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Trust Building

A CPA's Guide to Serving as a Client's Trustee

So, you're a CPA and a trustee. You said, "Yes," when your client asked, "Will you serve as my successor trustee?" We don't need to belabor why you said yes or whether you regret saying yes or if your partners are happy about your decision. What's done is done. You said, "Yes, I will be your successor trustee."

Now the settlor is dead and you are the trustee. And for that you will receive treasures in heaven … and consternation here on earth, because the beneficiaries whom you serve likely don't yet trust or know you.

The disgruntled beneficiaries second-guess your every decision: to sell the apartment building or keep the apartment building; to buy stocks or to sell stocks; to make increase distributions to mom or to reduce distributions to mom. It doesn't matter what decisions you make—often, they believe they should have been the trustees and not you.

So, as a result, there's nothing you can do to make them happy.

Maybe it's good news that a trustee can only be found liable for breaching a duty of care that is owed to a beneficiary. A trustee cannot be removed from the office, surcharged or be forced to disgorge their compensation unless the beneficiary can prove the trustee has breached a duty of care. So, usually: No breach, no liability, no problem.

For CPAs who serve as trustees, adopting a simple governance process can help demonstrate they know what their duties of care are and have records that they've taken affirmative steps to fulfill these duties.

If there ever is a day when a disgruntled beneficiary comes calling with his or her legal representative claiming that you have breached your duties as a trustee, you will be prepared.

Our observation is that courts pay special deference to the trustee's decisions. The trustee's decisions "shall be conclusive" if the exercise of that discretionary power is made in good faith and according with the trustee's best judgment (*Estate of Bixby*, 55 Cal.2d 819).

So, this is easy: The court holds your decision as "conclusive" *so long as* you can prove those decisions were made in good faith and according to your best judgment—not the court's best judgment, not the beneficiary's best judgment, not the deceased settlor's best judgment—the trustee's best judgment.

> It doesn't matter what decisions you make—often, they believe they should have been the trustees and not you.

Further, your decision as trustee will not be judged in hindsight, but in the light of the facts and circumstances that existed at the time you made that decision. Only when the trustee acts intentionally with gross negligence in bad faith, or with reckless indifference to the interest of the beneficiary, will the standardized risk mitigation language included in most trust documents fail [California Probate Code (CPC) Sec. 16461]

The obvious question then: How are trustees to provide proof that their decisions, at the time they were made, were made in good faith and in their best judgment?

Easy: Write a memo. If the trustee adopts a discipline of defining why they did what they did, when they did it and provides some corroborating evidence for the basis of their decision, they greatly increase their likelihood of rebutting a "breach of duty" complaint.

A prudent trustee will develop an annual discipline of reviewing each of their duties of care and writing a memo demonstrating how they fulfilled those duties. This will enable the trustee to rebut any beneficiary's claim that they acted in bad faith or with reckless indifference to the beneficiary's interests.

To be sure, the beneficiary won't agree with your discretionary decision. That's OK.

Following is a summary of the duties of care that a trustee is obligated to fulfill under the California Prudent Investor Act (CPC secs. 16047-16052) and suggested topics that should be integrated into each memo that proves the trustee acted prudently and in good faith in the administration of the trust.

Prudently Administer

Sec.16047(a) of the CPC directs that "a trustee shall invest and manage trust assets … by considering the purposes, terms, distribution requirements, and other circumstances of the trust." A prudent fiduciary will create and maintain a "plan" that records their rationale for how the trust capital has been deployed. This memo should begin by reciting verbatim the statute noted above and the trust's purposes, terms and distribution requirements.

This first paragraph of this governance memo demonstrates that the trustee has

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recognized their duty of care: "The trustee will go on to record the size of the trusts (PV), the anticipated annual distribution from the trusts (PMT), the projected rate of return from the trust assets (I), the term of the trusts (N) and the targeted residual value of the trusts (FV). To simplify this analysis, we have provided the key items in your time value of money calculator that you need to punch to complete this analysis."

The courts recognize the trustee does not have a crystal ball and cannot accurately predict rates of return. You are obligated to exercise prudence, not be prescient. But as trustee you *do* have an obligation to use your best judgment to define these terms. You're a CPA. You know how Excel works. Make a *trust pro forma*.

Balance Risk and Return

Sec.16047(a) of the CPC directs "a trustee's investment and management decisions ... shall be considered part of an overall investment strategy having risk and return objectives reasonably suited for the trust."

A prudent fiduciary will create and maintain a document that defines the types and measures of risk that are being accepted to produce the return that the trust received. The American Law Institute identified the balancing of risk and return as the trustee's central consideration. Unfortunately, few trustees have any meaningful ways of measuring risk for trust assets.

Where investment duties have been delegated to an investment manager (in writing), a prudent trustee will require that the manager specifically define the various risks that the trust will be exposed to, how those risks will be measured and the targeted return that these risk exposures are designed to produce.

A trustee is also advised to ask that this analysis include a comparison of the portfolio's actual return to that of a blended benchmark that has an asset allocation comparable to the portfolio being managed. For assets that are illiquid or not professionally managed, a trustee will create a short inventory of the particular risk they are accepting by continuing to hold these illiquid assets.

This summary on risks that are frequently inherent with illiquid asset will include the amount of leverage being used, the lack of accurate valuation being accepted and the limitation on liquidity.

Diversify: Marketable Securities

Sec. 16048 of the CPC directs that "in making and implementing investment decisions, the trustee has a duty to diversify the investments of the trusteeship unless, under the circumstances, it is prudent not to do so."

Where the trustee has delegated investment duties to a professional investment manager the trustee need only ask, "Will you please send me a memo on your firm's letterhead that confirms that, in your professional opinion, the portfolio is reasonably diversified within the standards of Modern Portfolio Theory, with an objective of reducing or removing firm-specific risk from the portfolio?"

For trusts that cannot, or should not, be diversified (for example, by direction of a specific trust provision), the trustee will identify the rationale for *not* diversifying. A well-written memo also will argue that, though the trust is not diversified, the purposes of the trust are still able to be accomplished. The lack of diversification does not impede the trustee's ability to accomplish the trust purposes.

Suffice it to say, if you are the trustee where more than 20 percent of the trust is held in illiquid, undiversified, concentrated assets, a prudent trustee will have a series of well-argued reasons for not diversifying the trust.

Pay Fair Fees

Sec. 16050 of the CPC directs that "in investing and managing assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, overall investment strategy, purposes, and other circumstances of the trust."

In our experience the two largest fees that are charged to a trust are those incurred by hiring a professional investment manager and those paid to the trustee for their administration of the trust. A prudent trustee will conduct a simple fee study to determine whether the management fees being charged are consistent with industry standards for an account of similar size and complexity.

This study would include an analysis of the costs paid to the investment manager and fees incurred for the underlying products or separate account manager that the investment advisers have chosen to use. An additional inquiry will be made as to which fee study should be conducted which compares the compensation paid to the trustee against fees that would be charged by an institutional trust company or a professional trustee to confirm that the trustee's compensation is also within industry norms.

Prudently Select, Delegate and Monitor Agent's Activities

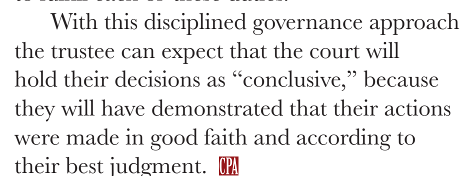
Sec. 16052(a)(1),(2),(3) of the CPC directs "the trustee shall exercise prudence in the … selecting of an agent, establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust, and periodically reviewing the agent's overall performance and compliance with the terms of the delegation."

A prudent trustee will conduct a background check of their investment manager to confirm the manager is in good standing with the regulatory agencies that oversee their activities. This investigation will take into account their industry experience, any complaints or lawsuits that have been filed against them, or any felony convictions that might put into question a high ethical standard expected of a delegate.

The trustee will also develop a document that serves as a clear delegation of investment duties, and which records the projected distributions from the trust, the targeted rate of return being pursued, a fair benchmark that the manager's activities will be compared against and the agreed upon fee the manager will be paid for providing their services.

If these five documents are created—and more important, reviewed, updated and reaffirmed each year— the trustee will have created the record that they recognize their duties of care and have taken affirmative steps to fulfill each of these duties.

With this disciplined governance approach the trustee can expect that the court will hold their decisions as "conclusive," because they will have demonstrated that their actions were made in good faith and according to their best judgment. CPA



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