The CPA and Attorney's Introduction to Serving as a Trustee

Anodos Advisors

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Are you overlooking your responsibilities as a trustee? Take a Free Assessment

Introduction

So, you're a CPA or attorney 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 and care for your widowed wife and orphaned children." 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 know or trust 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 increase distributions to mom or to reduce distributions to mom. It doesn't matter what decision you make. For the most part they believe they should have been made the trustee and not you. So as a result, there is nothing you can do to make them happy.

It is good news that the beneficiary's frustration is not the basis for the trustee's liability. A trustee can only be found liable for breaching a duty of care and 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.

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“Good Faith and Best Judgment”

CPAs or attorneys who serve as trustees should adopt a simple governance process that demonstrates that they (1) know what their duties of care are and (2) have records that they have taken affirmative steps to fulfill these duties. If there ever is a day when a disgruntled beneficiary comes calling with their over-eager legal representative claiming that you have breached your duties as a trustee, you will be prepared.

The 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 to the trustee’s best judgment. (Estate of Bixby, 55 Cal.2d 819.) This is the foundation upon which good fiduciary governance is based. The court holds your decision as "conclusive" so long as you can prove those decisions were made (1) in good faith and (2) according to your best judgment--not the court's best judgment, not the ticked off beneficiary’s best judgment, not the deceased settlor’s best judgment, but your best judgment.

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 interests of the beneficiary, will the standardized risk mitigation language included in most trust documents fail. (California Probate Code [CPC] §16461.)

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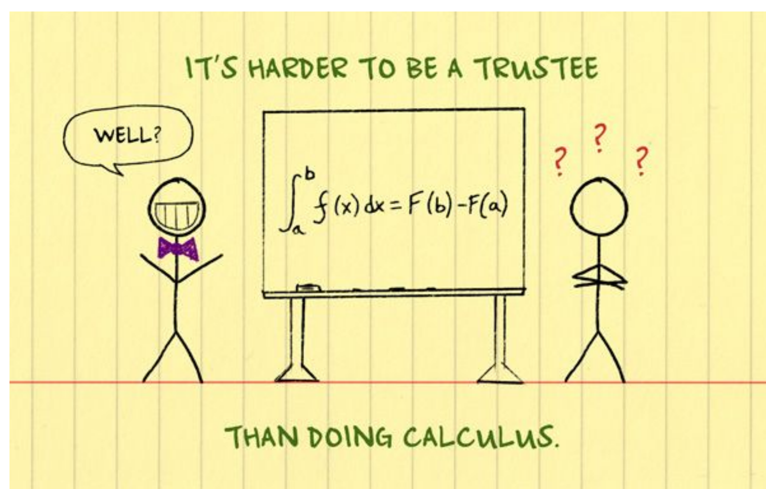
The Compliance Library

The obvious question then is, 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. A prudent trustee will adopt a discipline of defining why they did what they did, when they did it. Ideally this record will include corroborating evidence for the basis of their decision.

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 a 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 okay. There was a reason why Grandpa passed Junior over and asked you to serve as successor trustee.

Following is a summary of the duties of care that a trustee is obligated to fulfill under the California Prudent Investor Act (CPC §16047-§16052) and suggested topics that should be integrated into each memo that prove the trustee acted prudently and in good faith in the administration of the trust. (Note, though the California Probate Code language is cited throughout this document, the vast majority of states have adopted the model language from the Uniform Prudent Investor Act. If the trust is not in California, the language will be substantially similar to that which is noted here, though the statute citations will differ by state.)

Duty to Prudently Administer



Section 16047(a) of the California Probate Code directs, "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 the governance memo demonstrates that the trustee has recognized their duty of care.

The trustee will go on to record the size of the trust (PV), the anticipated annual distribution from the trust (PMT), the projected rate of return from the trust assets (I), the term of the trust (N), and the targeted residual value of the trust (FV). These are the keys that you can punch into your time value of money calculator 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 know how Excel works--make a "Trust Pro Forma".

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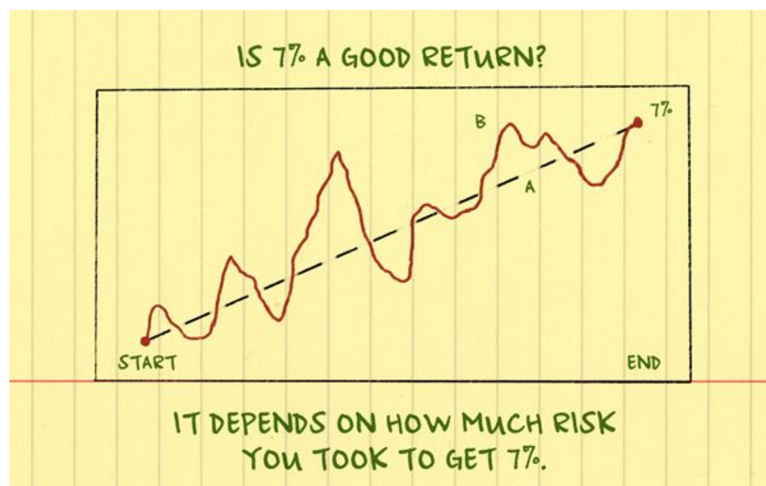
Duty to Balance Risk and Return



Section 16047(a) of the California Probate Code 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 were accepted to produce the return that the trust realized. The Uniform Law Commission identified the balancing of risk and return as the trustee's central consideration. Unfortunately, few trustees have any meaningful ways of measuring the various forms of risk that have been accepted.

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 expected 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 risks that are being accepting by continuing to hold these illiquid assets. This summary of the risks that are frequently observed with illiquid assets will include the amount of leverage being used, the lack of accurate valuation being accepted and the limitation on liquidity.

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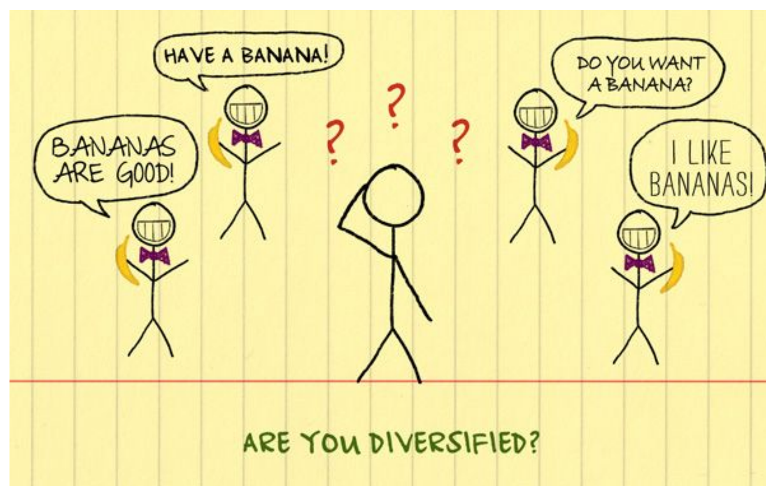
Duty to Diversify



Section 16048 of the California Probate Code directs, "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 for one reason or another cannot or should not be diversified, the trustee will identify the rationale for *not* diversifying. A well-written memo will also argue that although the trust is not diversified, the purposes of the trust can still be accomplished; the lack of diversification does not impede the trustee's ability to accomplish the trust purposes. Suffice it to say, if over 20% 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.

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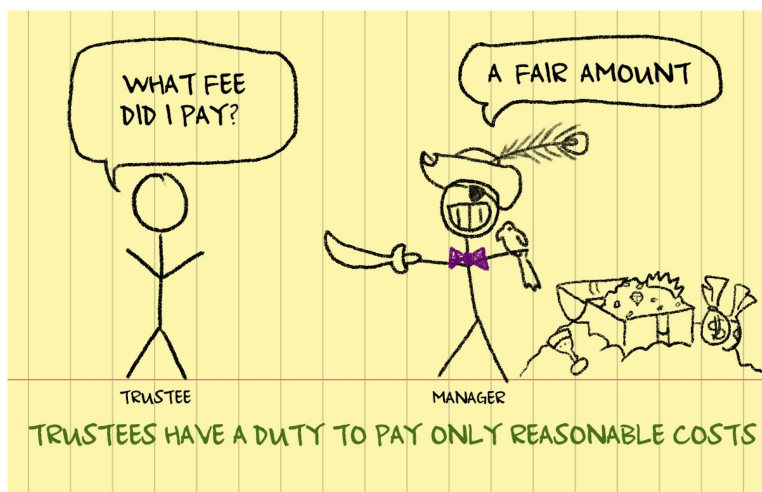
Duty to Pay Fair Fees



Section 16050 of the California Probate Code directs, "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 (1) the fees and expenses incurred by hiring a professional investment manager and (2) the fees paid to the trustee for their administration of the trust. A prudent trustee will conduct a simple fee study to determine whether the cost being incurred by the trust are consistent with industry standards for an account of similar size and complexity.

This study would include an analysis of the fees paid not only to the investment manager, but also those fees incurred for the underlying products or separate account manager that the investment manager has chosen to use. An additional inquiry would be conducted which compares the compensation paid to the trustee with the fees that would be charged by an institutional trust company or a licensed professional trustee.

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Duty to Prudently Select, Delegate & Monitor Agent's Activities

Section 16052(a)(1),(2),(3) of the California Probate Code 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 the manager's 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 which records the following: 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.

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Conclusion

If these five documents are created - and more importantly, reviewed, updated and reaffirmed each year - the trustee will have established the record that they (1) recognize their duties of care and (2) 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.

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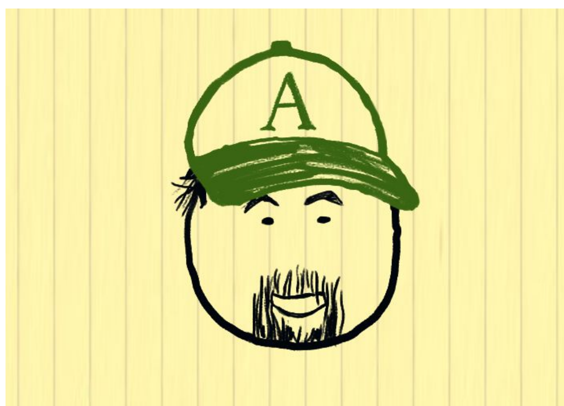
About Anodos

Anodos helps trustees understand their legal obligations, develop procedures to meet these obligations and act as a trustee representative to execute these governance disciplines. What makes us unique is this is all we do. We don't manage money, sell insurance or accept referral fees. We don't have a horse in the race.



Josh Yager

Josh is a recognized content expert on the issues of fiduciary duties relating to the management and oversight of trust as- sets. He lectures extensively on the policies and procedures for conducting investment manager audits to CPAs, attorneys, and professional fiduciaries throughout the country. Josh is Managing Partner at Anodos Advisors and a licensed attorney. Prior to founding Anodos in 2005, Josh worked for fteen years as an investment advisor with Mercer Advisors. Josh likes to read books about dead presidents.

Ryan Wolfshorndl

Ryan has been with the firm since its inception in 2005. Ryan holds the Chartered Financial Analyst (CFA(r)) and Certified Financial Planner (CFP(r)) designations. Ryan has 11 years of experience in monitoring the activities and risk/return experiences of investment managers. Additionally, he conducts performance attribution and other statistical analysis relevant to the investment experience. This work ensures accountability, adherence to investment parameters, and clarity of expectations between clients and their managers.