, 60 Misc.2d 232, 302 N.Y.S.2d 954; Matter of Lubin, 143 Misc.2d 121, 539 N.Y.S.2d 695)*;* Matter of Malasky, 290 A.D. 2d 631 (3rd Dept. 2002); Estate of Frances E. Francis, 239 N.Y.L.J. 50 (Surr. Ct. Westchester Co. 2008). For a comprehensive discussion of the history of exoneration clauses under New York law, *see* Cooper, Ilene S. and Harper, Robert M. (2012), *Incomplete Protection: Exoneration Clauses in New York Trusts in Powers of Attorney,* TOURO L. REV. Vol. 28, No. 2, Article 4, available at http://digitalcommons.tourolaw.edu/lawreview/vol28/iss2/4.

[153] EPTL §11-1.7(a)(1).

[154] NYSBA Trusts and Estates Law Section, Memorandum in Support of Proposed Legislation EPTL §11-1.7.

[155] Matter of Shore, 19 Misc.3d 663 (Surr. Ct. 2008)

[156] 98 A.D.3d 300 (4th Dept. 2012).